Expert-Grup
Independent Think-Tank

FRIEDRICH EBERT STIFTUNG

REPUBLIC OF MOLDOVA 2018

STATE OF THE COUNTRY **REPORT**

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Republic of Moldova 2018
STATE OF THE COUNTRY REPORT

With the support of:

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ABBREVIATIONS

ANRE	National Energy Regulatory Agency
ATU	Administrative Territorial Unit
CEE	Central and Eastern European
CEE EU	Central and Eastern European and EU
CTEM	Kuchurgan power station
EBRD	European Bank for Reconstruction and Development
EEA	Energy Efficiency Agency
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
FES	Friedrich-Ebert-Stiftung
GDP	Gross domestic product
HDI	Human Development Index
IPP	Institute for Public Policy
MDL	Moldovan Leu
NAC	National Anti-corruption Centre
NBM	National Bank of Moldova
NBS	National Bureau of Statistics
OECD	Organisation for Economic Co-operation and Devel-opment
PAS	Action and Solidarity Party
PDM	Democratic Party of Moldova
PSRM	Party of Socialists of the Republic of Moldova

KEY POLICY MESSAGES

The credibility of institutions and of the Government as a whole remained a fundamental issue undermining the state of the country, without sizable improvements since 2016-2017.

Authorities have not given up on the deficient policies criticised by the civil society, extra-parliamentary opposition and development partners. The change of the electoral system just before elections, the unprecedented invalidation of Chisinau municipality election, the initiative to exchange investments for citizenship or the package of laws on voluntary reporting and fiscal facilities distanced even more the ruling coalition from principles of democracy and rule of law. These measures also undermined other important reforms implemented by authorities in the financial-banking sector or business regulation and, finally, worsened dramatically the Government's relationship with the development partners.

The Moldovan economy continues to grow slowly following a non-sustainable model.

After a recovering growth of 4.5% in 2016, GDP continued to grow in 2017 (+4.5%), but there are signs that it will slow down in 2018 in spite of quite favourable regional context. Such an economic growth rate is not enough to converge the income to the standards of Central and Eastern European countries during the life span of the current generations. As shown in the previous editions of State of the Country Report, to converge Moldova needs growth rates of GDP closer to 7-8% per year. Moreover, replicating the model of the previous years, the 2017-2018 growth is based more on conjuncture or arithmetic, rather than fundamental factors (e.g. the remittances grew on the background of a low base of comparison and the increase in public investment and social spending is determined by proximity to elections and is hence temporary).

The liberalized access to the European market was one of the key factors that allowed the Moldovan economy to grow and diversify, despite the climate and internal economic stress factors.

Between 2015 and 2017, the export losses on the CIS market, caused by Russian trade restrictions and by the conflict in Ukraine, were fully offset by the increased exports to the EU market. The evolution of Moldovan foreign trade in recent years debunked all myths about the destructive impact of EU trade liberalization in DCFTA - on the contrary, exports to the EU have strongly increased, and European import products have not 'invaded' the country as many feared (in fact, the trade balance between Moldova and UE improved during DCFTA implementation).

Low investment attractiveness of the country is the main effect of institutional vulnerabilities, explaining the non-sustainable pattern of economic growth and poor competitiveness.

Since 2000, the Moldovan economy has not ever gone through such a long-lasting investment crisis. Investments in fixed assets - both in the private and public sector - declined dramatically in 2015-2016 (-20% compared to 2014), practically stagnating in 2017 (+1% compared to 2016). The investment gap affects the prospects of sustainable economic growth as it undermines the development of new production capacities. This is particularly important for the Republic of Moldova, which has passed through an extended structural transition resulting in physical and functional obsolescence of its productive capital. Moreover, the share of the industrial and agricultural sector - activities that produce the most traded goods internationally - in attracting investment has remained constant over the last few years (around 20% of total investment). For the Republic of Moldova, which does not have a vibrant domestic market and can grow sustainably only through exports, such a small share of investments in activities producing tradable goods is a major issue undermining its export potential.

With the banking system shaken by bank fraud and the embryonic capital market, the Moldovan economy suffers from a chronic shortage of domestic investment resources.

Moldovan banks do not fully exercise their function of accumulating resources and allocating them to finance productive investments. Therefore, investments are most often funded from firms' own resources. It reveals the constraints faced by small and medium-sized enterprises related to access to capital, limiting their investments, development of production capacities and competitiveness. As a result of bank frauds uncovered in 2014, in the near future the country's financial system will remain unable to provide the necessary funds for investment, especially for large investment projects, which makes foreign investment sources even more important.

The proximity of parliamentary elections fostered a series of policies with an obvious electoral interest and major risks to budgetary stability after the elections.

In pursuit of higher political stakes for the general elections set for February 2019, the Government engaged in budgetary obligations with popular appeal - 'Prima Casa' -1, -2 and -3, local roads rehabilitation projects, Chisinau Arena, wage increases and more generous indexation of allowances and pensions, introduction of new categories of beneficiaries of social benefits (a principle that was removed with great difficulties in 2011-2014) - notwithstanding the loss of direct budget support from the European Union, the risk of breaking the relationship with IMF and short-term losses of budget revenues as a result of the 'mini fiscal revolution'. These new policies risk reducing even more the public spending on productive investment in infrastructure and human capital. In particular, this could affect the health and education sectors - both already affected by shortages of specialists, infrastructure and equipment.

Demographic trends continue to be a fundamental constraint for the country's economic and social development.

The main risks are related to budgetary pressures. Thus, on the background of employment decline and increase in the number of labour emigrants, the number of people who have reached the retirement age is rising noticeably. In one decade only, the number of pensioners increased by 23%, from 528 thousand in 2007 to 652 thousand in 2017 and the trend will continue inexorably. Raising the retirement threshold offers a temporary relief rather than a sustainable solution to the problems of the public pension system. The demographic changes will also put more pressure on the healthcare sector, as well as on local budgets, especially due to the fact that a large proportion of highly advanced elderly population will live solitary and will need access to social support services. On this background, the level of public and publicly guaranteed debt could increase substantially. These trends are even more dramatic due to intense emigration of the working-age population that intensified recently and relatively low labour productivity. They affect the decent retirement prospects of the current employed population and undermine the country's ability to capitalize on the opportunities of the demographic dividend generated by the demographic changes.

To grow faster and more sustainably, the Moldovan economy needs substantial growth and diversification of exports.

In this regard:

- *Besides the necessary efforts to modernize the quality infrastructure and implement EU safety and quality standards, it is important that producer associations become more involved in promoting DCFTA. The Government should set up the institutional and legislative infrastructure to reduce transaction costs, to facilitate international trade, and to attract more foreign investors.*
- *It is important to renegotiate the access conditions for products that face too restrictive barriers on the EU market (quotas under anti-circumvention mechanism).*
- *The Government must continue its efforts to liberalize access to other partners' markets, in particular for agricultural products. It is important that the Republic of Moldova returns to the Russian market, hence the Government has to free the trade relationship with Russia from any political connotations - to the extent possible when it comes to Russia. Despite the risks, the efforts to negotiate free trade agreements with China, Switzerland, Canada, Israel and some Middle East countries are justified.*

The significant increase in exports will be possible only with more investments, especially foreign ones.

Therefore, it is necessary to identify new factors of investment attractiveness for the country. In the Republic of Moldova, the policy of attracting FDIs relies on fiscal and customs facilities offered to Free Economic Zones residents, as well as the relatively low labour cost. It is obvious that the relevance of labour cost could decrease over time due to emigration and rising labour market pressures. Here are the main alternative policy priorities that would spur investment growth:

- *As sales (volume of market) are one of the main factors that stimulate investment, it is necessary to promote international trade integration, by enhancing the corporate management efficiency and increasing people's access to consumer credit.*

- *The business access to long-term bank loans needs to be further improved, especially in the context of the country's weak financial intermediation after the banking frauds uncovered in 2014.*

- *In order to stimulate investments in advanced industries, the Government must facilitate the inter-branch and, implicitly, territorial mobility of the labour force. This once again highlights the importance of measures supporting lifelong learning. Although the reform of the vocational education sector is seen by the Government as an important priority, the importance of lifelong learning is under-evaluated. The already active labour force rarely returns to formal education to either improve the existing skills or acquire new ones.*

- *In order to get a higher investment multiplier, the country needs to develop its domestic supply. This requires industrial, competitiveness enhancement and human capital development policies.*

- *The investment activity in the Republic of Moldova can be expanded by reforms aimed at improving the functioning of the labour market by carefully liberalizing it, improving the quality of the anti-monopoly policy and fighting informal employment.*

> Policies to boost investment should also include actions that foster investment in human capital that underpin labour productivity and economy's competitiveness.

In any economy the growth in fixed capital investments is not sustainable unless it is accompanied by human capital investments. In this respect, profound structural reforms are needed, especially in the vocational and tertiary education sectors, in order to increase the efficiency of public and private investment in these areas and better match the supply of skills from the educational sector with the skills' demand from the real sector.

EXECUTIVE SUMMARY

Special Subject:

INVESTMENT AND ITS ROLE IN ECONOMIC DEVELOPMENT

After the 2009-2010 crisis, the investment rate in the Republic of Moldova oscillated around 22% of GDP, which is quite low compared to other countries with similar levels of revenue, geographic location or demographic context. Investments in fixed assets decreased dramatically in 2015-2016 (-20% cumulatively on a national scale) and increased by only 1% in 2017. After 2000, the period of 2015-2017 marked the longest investment crisis in the Republic of Moldova. Some districts and municipalities lost about 40-50% of their investment flows (in particular, Ocnita and Leova districts, with cumulative decline of investment by 70% and 60%, respectively).

The regional investment trends could exacerbate the emigration of labour force from these areas and worsen the economic crisis at the local level - which in turn will further reduce the local firms' appetite for investment. Our analysis shows that the level of investment is mainly determined by sales volumes and business profitability, while interest rates and other monetary policy factors, contrary to predictions of the economic theory, have not yet played an essential role. This is not surprising if we take into account that the company's own resources are the main source of investments financing at national level. Free Economic Zones do not have a significant influence - neither statistical, nor economic - on the overall investment process, but if we narrow our analysis to foreign direct investments only, the establishment and extension of FEZ appears to be one of the main factors that attracted foreign investors to our country.

Systemic factors - including the investment climate, the overall business quality of the entire economy - play a secondary role, and this strongly limits the technological development impact of foreign direct investments on the rest of the economic system. Investments do not have a visible impact on the number of jobs so far, but the data show a positive and statistically significant impact on labour productivity. As the economy is highly dependent on imports, the investment multiplier is quite small (about 1.15), limiting the possibility of using demand management as an counter-cyclical policy. With a very inelastic labour supply, such measures would encourage inflation rather than domestic supply. A more restrictive trade policy is not a good option, either. The domestic supply can be developed only by industrial policies that would encourage technological skills and develop the country's human capital.

ECONOMY

In 2016-2018 the Moldovan economy had an ambiguous evolution. After two years of GDP growth at 4.5%, the economic growth rate slowed down in 2018. Among other things, we expect that the impact of the increase in wages, social payments and remittances on household consumption will dissipate. In 2017-2018, the Deep and Comprehensive Free Trade Area (DCFTA) was the key driver for the growth of exports of industrial and agricultural products to the European market. Four years after signing the Association Agreement, statistical data suggest that the expansion of European exports has practically offset the losses incurred due to the Russian trade embargo and the conflict in Ukraine. But an overall assessment of the economy and foreign trade reveals a quite modest net impact of DCFTA, with Moldovan producers still having much to do to fully capitalize on trade opportunities on the European market. The industrial and ICT sectors grew more robustly in 2017 and 2018, but their growth has not created yet more jobs. More specifically, new jobs are created unevenly, being concentrated in certain geographic areas and economic sectors, with the main beneficiaries being the cities that have free economic zones active in the automotive field.

In 2017-2018, the National Bank of Moldova subjected commercial banks to an intensive therapy, which resulted in the elimination of obscure owners of systemic banks and the reduction of sector exposure to the risks associated with crediting affiliated persons. Visible progress was also made in the regulatory area, with the transition to the new Basel III principles for prudential supervision. However, the risks have not been fully mitigated, as not all shareholders have been tested against the fit and proper principles. Four years after the devaluation of Banca de Economii and the other two commercial banks, no substantial progress has been achieved yet in the recovery of embezzled assets. Moreover, unexpected risk areas are emerging in the financial system - in particular, the new Law on Non-Bank Financial Institutions establishes an under-regulated framework with some loopholes that financial institutions can use to attract quasi-deposits and thus expose third parties to the credit risk assumed by these financial institutions. New risks are also taking shape regarding the national public budget. If 2017 ended with a very low deficit, then the situation could change dramatically in 2018-2019 due to the new financial commitments made by the Government amid a buoyant and high-stakes electoral context.

LABOUR MARKET AND SOCIAL WELLBEING

Investments are crucial to increasing labour productivity. In the Republic of Moldova, the gross fixed capital formation per employee has been increasing at a high pace since 2000, which translated into labour productivity leaps. After 2012, however, the growth rates of both indicators literally halved, inter alia due to the worsening of the labour market efficiency. Labour market efficiency is one of the factors influencing the investors' decisions, and their perception of the functioning of Moldova's labour market has become increasingly negative. Thus, the 'Labor Market Efficiency' indicator, calculated by the World Economic Forum, had declined continuously between 2010 and 2017, from 4.4 to 3.5 points out of maximum 7. Changing the labor market trends requires not only an adjustment of the labour law, but also policies to stimulate competition and reduce the non-observed economy. Without additional efforts to stimulate investment in the Republic of Moldova, labour productivity and wages will remain at the current level of only 20-23% of the average of EU Member Countries from Central and Eastern Europe. Moreover, productivity and wages have been stagnating in the Republic of Moldova for the past four years.

EDUCATION AND HUMAN CAPITAL

Investments in human capital are needed to ensure sustainability of investments in fixed capital. In particular, the increasingly technologically sophisticated investments require more specialists with higher education. The Republic of Moldova had progressed rapidly in this area during 2000 - 2012, both by increasing the tertiary education enrollment from 32.5% to 40.1%, and by creating jobs requiring high and medium skills. The share of these jobs increased in this period from 20% to 31% of the total employed population, absorbing the labour supply delivered by universities. After 2012, however, the share of jobs requiring high and medium skills began to drop sharply, while the enrollment in the university system remained the same. Thus, an imbalance between the demand for and supply of university graduates emerged on the local market. A part of this surplus emigrated, with the emigration of people with higher education virtually exploding after 2012 (+ 52% between 2012 and 2017). Another part of the surplus was absorbed by jobs that do not require high and medium skills, with those individuals being over-qualified for their jobs. In 2017, the share of over-qualified employees with higher education reached 30% of the total number of the employed with this level of education. Thus, these worrying trends point to the waste of accumulated human capital and call for a radical reform of the university system in the Republic of Moldova.

ENERGY

The energy sector developed at a moderate pace, with some progresses in modernizing the legal framework on energy efficiency and renewable resources. Thus, although to a lesser extent, there were still signs of political interference in setting the gas and fuel tariffs. At the same time, when concluding the annual contracts for electricity procurement, the authorities favoured Energocom at the expense of other suppliers. Despite the positive dynamics stated in the previous Report, the gas interconnection project is facing difficulties due to the complications emerged after the Romanian investors privatized Vestmoldtransgaz. This reduces drastically the likelihood of completing the gas interconnection project in 2019. The following is recommended to improve the situation in this sector: i) develop concrete measures to unbundle gas supply from transmission; ii) eliminate any political interference in the tariff setting policy; iii) improve the electricity procurement mechanism; iv) complete the privatization of Vestomoldtransgaz and start the construction of the Ungheni-Chisinau pipeline.

INSTITUTIONS AND POLITICS

The image of Government institutions was heavily affected by several decisions of the ruling parties. The change of the electoral system, from a proportional to a mixed one (one round), which increased the risk of political corruption of candidates to the next parliamentary elections, generated serious long-term consequences. Although the transparency and quality of financial reporting by political parties has improved compared to the previous years, there are concerns about the still high ceiling for donations by individuals and the under-regulated traceability of their origin. Alongside the challenges of a political crisis, the invalidation of the second round of municipal elections in Chisinau aggravated the lack of public trust in the professionalism, independence and functionality of the judiciary.

The failure of the justice reform in 2011-2016 was confirmed by the definitive withdrawal of European funding for this sector. The effects of governance and stagnation in justice are detrimental to the country's investment attractiveness. At the same time, the authorities have launched mechanisms for attracting investments ('citizenship for investment'), which can in fact repeat Moldova's involvement in new illegal schemes, similar to the 'Russian laundromat', and contribute to the corruption of Moldovan institutions. Some signs of regress have been noticed in the coordination of local public administration reform. The following measures can help improve the situation: i) develop an 'action plan' for justice reform, with the participation of the civil society and external partners; ii) improve the record-keeping tools and decrease the ceiling for individuals' cash donations to political parties; iii) clarify and improve the procedures for independent candidates and political parties under the new electoral legislation; iv) urgently review the law on citizenship for investment in order to introduce additional anti-corruption filters; v) strengthen the structure involving the participation of local authorities in the decentralization reform.

SPECIAL SUBJECT:

INVESTMENT AND ITS ROLE IN ECONOMIC DEVELOPMENT

The special issue of the 2018 State of the Country Report looks at the role of investments in economic development. The chapter begins by analysing the evolution of investments in the Moldovan economy in terms of geographic location and economic sectors. The main determinants of investments, including the foreign ones, are highlighted. Using simple but robust econometric methods, the authors estimate the impact of investment multiplier. The chapter ends with a series of recommendations aimed at augmenting the impact of Moldova's investment policy.

EVOLUTION OF INVESTMENTS IN THE MOLDOVAN ECONOMY

INVESTMENTS INFLUENCE BOTH THE CURRENT ECONOMIC ACTIVITY AND FUTURE ECONOMIC DEVELOPMENT.

Investing in productive capital is important because: 1) investment is an essential component of the aggregate demand, thus having a direct and multiplier impact on current economic dynamics; 2) it replaces the old production capacities and forms new ones, laying the foundation for economic growth in the future periods. The second aspect is particularly important for the Republic of Moldova, which has undergone an extended structural transition resulting in physical and moral depreciation of its productive capital. Elements of this transition are still visible in the SOE and public property sector, which is affected by the poor management of its productive capacities[1].

AT AGGREGATE LEVEL, THE INVESTMENT PROCESS CAN BE MONITORED USING TWO MAIN INDICATORS.

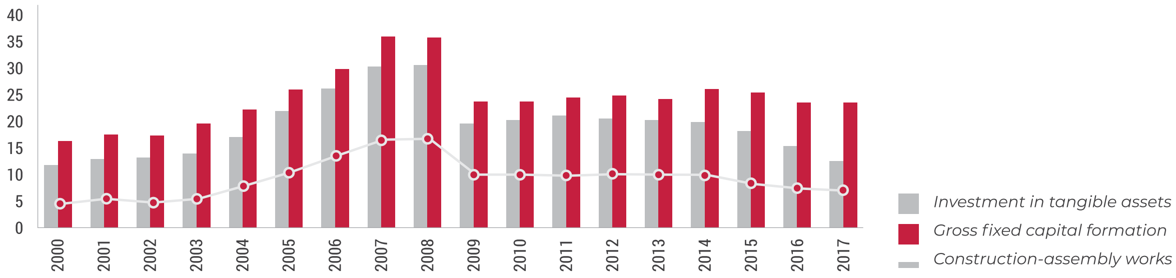
The first one is the investment rate, representing the ratio between Gross Fixed Capital Formation (a component of GDP per item of expenditure) and GDP. The second indicator is the index of investments in tangible or fixed assets ('immobilized' since 2017) and reflects the deliberate process of creation/replacing/developing the companies' productive capacities. The former has a broader coverage (by institutions, assets and types of transactions) and is internationally comparable, while the latter offers useful disaggregations (by regions, technological structure, funding sources, ownership forms), but was subjected to several methodological changes over the years, the latest one made in 2017.

WHILE DEMONSTRATING A HIGH LEVEL OF POSITIVE CORRELATION, THE TWO INDICATORS HAVE EVOLVED DIFFERENTLY SINCE 2014.

From the perspective of gross fixed capital formation, we can conclude that the investment activity has been rather stable after the 2009-2010 crisis, with the investment rate oscillating around 22% of GDP *(Figure 1)*. From the perspective of the second indicator, however, the investment process looks more unfavourable. Investments in fixed assets - both in the private and public sector - declined dramatically in 2015-2016 (-20% compared to 2014), and practically stagnated in 2017 (+1% compared to 2016). Since 2000, the Moldovan economy has not ever gone through such a long-lasting investment crisis. At the same time, investments in fixed assets evolved very heterogeneously across the regions *(Figure 2)* and, in fact, in some districts the current investment crisis is even worse than in 2009. In the North, the districts of Glodeni, Soroca, Ocnita, Sangerei and Riscani experienced a 50% decrease in

1. *One of the latest striking evidences in this regard is the 'outcomes' obtained by State-Owned Enterprise 'Moldova Railways', reflected in Decision No 8 of 26 March 2018 of the Court of Accounts of the Republic of Moldova on the Performance Audit Report entitled 'The performance of the railway sector is dependent on the consistent implementation of corporate governance and investments attracted in this area'.*

Figure 1.
Key investment indicators, % of GDP



Source: Author's calculations based on NBS data

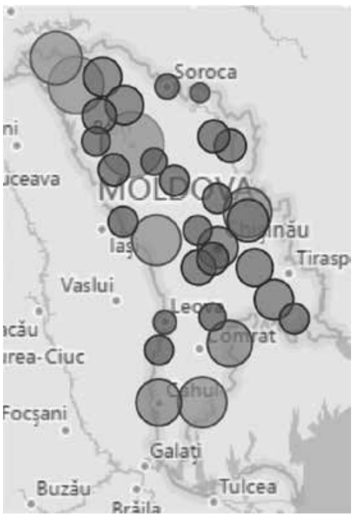
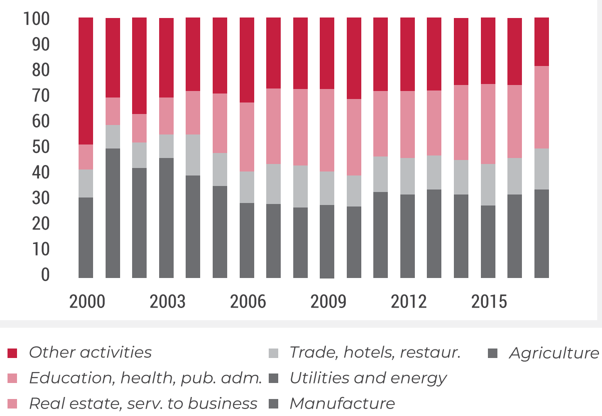


Figure 2.
Indices of investment in tangible assets in 2017, by districts and municipalities, 2014=100%

Source: Author's calculations based on NBS data

Figure 3.
Structure of investments in material assets by economic activities, % of total



Source: Author's calculations based on NBS data

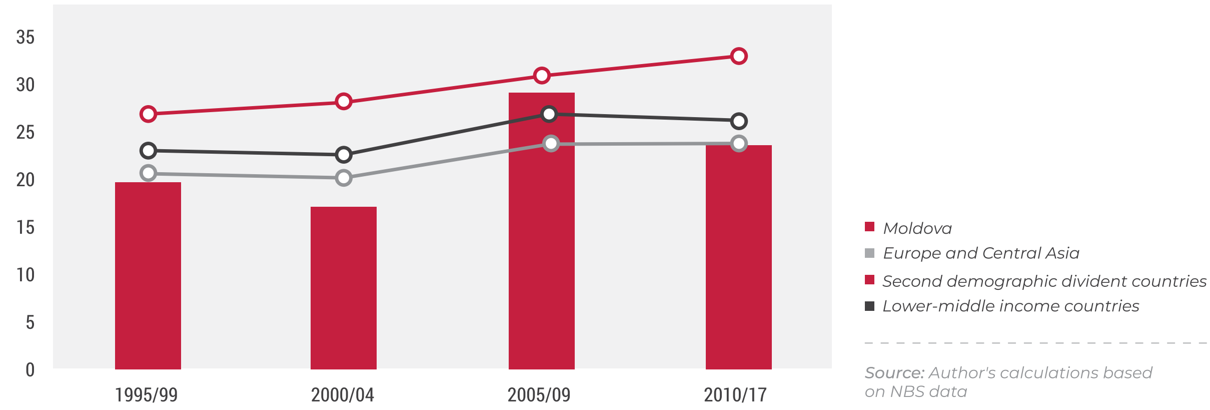
investments (and in Ocnita, the indicator was -70%, the country's absolute anti-record). In the Center, in 9 out of the 13 districts investments decreased by about 40% for two consecutive years. The Leova-Cantemir-Cimislia subregion in the South region lost about 45% of its investment over the last three years compared to 2014 (Leova district stands out with a 60% decrease in capital investment). Some areas, such as ATU Gagauzia, Ungheni and Dubasari, would have had a much deeper investment recession without the investments financed from the state and local budgets.

THE ECONOMIC SECTORS THAT ATTRACTED INVESTMENTS HAVE UNDERGONE A SLIGHT STRUCTURAL DIVERSIFICATION IN THE RECENT YEARS.

In particular, the weight of agricultural businesses in total investments in tangible assets has increased *(Figure 3)*. State subsidies for agricultural producers were one of the factors driving the increase in agricultural investment, although it should be noted that mainly large producers have access to subsidies. Investing more resources in agriculture is a good thing because it will allow harnessing better the country's natural and human potential - only that the environmental and social risks posed by this model of agricultural expansion should be carefully managed in the long run. Clearly, the real estate sector attracted an overwhelming volume of investment (almost 20%), an excess reflected by the many ghost blocks, with few inhabited apartments, or unfinished buildings that span the urban landscape. On the other hand, industry and agriculture - activities that produce goods that are the most easily traded interna-

Figure 4.

Investment rate in Moldova and average by three groups of countries for five-year periods, % of GDP



Source: Author's calculations based on NBS data

tionally - have had a virtually constant share in total investments in the past decade (a combined share of about 20%). For the Republic of Moldova, which does not have a vibrant domestic market and can grow sustainably only through exports, such a small share of investments in activities producing tradable goods is a major problem.

A NATURAL QUESTION IS WHETHER, IN GENERAL, MOLDOVA IS INVESTING ENOUGH IN THE REPLACEMENT AND DEVELOPMENT OF ITS PRODUCTIVE CAPITAL?

The need for investment depends on factors specific to each economic system, but an international comparison can provide a useful overview. Comparing Moldova with several groups of countries classified by geographic, demographic and revenue criteria, we conclude that the investment rate has been historically quite low *(Figure 4)* and the investment boost that Moldova had accumulated before the 2009-2010 economic crisis has not been yet regained. Besides, if we take into account that a large part of the investments are made in sectors with a high speculative potential (such as the real estate), but which do not increase the labour productivity of the entire economy, we can say without hesitation that the Republic of Moldova is investing too little, and the longer this situation persists the worse will be the impact on the productive capacities of firms, especially in rural communities and small towns.

INVESTMENT FACTORS

MARKET POTENTIAL IS THE MOST SIGNIFICANT FACTOR EXPLAINING THE DYNAMICS OF PRIVATE INVESTMENTS IN THE REPUBLIC OF MOLDOVA.

The literature identifies a number of determinants of corporate investments. These include interest rate, price index and volatility, sales volume, profitability rate, expected consumer demand dynamics, indebtedness level, technological progress, wage size and trade union strength, tax policy, and others. Although the time series of statistical data are rather short and we did not have any corporate data, our quantitative analysis based on a time series model shows that, on the aggregate, the volume of sales is the main factor determining the level of investments in the Republic of Moldova, serving as the main way to accumulate own investment resources. The 1% increase in sales volume boosts investment growth by around 1.3-1.6%. An alternative panel data model, which includes all districts and municipalities for the period of 2005-2016, leads to a similar conclusion, even though the elasticity is lower. Controlling for the number of local companies and their size (expressed as the average number of employees), the evolution of the local/regional market is once again the main determinant of investments made by private companies at district and municipality level.

PUBLIC INVESTMENTS HAVE A POSITIVE BUT MODEST ROLE IN FOSTERING PRIVATE INVESTMENTS.

The panel data model shows that public investments have a positive, albeit smaller, impact on stimulating private investments. Within each district/municipality, the 1% growth of public investments (funded from the state and local budgets) is on average associated with a 0.1% growth in private investments in the coming year. At the same time, due to local peculiarities, which we could not identify due to insufficient data, the dynamics of public investments does not convincingly explain the differences in private investment between districts/municipalities.

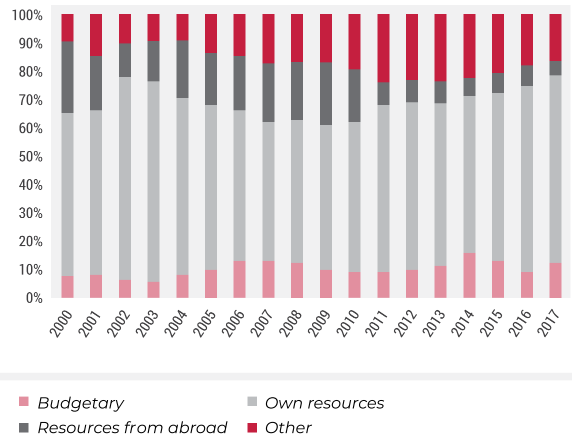
POLICY VARIABLES ARE LESS IMPORTANT IF WE CONSIDER PRIVATE INVESTMENTS AS A WHOLE.

In particular, the panel data model convincingly shows that the presence of a Free Economic Zone (EEZ) in a municipality/district does not lead to significantly more private investments than in districts/municipalities without a FEZ or compared to the period before the FEZ establishment. (This conclusion could change if the analysis would cover only foreign direct investments made at the local level, but we don't have data at such a level of detail). Profit rate, tax regime, year-on-year inflation rate and volatility - all of these variables do not convincingly explain the temporal dynamics or geographic differences in the investment volumes. The time-series model suggests that the interest rate is statistically significant only if the volume of sales is omitted. This result, even if it runs against the economic logic, is not surprising at all if we take into account that the company's own funds are the main source for capital investments *(Figure 5)*.

WITH THE BANKING SYSTEM SHAKEN BY BANK FRAUD AND WITH AN EMBRYONIC CAPITAL MARKET, THE MOLDOVAN ECONOMY SUFFERS FROM A CHRONIC SHORTAGE OF DOMESTIC INVESTMENT RESOURCES.

The companies' own funds are the main source of investments (with an average of 50% in total over the past two decades). After the 2009-2010 crisis, the role of own sources in financing investments has grown even more, reaching 60% over the past 2-3 years *(Figure 5)*. This funding model, which is natural for the early transition period, has reached its limits and is currently creating major constraints for the investment process. Moldovan banks do not fully exercise their function of accumulating resources and allocating them to finance productive investments. Due to the bank fraud, in the near future the country's financial system will be unable to provide the necessary funds for investment, especially for large investment projects, which makes foreign investment sources even more important. However, this source of funding is important not only because it compensates the deficit of domestic investment resources, but also thanks to the innovative organisational, management and marketing technologies and models that foreign direct investments (FDIs) bring along.

Figure 5.
Structure of investments in material assets by main funding sources, % of total

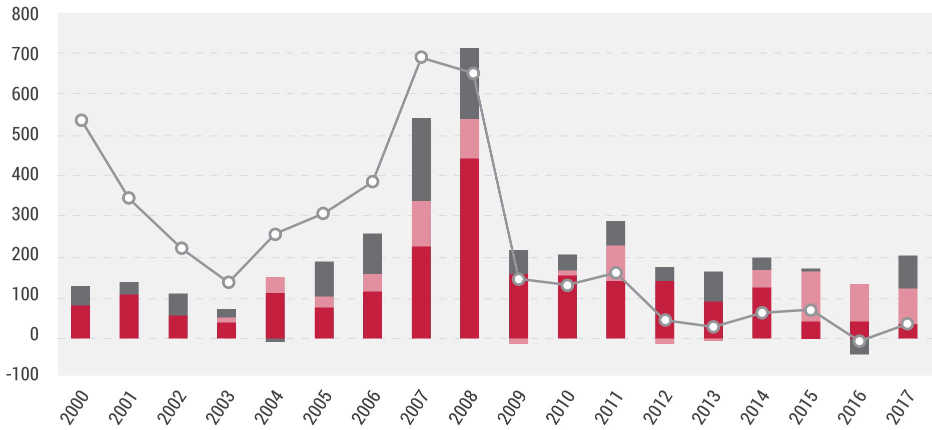


Source: Author's calculations based on NBS data

DESPITE SOME INDIVIDUAL SUCCESS STORIES, MOST OF THEM LINKED TO FEZ, THE REPUBLIC OF MOLDOVA DOES NOT HAVE GOOD PERFORMANCES IN ATTRACTING SUBSTANTIAL FDI FLOWS.

After the 2009 crisis, average annual net inflows of FDI amounted to about USD 190 million. As a share of GDP, annual FDI volumes have declined in the last decade, oscillating at 2-3% of the GDP in the recent years. Having a total FDI stock of about 37% of GDP, Moldova ranks middle to low in the international ranking, and obviously this indicator will be continually decreasing unless the stock is fed by substantial net inflows.

Figure 6.
Evolution of FDIs by type of capital and as % of GDP, 2000-2017



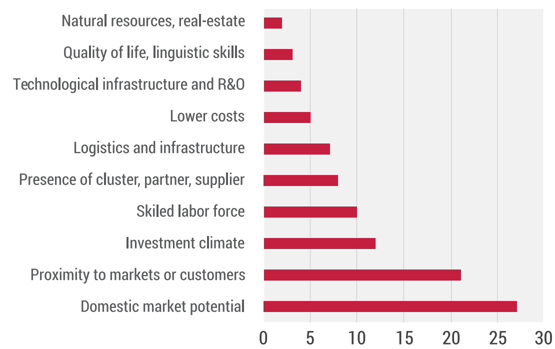
Source: Author's calculations based on NBS data

Figure 7.
Determinants of foreign direct investments in international empirical studies

Number of studies identifying the factor as key determinant of FDI, out of 30 international studies

Source: The World Bank, 'Attracting FDI: How much Does Investment Climate Matter?', Viewpoint Note Public Policy for the Private Sector, number 327, August 2011.

Figure 8.
Determinants of geographic location of investment projects



Projects for which the factor was the key localization determinant, % of total

Source: The World Bank, 'Attracting FDI: How much Does Investment Climate Matter?', Viewpoint Note Public Policy for the Private Sector, number 327, August 2011.

INTERNATIONAL EMPIRICAL STUDIES LARGELY CONVERGE TO THE CONCLUSION THAT ECONOMIC OPPORTUNITIES ARE THE MAIN PREDICTOR OF FDIS AT THE NATIONAL LEVEL[2].

Among 30 relevant studies, 17 identified the market size and potential as the main factor of FDIs (Figure 7). The location decisions in nearly half of the almost 30,000 investment projects in the period 2003-2011 were based on the domestic market potential and proximity to sales markets (Figure 8). To a certain extent, these conclusions resonate with the results of our quantitative analyses presented above. At the same time, elements of the investment climate, including strong institutions and investor-friendly regulations, are also important and can boost the impact of FDIs on national economic development. In the Republic of Moldova, the policy of attracting FDIs relies on fiscal and customs facilities offered to FEZ residents, as well as the relatively low labour cost and its relative availability. It is obvious that the relevance of labour cost and availability could decrease over time due to emigration and rising labour market pressures. On the other hand, international competition to attract FDIs is getting tighter as the global flows fall (-23% in 2017), particularly those targeting transition countries (-27%[3]). This could motivate countries from the region, with which Moldova competes directly for attracting and retaining foreign investments, to develop more attractive investment offers than the conditions currently enjoyed by Moldovan FEZ residents.

2. The World Bank, „Attracting FDI: how much does the investment climate matter?", Viewpoint Note Public Policy for the Private Sector, number 327, August 2011..
3 UNCTAD, World Investment Report 2018, Investment and New Industrial Policies, UN, New York and Genera, 2018.

ECONOMIC IMPACT OF INVESTMENTS

IN THE MOLDOVAN ECONOMY AS A WHOLE, CAPITAL INVESTMENT IS NOT YET ASSOCIATED WITH JOBS CREATION.

More jobs is obviously the most wanted outcome of investments. But Moldova has not yet achieved this outcome. The number of the employed population is decreasing - from 1.5 million in 2000 to 1.2 million nowadays - despite the three-fold increase in real investment during the same period. The dynamic is more complex across the industries: some branches liquidate jobs, others create new jobs, but most of them invest increasingly larger volumes of resources. These contradictory dynamics also have a territorial reflection, depending on the economic specialisation of the districts/municipalities. The analytical models we have used (panel data for districts/municipalities and panel data for industries) do not identify any significant link between investment and new jobs. This counterintuitive state of affairs is mainly caused by the ongoing organisational restructuring of companies that continue shedding unproductive employees, and the slow but steady digitization, automation or mechanisation of jobs. When labour supply is very inelastic and subjected to uncertainties caused by emigration, firms are not interested in expanding through jobs creation, but rather through increasing the existing labor productivity.

THE DATA HIGHLIGHT A CLOSE LINK BETWEEN INVESTMENTS AND LABOUR PRODUCTIVITY.

Although investments do not increase the number of jobs, they improve the productivity of the existing employees. About 15-20% of inter-municipal labour productivity variation at the firm level (approximated by sales per employee) is explained by the variation of total investments at district/municipality level (covering all sources of funding). The 1% increase in investments is associated with a 0.5-0.6% increase in employee productivity Investments support productivity growth by increasing production capacities per employee and per company. *Table 1* reveals that more than one third of investment resources are used to purchase machinery, equipment and installations, i.e. investments that save labour, which is the main source of production costs.

COMPANIES WITH PRESENCE OF FOREIGN CAPITAL ARE MORE EFFICIENT THAN THE OTHERS.

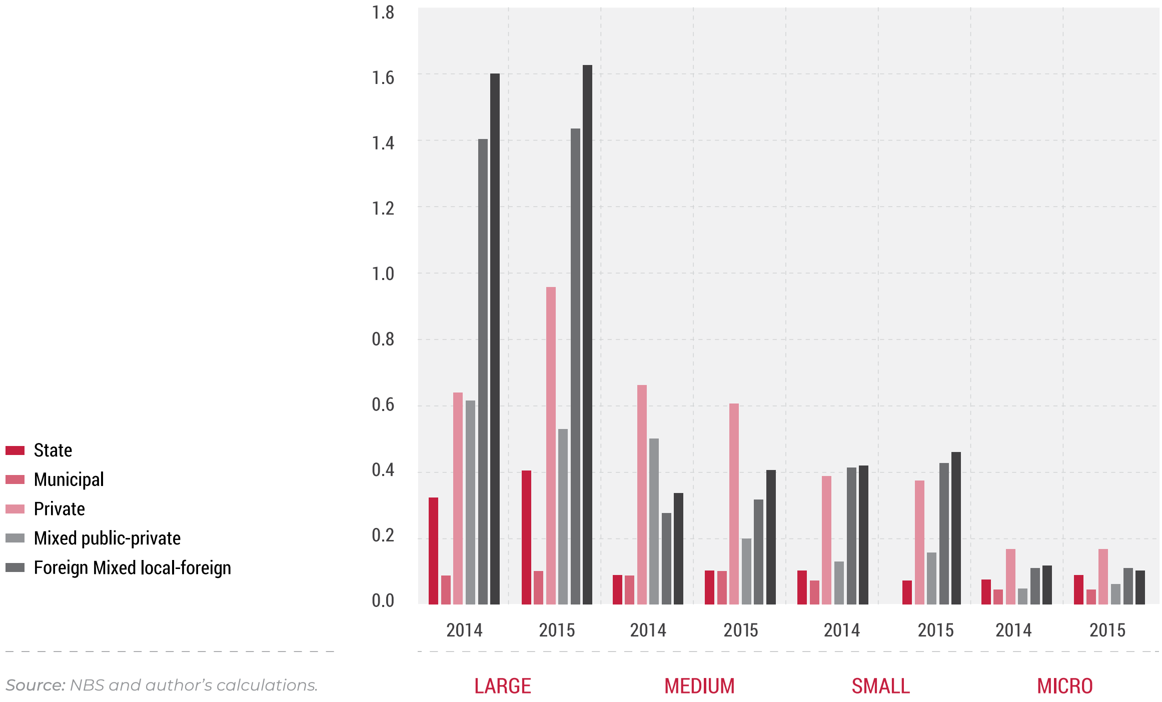
Companies with foreign capital are twice as productive as those with local capital only *(Figure 9)*. But data reveal a slightly more complex dependency between productivity levels, company size and type of property. Thus, foreign capital is associated with a higher productivity only in case of large companies. However, joint-venture companies (with both foreign and local capital) are even more productive than those purely foreign-owned. Mid-sized companies with local capital are significantly more productive, by about 40% than those with foreign capital. But for small and micro-enterprises, the level of productivity is almost the same. Concurrently, according to other recent studies, companies with foreign capital based in the Republic of Moldova systematically pay higher wages: joint-venture companies pay salaries by 52% higher than the labour market average; the foreign-owned ones - by 59% higher[4]. The quoted source states that FDI companies also reduce emigration, thus contributing in many ways to the welfare of the population, and by paying taxes and social security contributions — to the social welfare, as a whole. Thus, despite the relatively small stock, FDIs play a very important economic role in the Moldovan economy.

THE MAJOR IMPACT OF INVESTMENTS IS PROPAGATED THROUGH THE MULTIPLIER MECHANISM.

The results presented above are part of the 'immediate' impact of investments. However, the major

4. Woldemar Walter, Matthias Luecke, Adrian Lupusor, 'The economic impact of FDI in Moldova: results from an empirical analysis', German Economic Team Moldova, Policy Study Series [PS/01/2017].

Figure 9.
Sales per employee, by form of ownership and company size, MDL million, 2015-2016



Source: NBS and author's calculations.

role of investment stems from the fact that any increase/decrease in investments has a more than proportional impact on the overall economy and income. In any economy, the expenditures of an individual/company are income for another individual/company. The ratio between GDP growth and initial investment growth is called investment multiplier. In an economy open to international trade, the level of investment multiplier depends on the marginal propensity to consume and on the marginal propensity to import, and is obviously lower than in autarchic economies. At the same time, income taxation reduces the multiplier level[5]. Propagation of the investment effect is possible only if there are spare capacities in the economy to respond to the growing demand. If there are no such capacities - for example, if equipment, machinery and agricultural land are already operating at full capacity, or if the labour supply is inelastic - the multiplier effect will not manifest fully because a higher aggregate demand will lead to inflation, rather than push up the aggregate supply.

THE INVESTMENT MULTIPLIER IN THE MOLDOVAN ECONOMY IS VERY SMALL DUE TO 'SYSTEM LEAKAGES'.

Using the System of National Accounts data, we estimated that in Moldova the current marginal propensity to consume (MPC) is around 0.85, which means that the marginal propensity to save (MPS) is 0.15. The actual tax rate (MTR) is estimated at 0.1. The most important component, however, is the marginal propensity to import (MPI), estimated at 0.63 - i.e., the increase in revenue by MDL 1.00 leads to an increase in imports by MDL 0.63. Using the formula stated in the footnote, we get an investment multiplier of about 1.15: in other words, MDL 1.00 invested generates a total revenue increase by MDL 1.15. This is a relatively small level, mostly determined by the high level of MPI. According to the IMF calculations, the multiplier is around 1.5 for developed countries and around 1.6 for developing countries. In the short term, the multiplier could be even smaller, due to the inelastic supply (caused by labour force emigration) and the very low rates of business activity of the population.

5. *For an open economy subjected to taxes, the investment multiplier is mI = 1/(MPS+MTR+MPI), where MPS is the marginal propensity to save (MPS = 1-MPC, where MPC - marginal propensity to consume), MTR - marginal tax rate, and MPI - the marginal propensity to import. In economies closed to the international trade, MPI=0, which leads to a higher investment multiplier.*

COMPANIES' SALES ARE ONE OF THE KEY FACTORS UNDERPINNING INVESTMENTS IN THE MOLDOVAN ECONOMY, BECAUSE THE COMPANY'S OWN RESOURCES ARE THE MAIN SOURCE OF FUNDING CAPITAL EXPENDITURES.

The situation will not change in the short term. The domestic market is quite small, so a leap in company sales growth can be achieved by promoting international trade integration, by enhancing the corporate management efficiency and increasing people's access to consumer credit. In the last decade, the situation with companies' access to international markets has improved visibly (even despite Russian embargoes) and this is a favourable factor that will allow companies to accumulate new investment funds.

THE BUSINESS ACCESS TO LONG-TERM BANK LOANS NEEDS TO BE FURTHER IMPROVED.

Until 2014, bank loans fraudulently granted to affiliated persons restricted the funding available for efficient investment projects and led to large volumes of non-performing loans. The measures taken by the NBM over the past 3 years have severely limited the opportunities for fraudulent financing, freeing thus more resources that could be channelled to the productive sector. However, managers and owners of companies, especially of small and micro enterprises, need to improve their financial and entrepreneurial literacy to be able to access the available loan resources.

KEEPING THE EXISTING JOBS MUST NOT BE SEEN AS THE ULTIMATE OBJECTIVE OF THE INVESTMENT POLICY.

Labour productivity is more important than the number of jobs. Objectively, some branches and traditional industries are less capable than others, the new ones, to cope with the international competition that Moldova is facing by virtue of its liberal trade opening policy. In order to stimulate investments in advanced industries, the Government must facilitate the inter-branch and, implicitly, territorial mobility of the labour force. This once again highlights the importance of measures supporting lifelong learning. Although the reform of the vocational education sector is seen by the Government as an important priority, lifelong learning is incorrectly given a secondary role. The already active labour force rarely returns to formal education to either improve the existing skills or acquire new ones.

IF WE WANT A HIGHER INVESTMENT MULTIPLIER, WE NEED TO DEVELOP THE DOMESTIC SUPPLY.

This, however, does not mean imposing a more restrictive trade policy. The development of domestic supply requires industrial, competitiveness enhancement and human capital development policies, rather than limiting imports. The competitiveness of local producers must grow in an organic and sustainable manner, and not in 'greenhouse' conditions. At the same time, the currently low multiplier has implications for the macroeconomic policy - the Government cannot encourage economic growth by applying aggregate demand management policies. Such measures will increase prices rather than stimulate domestic production. This does not mean that public investments are pointless: on the contrary, as shown in this analysis, in the current fiscal and economic circumstances, public investment in Moldova crowds in rather than out the private investment. However, investments must be well targeted on high priority projects, which augment directly the domestic productive capacity.

MOLDOVA DOES NOT ONLY NEED MORE FOREIGN INVESTMENTS, BUT ALSO MORE INVESTORS.

Moldova has a fairly small FDI volume and, as shown in *Table 1*, these flows mainly come from foreign companies already present in the country, in the form of reinvested income or intra-company debts. Almost 1/3 of them are made by FEZ residents. This makes the economy vulnerable to an eventual change in the conditions for FEZ residents or to more competitive conditions that can be potentially offered by other countries in the region. This vulnerability can be reduced by attracting a larger number of investors to underwrite the capital of the existing companies or to set up new companies in general economic conditions, not only in FEZ. Becoming a part of the ecosystem, FDIs will make the whole economy more robust.

Table 1.
Investment key indicators

INDICATORS	2015	2016	2017
GROSS FIXED CAPITAL FORMATION, % GROWTH Y-O-Y	-1,2	-3,0	5,3
INVESTMENTS IN TANGIBLE ASSETS, % GROWTH Y-O-Y	-10	-19,4	+1,3
STRUCTURE OF INVESTMENTS IN TANGIBLE ASSETS	100	100	100
- Companies' own funds,% of total	59	65	66
- Funds from the state budget and local budgets, % of total	13	9	12
- Funds from abroad,% of total	7	7	5
- Other funds,% of total	21	18	17
TECHNOLOGICAL STRUCTURE OF INVESTMENTS IN TANGIBLE ASSETS	100	100	100
- Construction-assembly works,% of total	48	51	51
- Machinery, equipment, installations,% of total	38	34	36
- Vehicles,% of total	10	10	9
- Other expenses and works,% of total	4	5	4
FOREIGN DIRECT INVESTMENTS, NET, USD MILLION	216,0	91,0	209,0
STRUCTURE OF NET FOREIGN DIRECT INVESTMENTS, BY TYPE OF CAPITAL	100	100	100
- Social capital, % of total	25	45	19
- Reinvested income,% of total	72	92	42
- Other capital (intra-company loans, etc.),% of total	3	-37	38

Source:
Author's calculations based on NBS and NBM data.

ECONOMY

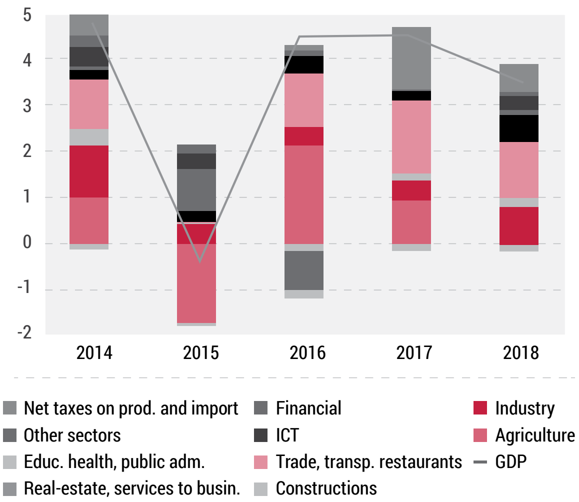
This chapter reviews the most significant macroeconomic developments in the real, financial and fiscal sectors during 2017 and the first half of 2018. It points out that recent economic growth cannot be regarded as sustainable, and identifies the main systemic vulnerabilities that could undermine the economic growth. The chapter ends with a series of policy recommendations aimed at strengthening the economic system and mitigating the medium and long-term risks.

REAL SECTOR

IN 2017-2018 THE MOLDOVAN ECONOMY HAD AN AMBIGUOUS EVOLUTION.

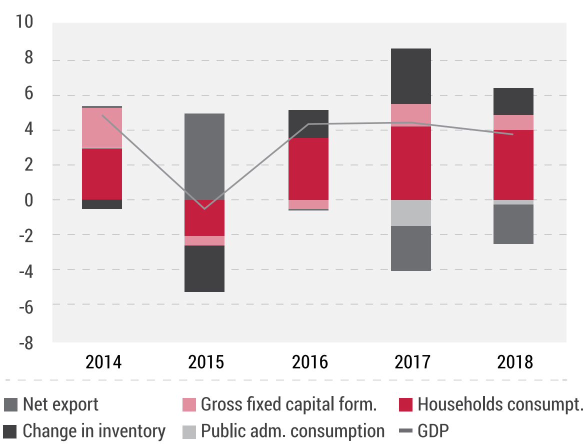
After a recovering growth of 4.5% in 2016, GDP continued to grow in 2017 (+4.5%), but there are signs that it slowed down in the first half of 2018 (+3.0%), in spite of the quite favourable regional context. At the first glance, the growth is robust and covers all key economic sectors, except for the public administration that contracted as a result of the structural optimisation *(Figure 10)*. The role of industry and ICT sector increased substantially. However, such an economic growth rate is not enough for the income converge with the Central and Eastern European countries during the life span of the current generations. As shown in the previous editions of State of the Country Report, convergence requires from Moldova growth rates closer to 7-8% (although, as shown several paragraphs below, the revision of demographic data and the new and more generous methodology of GDP calculation shed a different light on the issue of convergence). Moreover, reproducing the model of the previous periods, the 2017-2018 growth seems to be based more on temporary or arithmetic, rather than fundamental factors. *Figure 11* shows that in 2016-2018 the households' consumer demand supported significantly the economy. It was catalysed largely by the increase in public sector wages and social benefits for some categories (elections are coming!), higher remittances, and larger in-kind consumption of goods and services. The sustainability of some of these sources

Figure 10.
Evolution of GDP (% y-o-y) and resource components (pp), 2014-2018



Source: Author's calculations based on NBS data

Figure 11.
Evolution of GDP (% y-o-y) and expenditure items (pp), 2014-2018



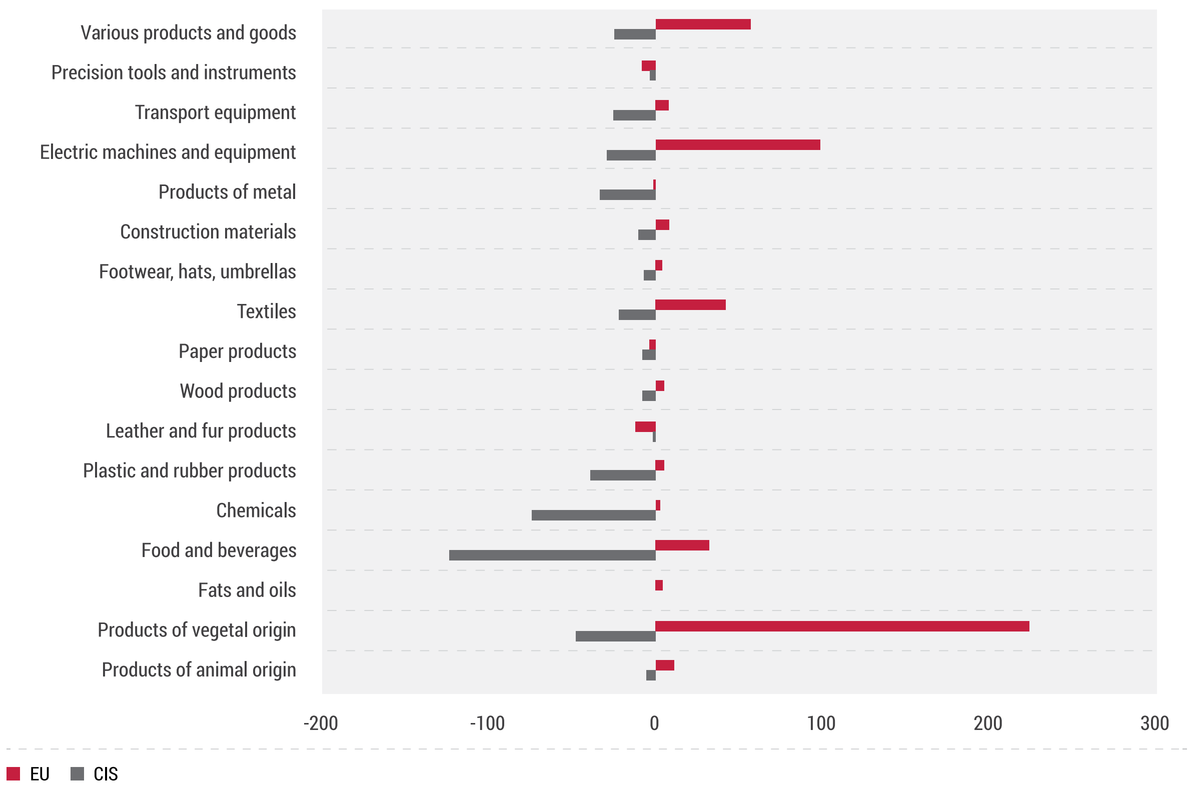
Source: Author's calculations based on NBS data

of growth can be questioned, in particular the likelihood that public sector wages and social benefits will continue to grow after the electoral campaign comes to an end.

Agriculture has recovered from the shock caused by the 2015 drought and continues to advance in spite of the quite mediocre weather conditions in 2017 and 2018.

Growth in the sector is driven by technological intensification (because of more investments, including those funded by Government subsidies) and the changes in the ownership structure of agricultural lands (extended agricultural areas cultivated by large enterprise and decreasing role of households). Increasing global prices for some agricultural products was a factor that favored the evolution of the agricultural sector over the past 2 years. The Deep and Comprehensive Free Trade Area (DCFTA) provides a favourable framework that has already boosted agricultural and food exports *(Figure 12)*, although a more disaggregated analysis reveals that not all products are able to harness the opportunities offered by DCFTA. In general, the DCFTA opportunities have already made it possible to offset the losses caused by the Russian embargo and the Ukrainian conflict (around USD 400 million in 2014-2018) through an equivalent expansion of exports to the EU market. However, DCFTA has not yet produced a statistically significant effect on total exports. This seems to be caused not only by the objective difficulties of returning to the Russian market, but also by the marketing and logistical competences of agricultural exporters - not all of them are able to comply with the EU food

Figure 12.
Volume of exports to the EU and CIS in 2018 versus 2014, million USD



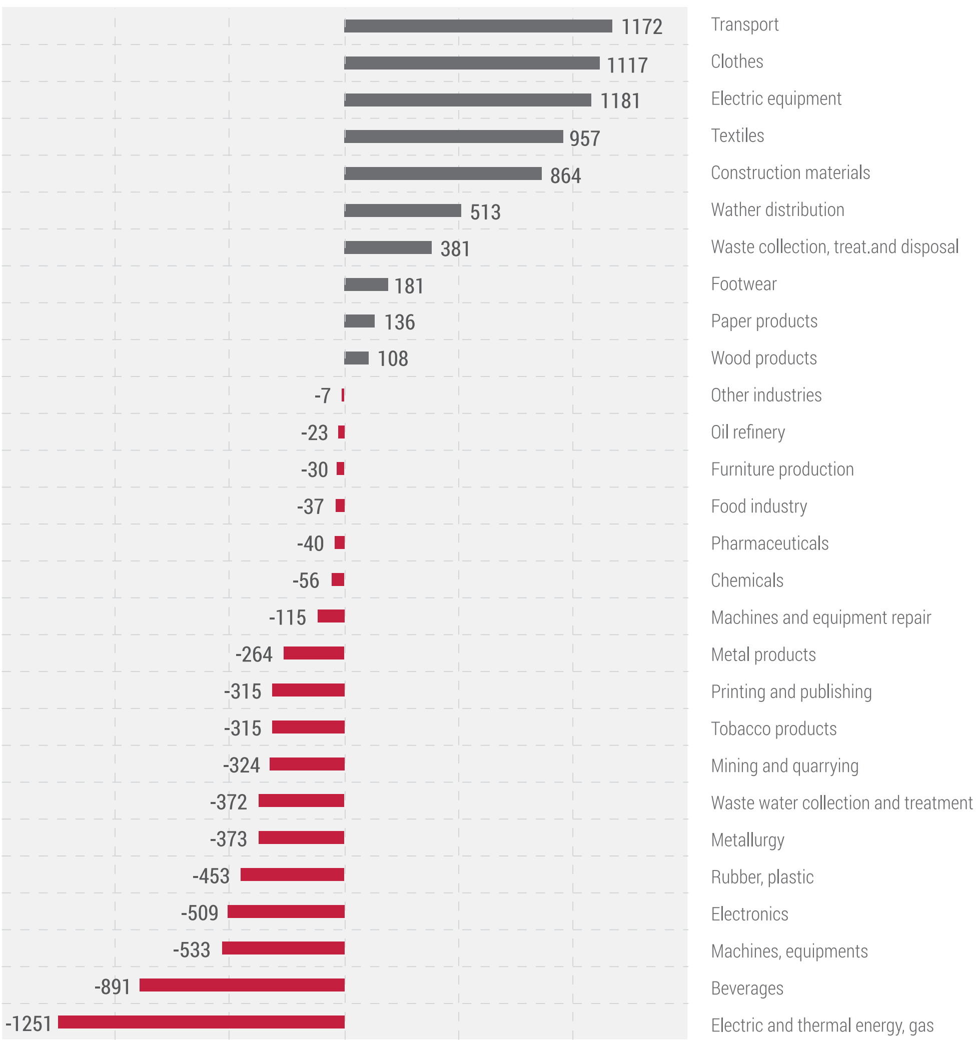
Source: Author's calculations based on NBS data

quality and security requirements. For other products, however, market access is still limited by the quotas and anti-circumvention mechanism envisaged in the Association Agreement. The sector is still very vulnerable to natural disasters, especially the small agricultural producers and households. The persistence of these vulnerabilities pose the risks of pushing the sector towards the development of industrial agriculture, a model which will prevent the sustainable use of natural and human capital under an organic farming model and could lead to the economic, cultural and demographic collapse of the rural space.

The industrial sector evolved according to a pattern of expansion of sales with a slow job creation.

The industry advanced sluggishly in 2015-2016, largely due to the spread of drought effects in the food industry. But the industry grew at higher rates in 2017 (+3.4%) and, especially, in the first half of 2018 (+12% y-o-y), the growth covering most of the industrial branches. Automotive sector, mostly located in FEZs or areas with special status, is the absolute champion of industrial growth (+40% in the first half of 2018). The sector is one of the main beneficiaries of foreign direct investments, which grew from USD 90 million in 2016 to slightly over USD 200 million in 2017. This sector

Figure 13.
Number of jobs per industries, 2016-2017 average versus 2014-2015 average



Source: Author's calculations based on NBS data

has boomed in recent years thanks to both the expansion of FEZs and the almost perfect use by producers of the European Union's trade openness. Thanks to the industrial sector, exports grew faster than imports in the past four years, which made it possible to recover the trade deficit *(Table 2)*. The industrial sector has the greatest potential to create jobs, especially if we take into account the massive investments made in some branches. However, as statistics show, the sector has not yet fully played its part: in the past 5 years the industrial businesses have cut the number of their staff by about 1500 people. The new industries that rely on cheap labour force (automotive, textiles and leather goods) are increasing the number of staff, but not quickly enough to compensate for the loss of jobs in the 'traditional' ones – including food, beverages, tobacco industries *(Figure 13)*.

Services are still the core sector of the economy.

On the aggregate level, the services sector has recently grown quite robustly (+3.5% in 2017 and +5.0% in 2018). Generating nearly half of the net economic expansion in this period, the services sector is the driver of economic growth and absorbs most of the labour force (51% of the total, including 17.3% in trade, restaurants and hotel services and 19.4% in education, health care and public administration). Households' consumer demand grew robustly in 2017 - the first half of 2018 (+5% over the previous period). However, the sophistication of these services - except for the financial ones - is still at a primary level. This is true both for private and public services, such as health care and education. This state of affairs is mainly determined by the 'natural' monopolies, obscure anti-competition arrangements, or irrelevant regulations that hinder innovation.

The evolutions in the official statistics shed a new light on the issue of Moldova's convergence to the income levels in Central and Eastern European countries.

Since the first quarter of 2018, GDP is calculated according to the UN System of National Accounts, 2008 / European System of Accounts, 2010. Until 2017, the NBS had used the System of National Accounts, 1993 (SNA). The new methodology has a totally different treatment (compared to SNA 1993) of the expenditure on research and development, military expenditure, indirectly measured financial intermediation services and imputed rent. As a result, the nominal GDP for 2017 was calculated at MDL 177 billion, compared to MDL 150 billion according to the old methodology. In line with the new methodology, per capita income increased from USD 2200 to USD 2700. Moreover, if starting with 2019 or 2020 the per capita income is not calculated anymore for the official population of 3.5 million people, but for the number closer to the results of the 2014 census (2.8 million), then the per capita income will exceed USD 4000. Moldova will 'graduate' from the group of lower-middle-income economies and will enter the group of upper-middle-income economies, according to the World Bank classification. One of the implications of this transition will be that Moldova will receive World Bank loans under less favourable conditions (IBRD conditions) than currently (IDA conditions).

FINANCIAL SECTOR

In 2017-2018 the Republic of Moldova progressed strongly in the rehabilitation of the long-suffering banking system.

Assessment of shareholders' quality was completed in the three largest commercial banks that were under special supervision/ administration. A strategic investor with good reputation (Banca Transilvania) bought 39% of the capital of Victoriabank in January 2018. In April 2018, an international consortium led by EBRD expressed its strong interest to buy 41% of Moldova-Agroindbank's shares. In general, public trust in the banking sector seems to improve, as revealed by the dynamics of individual bank deposits, including the declining deposits in foreign currency.

Progress was made in the regulatory sphere.

On 1 January 2018, the Law on Bank's Activity entered into force, which establishes a new regulatory and activity framework for these financial institutions, stating, inter alia, the institutions' transition to Basel III principles for prudential supervision. NBM also approved the new Regulation on Bank Management Framework. The Central Securities Depository (CSD) was established in March 2018. It will replace the independent registrars. The systemic failures in the work of these registrars facilitated the hostile takeover of bank's shares and subsequently the devaluation of those banks. CSD will keep records of securities in a way that will secure the safety and integrity of their owners, protect their rights and increase transparency of shareholders up to knowing exactly the ultimate beneficial owners of each financial institution. These progresses have been praised by external partners, including the IMF and the European Union. But the recent 'fiscal mini-revolution' package (with a fiscal amnesty at its core), wiped off all reputational gains accumulated by the Government and NBM over the past two years.

Thus, despite all progresses, risks still persist.

Moldindconbank remains an essential source of major risks, the legal risks of which are an important obstacle to identify a strategic investor. At the same time, the elimination of other banks' shareholders that do not meet the fit and proper requirements, is still far from complete. The activity of non-bank financial institutions poses a short-term risk to the financial sector, mainly due to the exposure of some banks to this risk, the under-regulation of the sector and insufficient financial education of customers. A new Law on Non-Bank Financial Institutions entered into force on 16 March 2018, and some of its provisions are much too vague, making it possible to attract quasi-deposits from the population (in particular, *Article 9* that is supposedly intended to establish restrictions for these institutions). There was no substantial progress in recovering the bank assets embezzled through the 2012-2014 bank fraud.

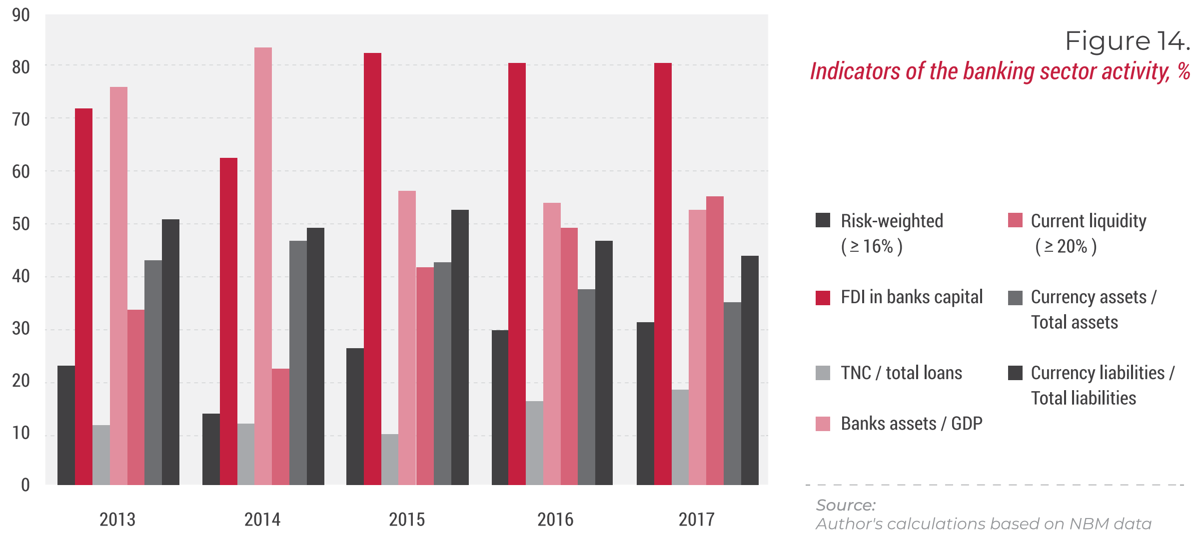


Figure 14.
Indicators of the banking sector activity, %

Source:
Author's calculations based on NBM data

The system-level bank loan portfolio shrank in 2017, reflecting the banks' lower appetite for risks and a reorientation of customers from banks to microfinance institutions. The share of bank loans in GDP decreased in tandem with the increase in the share of non-performing loans in total bank loans *(Table 2)*. The increase in non-performing loans can be explained almost entirely by the NBM imposing a stricter supervision and assessment of commercial bank's debtors. On the other hand, the ratio of total bank deposits to GDP remains at about 40%, so the larger liabilities are used by banks to buy Government securities and National Bank certificates rather than credit the real sector. As a result, banks remain well capitalized and hold more than enough liquidities, which ensures the stability of the system but does not contribute to expanding the crediting activity and, respectively, to more qualitative investments and economic growth.

Commercial banks are more prudent.

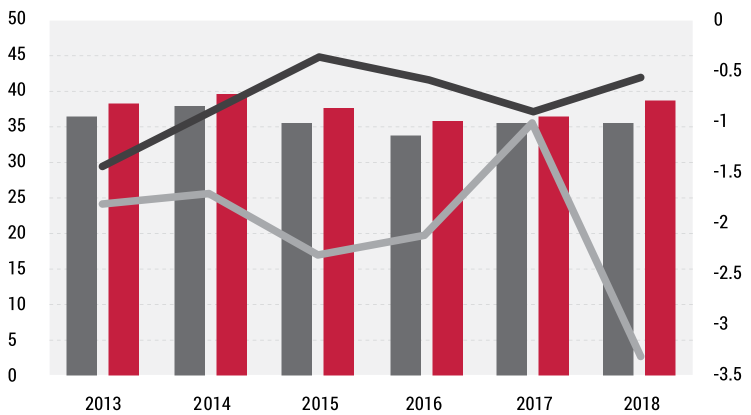


Figure 15.
Key indicators in the budgetary sector, % of GDP

Source:
Author's calculations based on Ministry of Finance data

FISCAL SECTOR

In 2017, macro and budgetary policy conditions were conducive to stabilizing the public budget.

The tax revenue grew faster than planned, thanks to the institutional reorganisation and reform of the customs and tax service. The spending was generally under-executed, this was the main factor that led to a budget deficit slightly below 1% of GDP *(Figure 15)* compared to the 2.8% target previously agreed with IMF.

In 2018-2019 the situation could change radically.

In pursuit of higher political gains for the general elections set for February 2019, the Government committed in budgetary obligations with popular appeal - 'Prima Casa' -1, -2 and -3, local roads rehabilitation projects, 'Chisinau' Arena, introduction of new categories of beneficiaries of social benefits (a principle that was removed with great difficulties in 2011-2014) - notwithstanding the loss of direct budget support from the European Union, the risk of breaking the relationship with IMF and short-term losses of budget revenues as a result of the 'fiscal mini-revolution'. These new policies risk to reduce even more the public spending on productive investment in infrastructure and human capital. In particular this could impact the health and education sectors - both already affected by shortages of specialists, infrastructure and equipment.

In the long run, demographic factors pose some risks to the budget.

For example, on the background of employment decline and increase in the number of labour emigrants, the number of people who have reached the retirement age is rising noticeably. In one decade only, the number of pensioners increased by 23%, from 528 thousand in 2007 to 652 thousand in 2017 and the trend will continue inexorably. Raising the retirement threshold offers a respite rather than a solution to the problems of the public pension system. The demographic changes will also put more pressure on the healthcare sector, as well as on local budgets, especially due to the fact that a large proportion of the highly advanced elderly population will live solitary and will need access to social support services (social workers, care homes, etc.). If today the public sector is not over-indebted (Figure 15), the level of public and publicly guaranteed debt could increase substantially in the future. It is well known that changes in the population age structure also produce demographic dividends[6]. But these could be capitalized only if the labour emigration was not so intense and employees' labour productivity increased strongly.

6. *Expert-Grup, 'Demography matters: How population dynamics impacts the economy of the Republic of Moldova? An Analytical Report on National Transfer Accounts for the Republic of Moldova', UNFPA/Expert-Grup, 2017.*

Between 2015 and 2017, the export losses on the CIS market, caused by Russian trade restrictions and by the conflict in Ukraine, were fully offset by the increased exports to the EU market. The evolution of Moldovan foreign trade in recent years debunked all myths about the destructive impact of EU trade liberalization in DCFTA - on the contrary, exports to the EU have strongly increased, and European import products have not 'invaded' the country. Note that in 2017 the exports of agricultural products to the EU market increased by USD 235 million, exceeding significantly the loss of USD 53 million incurred on the CIS market. Producer associations should actively promote the trade opening opportunities, and the Government should set up the institutional and legislative infrastructure to reduce transaction costs, to facilitate international trade, and to attract more foreign investors.

The easy access to the European market was one of the key factors that allowed the Moldovan economy to grow and diversify, despite the climate and internal economic stress factors.

At the same time, DCFTA has made it possible to highlight and reveal the country's real comparative advantages on the European market and to debunk the myths related to the country's benefits in the 'traditional' industries (such as tobacco products, which has been decreasing at nearly free fall speed in the past decade). It is important that at the first joint assessment of the DCFTA the Government negotiates the access conditions for products that face too restrictive barriers, such as customs tariffs or not tariff quotas.

It is important that the Republic of Moldova returns to the Russian market, hence the Government has to free the trade relationship with Russia from any political connotations - to the extent possible when it comes to Russia. Despite the risks, the efforts to negotiate free trade agreements with other countries - if Moldovan producers cope with competitive pressures on the European market, why wouldn't they manage to do the same on other markets?

Moreover, the Government must continue its efforts to liberalize access to other partners' markets, in particular for agricultural products.

Two factors contributed essentially to this - foreign direct investments and opportunities offered by FEZ. At present this combination of investment and industrial policy can be regarded as a success, but in the long run the Government must make sure that foreign investments contribute to technological recovery of the entire economy - because currently the inter-industrial connections between foreign and local producers are quite weak. In the current FEZ-centred model, this technological diffusion is unlikely to occur on large scale.

The automotive industry will remain one of the main sources of export growth in the near future.

In the financial sector there are many priorities that still need to be achieved.

Due to some objective factors, the NBM focused on systemic banks. But it is worth remembering that small banks also need to be carefully monitored and stress-tested. Also, the Government, the NBM and the National Commission for Financial Markets must monitor closely the dynamics of microfinance institutions and prevent the exposure of third parties to the risks undertaken by these companies in their lending process.

Efforts to modernize the fiscal and customs service must continue.

During 2017-2018 the efforts focused largely on more efficient internal organisation and external supervision. However, major resources and actions are needed to change their organisational culture and remove the 'military' vestiges from their operation. At the same time, unwelcomed experiments such as the 'fiscal mini-revolution' of 2018 can compromise all efficiency and reputation gains of those services.

Table2.
Main indicators monitored regarding the economy of the Republic of Moldova

	2015	2016	2017
GDP, percentage growth y-o-y	-0,4	4,5	4,5
GDP per capita, % of CEE average	21,9	22,2	22,0
Agricultural production, percentage growth y-o-y	-13,4	18,8	8,6
Industrial production, percentage growth y-o-y	0,6	0,9	3,4
Volume of services provided, percentage growth y-o-y	1,9	2,5	3,0
Volume of construction work, percentage growth y-o-y	0,1	-4,7	4,4
Final household consumption, percentage growth y-o-y	-2,3	3,6	4,9
Exports, percentage growth y-o-y	2,3	8,8	12,7
Imports, percentage growth y-o-y	-4,3	5,9	11,4
CPI, percentage growth y-o-y	9,7	6,4	6,6
Total bank loans, % of GDP	31,2	25,8	22,5
Total bank deposits, % of GDP	41,0	40,3	40,3
Risk-weighted bank capital adequacy, %, end of period	29,1	30,7	31,0
Total non-performing loans/total loans, %, end of period	17,6	17,4	18,4
Current liquidity index in the banking sector (min 20%),%	41,7	49,3	55,5
Long-term liquidity index in the banking sector (max 1)	0,70	0,64	0,61
NBM base interest rate, %, end of period	19,5	9,0	6,5

***Sources:** NBS, NBM, author's calculations*

LABOUR MARKET AND SOCIAL WELLBEING

This chapter analyses the interdependence between the investment activity and the labour market functioning. It highlights the role of investing in fixed capital as a crucial factor for the sustainable growth of labour productivity, as well as the fact that labour market efficiency can either foster or inhibit companies' decisions to invest. Based on the analysed trends and identified vulnerabilities, a number of recommendations are made to improve the labour market functioning and to boost investments.

INVESTMENTS - A CRUCIAL ELEMENT FOR PRODUCTIVITY GROWTH

The qualitative changes on the labour market result from the fact that, with a more sophisticated and larger capital stock (equipment, machinery etc.) per employee, labour productivity tends to grow. In its turn, the labour productivity growth is almost the only source of wage increase and poverty reduction in the long run, as the rest of the factors have a cyclical or short-term effect. Indeed, the international statistical data highlight an almost linear relationship between labour productivity and gross fixed capital formation per employee *(Figure 16)*. Thus, one of the few options for poor countries to accelerate economic growth, including for the Republic of Moldova, is to foster investments. .

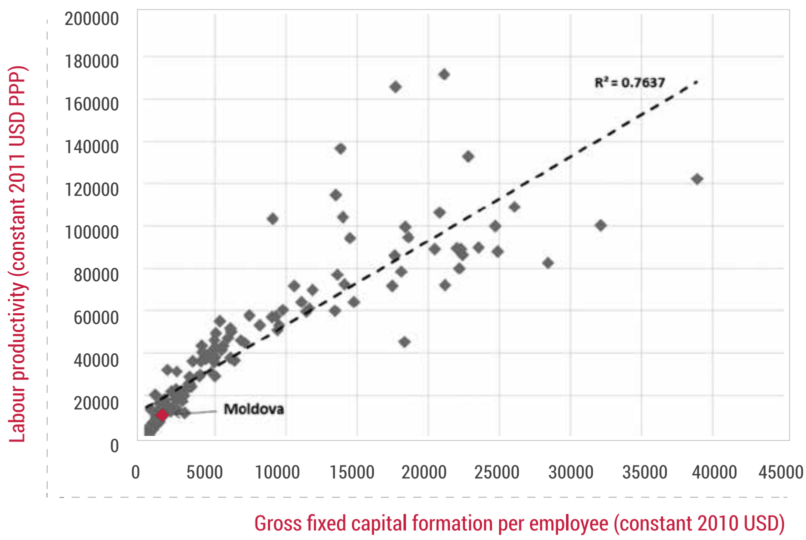
Investments in fixed capital are a driver of qualitative transformation of the labour market and sustainable economic growth.

Before the 2009 crisis, the average rates of fixed capital accumulation per employee were about 14%, which led to high rates of labour productivity growth of about 7% on average. However, in 2012 both indicators started to slow down, with their growth rates stabilising at an average of 3% annually, this trend becoming stronger after the 2014 economic crisis *(Figure 17)*. Thus, the lower investments growth rates is a key factor of labour productivity slowdown in the national economy in the last few years. As mentioned in the previous edition of the State of the Country Report, the slowdown of productivity and investments growth will maintain the gap between the Republic of Moldova and the CEE EU countries. In 2017, labour productivity in the Republic of Moldova was 22.7% of the average for this group of countries, or approximately at the same level as during the last four years (around 22%).[7]

Ever since 2000, the fixed capital accumulation per employee in the Moldovan economy has grown at high rates, enhancing labour productivity, but it has slowed down sharply in the recent years.

7. A. Lupusor, A. Fala, A. Popa, D. Cenusa, I. Morcotilo 'State of the Country Report 2017', Expert-Group, 2017.

Figure 16.
Relationship between labour productivity and gross fixed capital formation per employee (2005-2015 average)



Source:
Author's calculations based on World Bank data

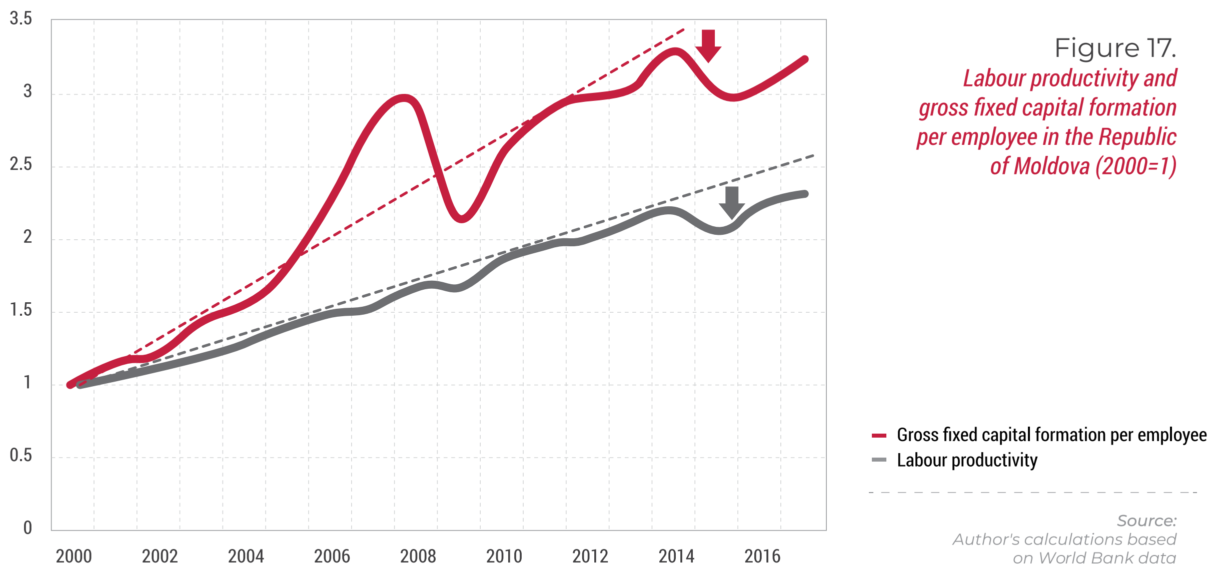


Figure 17.
Labour productivity and gross fixed capital formation per employee in the Republic of Moldova (2000=1)

Source:
Author's calculations based on World Bank data

Labour market efficiency is an important factor that motivates the private sector to invest.

Usually, the level of investments tends to be lower in economies with a too restrictive regulatory and fiscal framework for labour matters due to reluctance of businesses to invest. Indeed, the statistical data published by World Economic Forum (WEF) underpin this link between labour market efficiency and the level of fixed capital formation per employee (Figure 3). This link is not very strong though, which can be explained both by the particular way of compiling the WEF labour market efficiency indicator and by the importance of other factors that (de-)motivate companies to invest. Despite these explanations, the positive relationship between labour market efficiency and investment activity points to the fact that the Republic of Moldova needs to make efforts to improve the functioning of its labour market in order to increase investments.

The labour market efficiency index of the Republic of Moldova, calculated in the Global Competitiveness Report, decreased from 4.41 to 3.94 (out of maximum 7 points) between 2010 and 2017 *(Figure 4)*.[8] In fact, this index contains 10 sub-indices, which are calculated on the basis of business entities surveys.[9] An analysis of each sub-index highlights that the main areas responsible for the worsening of the aggregate index are not related to the strictness of labour law. Surprisingly, only 3.2% of respondents mentioned the strictness of labour law as a major impediment to the business environment in the latest edition of the Global Competitiveness Report (GCR) 2017-2018.[10] However, this does not mean that the labour law should not be improved. On the contrary, Moldova's score of 3-4 points for these sub-indices (out of maximum 7 points) shows a wide leeway for possible legal adjustments.

The efficiency of the labour market in the Republic of Moldova is continuously decreasing, which can partly explain the shrinking investment activity.

'Pay and productivity' and 'Reliance on professional management' were the only sub-indices of labour market efficiency aggregate index that had declined significantly during the mentioned period. These sub-indices decreased from 4.4 to 3.5 between 2010 and 2017, which explains almost completely the aggregate index dynamics. An explanation of why remuneration is becoming less correlated with labour productivity and why promotion to management positions is not based on merit would be that the competitive environment becomes more comfortable for many business operators. A comfortable competitive environment means getting non-competitive advantages, such as secure access to budget sources by some companies through corruption, which allows them to ignore the labour costs and management professionalism. Indeed, the score assigned in the GCR by the private sector for the effectiveness of anti-monopoly policy also declined significantly between 2010 and 2017, from 3.2 to 2.8 points out of maximum 7. Thus, improving the quality of anti-monopoly policy in the Republic of Moldova can have a positive impact on the functioning of labour market.

The main factors that affected the labour market efficiency are mainly related to the competitive environment of the economy.

Informal or formal businesses that avoid paying taxes and social contributions have comparative non-competitive advantages compared to the other companies, which also distorts the labour market efficiency. The proliferation of informal economic activity also decreases the companies' funds available for investments in fixed capital and for business expansion. Potential resources for investment will decrease both because of tax evasion and companies' unwillingness to extend their activity in order to remain off the supervisory authorities' radar. Both processes (tax evasion and informal employment) have expanded in the Republic of Moldova in the recent years. For example, between 2010 and 2016, hidden

The size of non-observed economy is another important factor that influences negatively labour market efficiency and investment dynamics.

8. The aggregate index ranges from 1 (worst performance) to 7 (best performance).

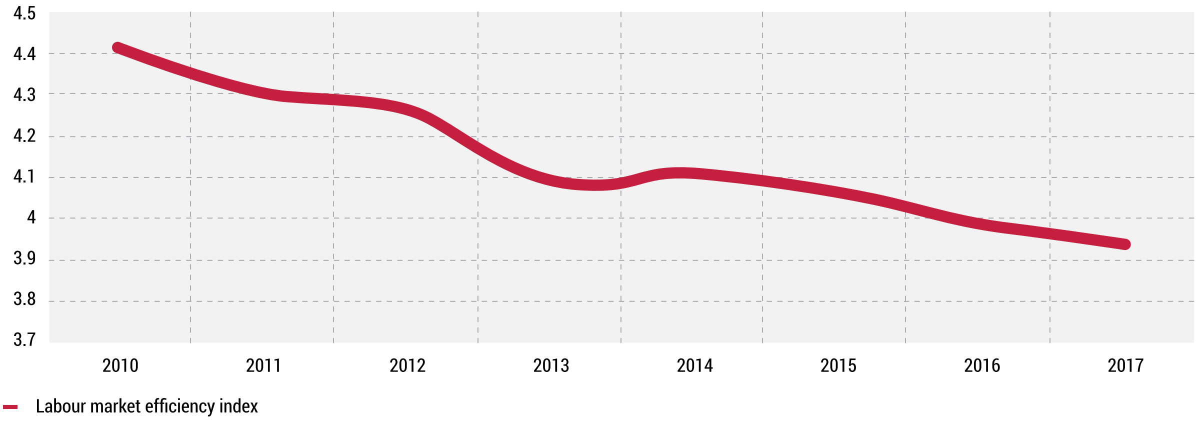
9. These sub-components are (i) Cooperation in labor-employer relations; (ii) Flexibility of wage determination; (iii) Hiring and firing practices; (iv) Effect of taxation on incentives to work; (v) Pay and productivity; (vi) Reliance on professional management; (vii) Country capacity to retain talent (viii) Country capacity to attract talent; (ix) Female participation in the labour force; (x) Redundancy costs.

10. http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017%E2%80%932018.pdf

Figure 18.
Relationship between labour market efficiency and gross fixed capital formation per employee (2006-2014 average)

Source: Author's calculations based on World Bank and World Economic Forum data

Figure 19.
Evolution of labour market efficiency index in the Republic of Moldova[11]



Source: Author's calculations based on World Economic Forum data

production in the formal sector of the economy (i.e. tax evasion) rose from 5.6% to 8.3% of GDP.[12] During the same period, the informal employment rate increased from 31% to 36.4% of employed population, recording a slight decline in 2017 down to 34.7%. Because of the increasing non-observed economy and shrinking investments, the aggregate productivity decreases because informal activities are less productive, as shown in the previous edition of the State of the Country Report.[13] As with the negative relationship between productivity and informal employment, there is a similar relationship for investments, too. Hence, countries with a higher non-observed economy also have much lower fixed capital investments per employee *(Figure 18)*.

12. Indicele de eficienţă a pieţei muncii a început să fie calculat pentru Republica Moldova începând cu ediţia din anul 2010 a Raportului de Competitivitate Globală.

13. I. Morcotîlo „Economia neobservată şi corupţia: legături şi consecinţe", Expert-Grup, 2018.

14. A. Lupuşor, A. Fală, A. Popa, D. Cenuşă, I. Morcotîlo „Raportul de Stare a Ţării 2017", Expert-Grup, 2017.

11. http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017%E2%80%932018.pdf

POLICY RECOMMENDATIONS

The investment activity in the Republic of Moldova can be expanded by reforms aimed at improving the functioning of the labour market.

Functioning of the labour market is among the factors that can stimulate or inhibit investments, and the following main priority actions are needed in the Republic of Moldova:

- **Adjust the regulatory framework of the labour market.** The perception of the labour market regulatory framework invokes a liberalisation in this area. The businesses' perception is also confirmed by international rankings of labour law, in which the Republic of Moldova ranks among the laggards. Nevertheless, the planned liberalisation of labour law must be preceded by the updating of these rankings for the Republic of Moldova, because currently the most restrictive areas of law are not known for our country compared to the countries of the region.[14] The liberalisation should also be based on a broad ex-ante analysis of effects, including from the social point of view.

- **Improve the quality of anti-monopoly policy.** As revealed by labour market efficiency indices, the anti-monopoly policy has a major role. The worsening of businesses' perception of some sub-indices of the labour market that are directly related to the implementation of the anti-monopoly policy, as well as to this policy per se, indicates that more attention needs to be paid to this area. The Competition Council must carry out both analytical studies and field work in critical areas such as public procurement, import and export of the main products etc.

- **Fight against non-observed economy.** All recommendations from the previous edition of the State of the Country Report on efforts of fighting against non-observed economy, on each separate component, remain valid. The main efforts to fight the non-observed economy focused on fiscal issues, recently being adopted by the authorities the single tax rate, decrease of the employer social contribution rate etc. However, these tax and administrative efforts need to be supplemented with structural policies, able to decrease the number of population employed in subsistence agriculture. Thus, the fiscal measures will only help legalizing the existing informal companies, but they will not address the problem of non-productive employment in subsistence agriculture.

14. A. Lupusor, A. Fala, D. Pintea, I. Morcotilo, V.Gumene, the 18th MEGA edition: 'Economic Perspectives in an Election Year', Expert-Group, 2018.

Table 3.
Main indicators monitored regarding labour market and social wellbeing

Indicators	2015	2016	2017
EMPLOYMENT RATE (%)	40,3	40,8	40,5
Men	42,3	43,0	43,1
Women	38,4	39,0	38,1
UNEMPLOYMENT RATE (%)	4,9	4,2	4,1
Men	6,2	5,5	4,8
Women	3,6	2,9	3,3
Absolute poverty rate (%, under the absolute poverty threshold)	9,6	-	-
Real wage growth rate (%, y-o-y)	0,7	3,7	5,2
Emigration growth (%, y-o-y)*	-4,8	-2,0	-2,0
Remittances (% of GDP)	23,6	21,5	20,2
Gini index (total available revenue)	0,3164	0,3222	-
Average wage in USD (% of the average wage in CEE EU)	23,3	23,4	-

Source:
Author's calculations based on NBS, WB, UNECE and NBM data

Note:
The change in external migration, calculated here, taken into account only the people declared to be abroad when filling in the Labour Force Survey, excluding those who were in the country, but had already established a connection with the foreign labour market.

EDUCATION AND HUMAN CAPITAL

This chapter reviews the key developments in human capital formation and its use in the national economy. Taking into account the increasing importance of higher education for an efficient absorption of investments and higher labour productivity, the analysis focuses on this component of human capital. The chapter ends with a set of strategic recommendations for reforming the tertiary education system, based on the identified trends and vulnerabilities.

HUMAN CAPITAL - INVESTMENTS WITH UNCERTAIN RESULTS

In any economy the fixed capital investments growth is not sustainable unless accompanied by human capital investments, especially of public ones. Given the increasing technological sophistication, people need to have now more knowledge and skills to use efficiently the fixed capital investments (equipment, machinery etc.) and enhance their labour productivity. Otherwise, labour productivity decreases and companies have either to invest themselves in developing the human capital or relocate to countries with a more educated human capital. Also, the capital investments in increasingly more sophisticated technologies lead to a higher demand for specialists with more advanced degrees, especially graduates of tertiary education. Thus, countries with a higher enrolment rate in tertiary system also tend to have a higher level of labour productivity and more fixed capital investments per employee. The Republic of Moldova, however, lags significantly behind other countries in this respect because the current accumulated human capital is used extremely inefficiently and non-productively *(Figure 20)*.

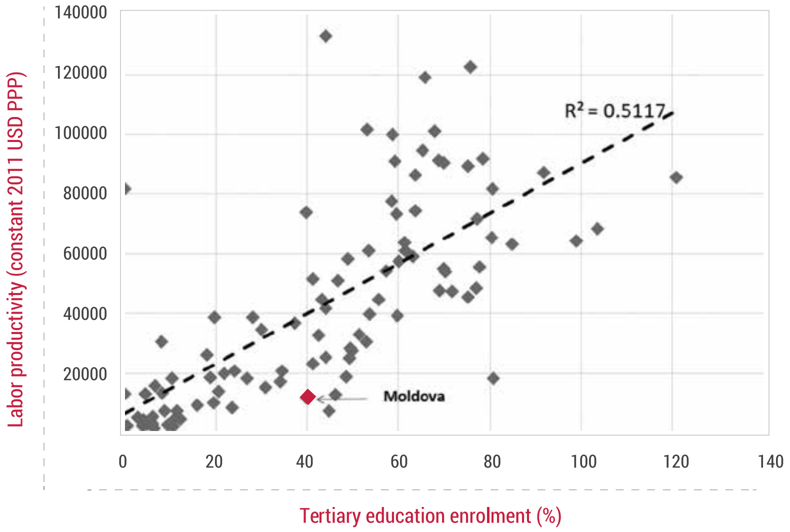
Accumulation of human capital is a key factor in fostering fixed capital investments and labour productivity growth.

The number of jobs requiring medium and high skills (calculated according to ISCO 08) had increased rapidly from 2000 to 2012. During this period, their share jumped by about 1.6 times, or from 20% to 31%. As most of these jobs require university degree, the demand and supply grew in a balanced way. During the same period, the enrolment rate in the tertiary system increased from 32.5% to 40.1%. After 2012, however, the number of jobs requiring high and medium skills started to decline, which affected negatively the labour productivity dynamics *(Figure 21)*.[15] The decreasing number of these jobs after 2012 coincided with the investment slowdown, as was mentioned in previous chapters. The disturbing issue is that the enrolment rate in the tertiary system is still over 40%, so there is a surplus of educational supply for high and medium skills jobs.

The Republic of Moldova has used more inefficiently its human capital during the recent years due to the decreasing number of high- and medium-skilled jobs requiring.

15. A. Lupusor, A. Fala, D. Pintea, I. Morcotilo, V.Gumene 'MEGA, 18th edition: Economic Perspectives in an Electoral Year', Expert-Group, 2018.

Figure 20.
Relationship between labour productivity and tertiary education enrolment rate (2005-2015 average)



Source: Author's calculations based on World Bank data

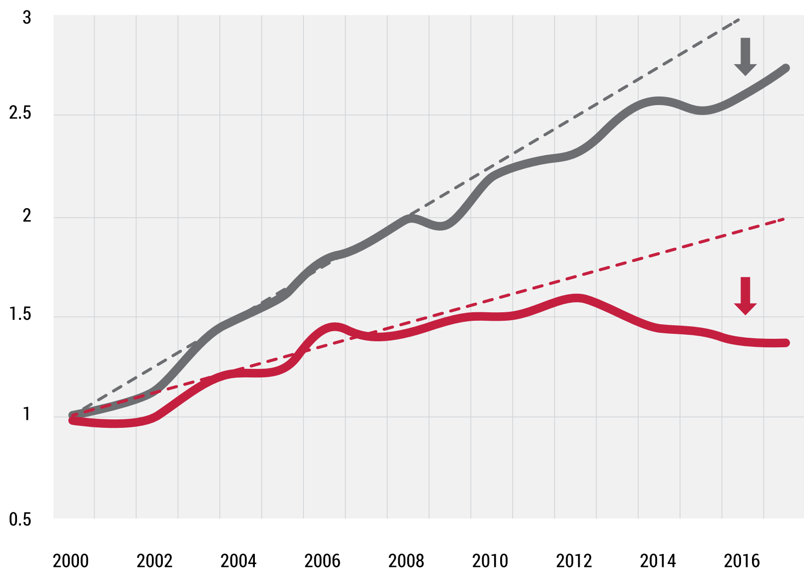


Figure 21.
Indices of labour productivity and the share of jobs requiring high and medium skills (2000=1)

Source: Author's calculations based on National Bureau of Statistics data

A part of the surplus labour force with higher education chose to emigrate, and this process only intensified over the past years.

During 2008 - 2012, the number of emigrants with higher education increased at about the same pace as the total population with this level of education.[16] The migration growth rates of the population with higher education were slightly larger, if we take into account people who identified themselves as inactive during the survey, but declared that they had recently moved back or planned to leave for abroad in search of a job. The emigration of those with higher education exploded in 2012, especially if are tak-

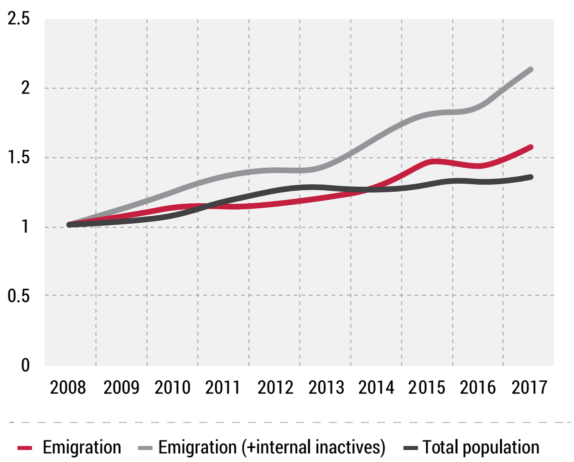
16. The calculations cover the period since 2008, because starting with this year the National Bureau of Statistics publishes disaggregated data on inactive population by the main reasons for not participating on the local labour market.

en into account all categories of emigrants. The most worrying fact is that the migration trends of these people are only getting stronger. Thus, if in 2017 the total number of Moldovan population with higher education was 1.4 times higher than in 2008, then the number of emigrants with the same level of education increased 2.1 times during the same period of time *(Figure 22)*. The migration affected equally men and women with higher education, both groups growing two times over the mentioned period. At the same time, the growth rate is higher for men than for women (2.2 vs 2 times).

Since 2012, the number of formally employed with higher education has stopped growing and has remained at about 35% of the total formally employed population. The exceeding supply of people with higher education was absorbed by the informal sector, but the growth was insignificant (about three-four thousand people). The stabilisation of the share of employees with higher education, accompanied however by a decrease in the number of jobs requiring high and medium skills, led to a sudden increase of mismatches between the education acquired and the skills required at the workplace. The share of formally employed people with higher education who held jobs requiring lower skills (over-qualified staff) started to grow slowly in 2007, with the growth rates increasing significantly in 2012 and afterwards remaining stable until 2016 *(Figure 23)*.[17] In 2016, about 30% of the total formally employed population with higher education were overqualified for their job (calculated according to ISCO-08).

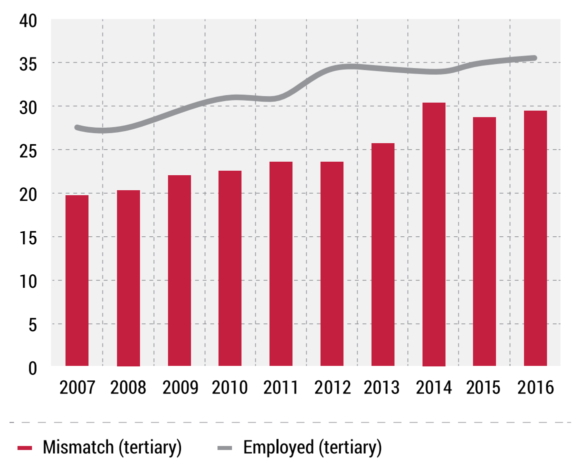
Another consequence of surplus labour force with higher education is the increasing skills mismatch on the labour market.

Figure 22.
Indices of total population and emigrants with higher education (2000 =1)



Source:
Author's calculations based on National Bureau of Statistics data

Figure 23.
Share of employed population with higher education and share of employees with higher education with lower skills jobs in the formal sector (%)



Source:
Author's calculations based on National Bureau of Statistics data

17. The calculations cover only 2007-2016, because only for this period there are disaggregated data on the occupations, level of education and the formal sector of the economy.

The worrying labour market trends highlight the necessity to choose a new model of tertiary educational system.

The main dilemma for the university system is how to adjust to the new labour market equilibrium - low investment growth rates and decreasing number of jobs requiring high and medium skills. Hypothetically, there are three major scenarios for a quantitative reform of the sector, but all of them should focus on enhancing the quality of education. One scenario would be a dramatic decrease in the number of universities as a result of the quality audit (most likely it will not be difficult to detect major problems in many universities) and in the number of enrolled students, extending the funding for the remaining ones. The second scenario would be to keep the current number of universities and students, but focusing on improving the quality of education. The third scenario is a combination of the previous two. The chosen scenario will however depend on the decision regarding the path of structural reforms in the country. For example, if authorities emphasise attracting investments in sectors that have as comparative advantage low labour cost rather than high skills, then it is worth implementing the first scenario and encouraging the development of the vocational education system, etc. But it is important to take into account that improving the quality of education without any structural reforms in the national economy will further stimulate external migration.

POLICY RECOMMENDATIONS

The Republic of Moldova must adjust, as soon as possible, the educational system to the recent trends in the economy in order to capitalize on its investments in human capital.

As revealed by the figures above, the tertiary education system must become a priority area. The current efforts aimed at reforming this level of education must be adjusted, taking into account at least the following interdependent aspects:

- **Quantitative aspects of the reform.** *First, it is important to find an answer to the question if the Republic of Moldova actually needs the current number of higher education institutions and must continue investing in them. The answer to this question must be clearly anchored in the prospective and feasible model of the country's economic development. It is necessary to perform as quickly as possible a quality audit and a comprehensive analysis of whether the current system is optimal for the Republic of Moldova from the cost-benefit perspective (economic, social, financial etc.), regardless which model and scenario is chosen for the tertiary system optimisation.*

- **Qualitative aspects of the reform.** *The quality of education should be the number one priority in any scenario of tertiary education system reform. It is critical to expand the intervention toolkit in order to enhance the quality, rather than just focus on curriculum adjustment. The main initiatives would include changing the teacher remuneration system (fo-*

cusing on remuneration based on performance and scientific achievements), more active involvement of the private sector in developing specialised curricula, expanding the cooperation with foreign universities and funds, compulsory participation of universities in international rankings etc.;

- **Financial aspects of the reform.** *The current funding model of tertiary education system does not foster competition, performance and scientific research. The funding should be linked to the quantitative aspects of the reform and follow several fundamental principles of public funds distribution among the existing universities. One of the principles would the distribution of money among universities based on a competition or certain rigid formulas and rules. Also, it would be advisable to provide certain tax concessions in order to attract businesses into partnerships with universities. Finally yet importantly, universities need to be stimulated to attract foreign students in order to increase their income by liberalising the prices for this type of service.*

Table 4.
Main indicators monitored regarding human capital development

	2015	2016	2017
Human Development Index	0,699	-	-
Discrepancy between the Human Development Index of the Republic of Moldova and the average of the CEE EU countries (%)	82,9	-	-
Share of overqualified employees, %	21,4	21,6	-
Share of public expenses for education in GDP, %	6,9	6,3	5,5
Number of graduates with higher education	23630	21886	19943
Number of graduates from secondary technical vocational education	9220	3584	7585
Number of graduates from post-secondary technical vocational education	6252	6789	6367
School dropout rate, %	21,3	20,0	-

Sources: *Author's calculations based on NBS and UNDP data*

ENERGY: Political Interferences and Delays in the Construction of Gas Interconnection

This chapter assesses the dynamics of the energy sector and points out the main systemic weaknesses that diminish the security and efficiency of energy policies. The chapter end with a series of recommendations aimed at eliminating or minimizing the effect of negative factors on the development of this sector.

ANALYSIS OF THE MAIN TRENDS AND DEVELOPMENTS

During the monitored period, the authorities developed positive relations of cooperation with external partners (EU, Energy Community, EBRD, EIB, World Bank and IMF).

Special attention was given to the improvement of the National Energy Regulatory Agency (ANRE) work related to the development of documents needed to implement the secondary legislation for the Third Energy Package. The legal framework underwent qualitative changes concerning energy efficiency and management of renewable energy. Nonetheless, deficiencies in ensuring an effective independence of the regulator from political factors and the transparency of energy procurement have remained practically intact. Moreover, the first negative signals are related to the implementation of the projects on strategic interconnection with the Romanian system, which could paralyze the security of gas supply and diversification of routes. At the same time, there is no formal dialogue with the Russian Federation on the energy file and the Transnistrian gas debt, accumulated due to the failure of Kuchurgan power station to pay for the raw materials, which could increase considerably if the plans for producing the crypto-currency are materialized.[18]

The political interference in the regulation of energy tariffs is maintained.

Despite the provisions on regulator independence in the Energy Law of 2017 *(Article 8)*, like in the previous years, the ruling parties tend to take over the regulator's role in setting tariffs. Thus, at the beginning of 2018, the Government announced before the National Energy Regulatory Agency (ANRE) that gas tariffs should decrease by 20% — a tariff cut that was subsequently adopted by ANRE[19]. The prices for the gas procured from Gazprom had dropped below USD 200 per 1000 m3 during 2015-2016[20] *(Figure X)*. Thanks to these price cuts, ANRE was able to revise the tariffs in 2017. The regulator argued that the price recalculation was postponed because gas sup-

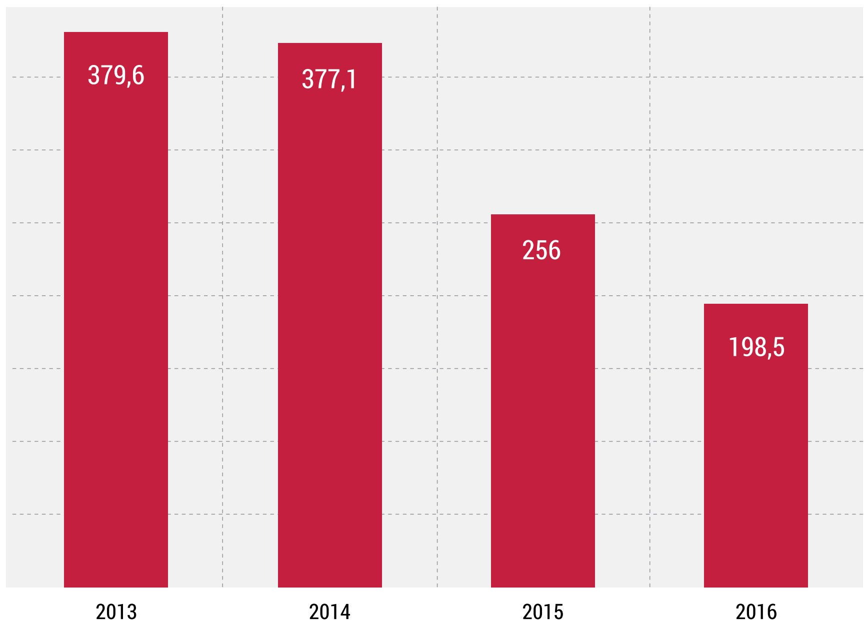
18. http://www.balkaninsight.com/en/article/russian-investors-attracted-with-transnistria-s-minefarms-for-bitcoin-05-24-2018

19. ANRE cut down the prices of gas delivered to consumers, 16 March 2018, http://anre.md/ro/content/anre-mic%C8%99orat-pre%C8%9Burile-de-furnizare-la-gazele-naturale-livrate-consumatorilor

20. As ANRE did not publish its Activity Report for 2017, the gas procurement price can not be indicated for 2017. Website anre.md accessed on 22 July 2018, www.anre.md

plier MoldovaGaz S.A delayed disclosure of costs. For these reasons, ANRE published the new tariffs in March 2018 and requested that MoldovaGaz refunded the payments made by final consumers on the basis of the old tariffs.[21] This episode highlighted the following: i) ANRE is slow at correct management of tariff policies; ii) ANRE synchronizes its decisions with political decision-makers and does not act separately from them, either because of an informal communication of the institution with political stakeholders or because of an invisible subordination; iii) ANRE tolerates deviations in case of energy operators managed by the Government (MoldovaGaz), even if this inevitably affects the regulator's image.

Figure 24.
Prices of natural gas purchased from the Russian Federation, 1000 m3, USD



Source: ANRE.md

The consumer dissatisfaction was handled incorrectly by the authorities, which again gave instructions to the regulator. In case of this year's electricity price reduction by about 10%, political stakeholders had a minimum implication compared to the previous periods and to other sectors.[23]

ANRE's decision to raise the fuel prices in May 2018 was another instance when the Government requested explanations from the regulator and demanded maximum transparency in price setting.[22]

21. https://www.europalibera.org/a/micsorarea-tarifelor-la-gaze/29104567.html

22. http://tvrmoldova.md/economic/pavel-filip-vreau-sa-avem-claritate-atunci-cand-vorbim-despre-stabilirea-preturilor-la-carburanti/.

23 ANRE cut down electricity prices delivered to consumers, March 15, 2018, http://anre.md/ro/content/anre-mic%C8%99orat-pre%C8%9Burile-de-furnizare-energiei-electrice-livrate-consumatorilor

There is a defective transparency and institutional favouritism in energy procurement.

The annual electricity procurement mechanism, introduced in 2017, was implemented more efficiently in 2018. However, the improvements made are insufficient to ensure a fair and competitive selection of the supplier. Thus, similarly to the situation of 2017, the Ministry of Economy and Infrastructure intervened in the tender, by changing the deadlines for submission of bids. This favoured Energocom state-owned company and affected the loyal competition among suppliers participating in the tender. Moreover, Energocom hijacked the tender with separate and opaque negotiations with two suppliers (the Ukrainian company DTEK and the supplier from the Transnistrian region — Kuchurgan power station). Therefore, although it is an intermediary trader who does not have its own production capacity, Energocom managed to win the supply contract for the period of 1 April 2018 to 31 March 2019. The final price proposed by Energocom is USD 52.8 per MWh and represents the average price of electricity procurements from the Kuchurgan power station and DTEK.[24] European partners made a number of recommendations to streamline the electricity procurement mechanism.[25] On the one hand, it is mandatory to clearly define the status of Energocom, which requires decisional independence from the Ministry of Economy and Infrastructure and the introduction of minimum rules of corporate governance and transparency (publication of financial reports, audit etc.). On the other hand, it is imperative to advance the procurement procedures by tightening the eligibility criteria and introducing penalties for non-compliant companies. These improvements can contribute both to securing electricity supplies and preventing the increase of the gas debt to Gazprom[26].

Completion of project of gas supply sources diversification from Romania to Chisinau is uncertain.

The construction of Iasi-Ungheni to Chisinau gas pipeline is advancing troublesomely, even if investors from Romania entered the gas market of Moldova. Thus, the Romanian Gas Transmission Company Transgaz JSC privatised the Moldovan operator Vestmoldtransgaz[27] for the amount of MDL 180.2 million and an investment program of EUR 93 million.[28] The way in which the privatization took place denotes that the Romanian investor was favoured from the start by the Moldovan side and promoted at the highest level by the Romanian policy makers.[29] The privatization notice was also sent to other potential investors (Azerbaijan), but already during the privatization itself, which was carried out in November and December 2017.[30] Once Transgaz JCS took over the project of building the Iasi-Ungheni to Chisinau gas pipeline (through Eurotransgaz SRL), the Moldovan authorities gave up on the loan

24. *Energocom has agreed that 70% of the procured energy should be delivered by Kuchurgan power station at a price of USD 50.4 per MWh and the remaining 30% — by DTEK at a price of USD 58.4 MWh.*
25. *Energy Community, Report of the Group of Observers 2018, 4 April 2018, https://www.energy-community.org/news/Energy-Community-News/2018/04/05.html.*
26. *The debt for natural gas reached about USD 7 billion in 2018 and is still generated by Kuchurgan power station, which produces energy using unpaid gas from MoldovaGAZ.*
28. *Datoria la gaze naturale a ajuns la circa șapte miliarde de dolari în 2018 și este generată în continuare de producţia de energie de către CERS Moldovenească, bazată pe consumul de gaze naturale neachitate către „Moldova-Gaz”.*
29. *De la fondarea sa în 2014 și până la vânzarea sa în martie 2018, „Vestmoltransgaz” funcţiona ca un operator de transport, controlat de stat, care gestiona segmentul moldovenesc al Gazoductului Iași-Ungheni, dat în exploatare în 2014.*
30. *Semnarea de contract de vânzare-cumpărare a ÎS „Vestmoldtransgaz”, Chișinău, 29 martie 2018, https://www.transgaz.ro/sites/default/files/Anunt%2004.04.2018.pdf.*
31. *https://economie.hotnews.ro/stiri-energie-22085876-transgaz-putea-participa-privatizarea-vestmoldtransgaz-compania-din-moldova-care-gestioneaza-gazoductul-iasi-ungheni.htm.*

agreed previously with EBRD and EIB (EUR 92 million). By doing so they also lost the EU grant of EUR 10 million, but got rid of a series of conditionalities requiring reforms to boost competition on the energy market[31]. The construction of pipeline to Chisinau is in a quandary for various legal, technical and geopolitical reasons. Major legal reasons involve the reorganization of Vestmoldtransgaz from a 'joint stock company' into a 'limited liability company' and the subsequent restoring of the necessary licenses, including from ANRE. The technical reasons are related to the incompatibility of the European standards for the construction of gas transmission infrastructure, based on which Transgaz JCS operates, with the technical regulations inspired by GOSTs, still applicable in Moldova. The geopolitical reasons are directly related to Moldtransgaz, which holds the monopoly (founded by MoldovaGAZ, over 50% controlled by Gazprom) and refuses to give its consent for the construction.[32] In addition, Transgaz JCS has a limited capacity to fund infrastructure projects as it transfers its profits to the Romanian public budget.[33] This could hamper the expansion of the capacity to deliver gas to Moldova[34] and the actual construction of the Ungheni-Chisinau pipeline, even if the technical and legal obstacles to the actual privatization of Vestomoldtransgaz are overcome. The use of the EBRD and EIB loan, already existing in 2017, would have increased the feasibility of building the Ungheni-Chisinau pipeline until 2019, with its subsequent commissioning in 2019-2020. Unlike gas interconnection, the prospects of the electricity interconnection project (Isacea-Vulcanesti-Chisinau) are more positive. Thus, the financial resources needed for the construction will be provided by EBRD, EIB, World Bank (EUR 230 million in loans) and EU (EUR 40 million grant).[35]

Improving energy efficiency and renewable energy legislation creates positive premises for the sector.

The new version of the Law on Renewable Energy establishes a mechanism to foster investments in the sector through financial support and setting the energy tariff (up to 15 years). The law also encourages consumers who have renewable energy production capacities to supply electricity to the network.[36] The revised Law on Energy Efficiency, adopted in July 2018, is another significant contribution to raising energy standards. Its provisions lay down specific quota for the public buildings rehabilitation, the principle of energy efficiency in public procurement, and the obligation for operators in the sector to invest in reducing energy inefficiency.[37] Legislation adoption must be followed by a rigorous implementation, which can be made more difficult if authorities do not attract sufficient public and private investments.

31. Ungheni-Chisinau Gas Pipeline, https://www.ebrd.com/work-with-us/projects/esia/ungheni-chisinau-gas-pipeline.html, http://www.eib.org/en/infocentre/press/releases/all/2016/2016-351-the-eu-bank-and-ebrd-support-gas-interconnection-between-the-republic-of-moldova-and-romania.htm
32. Mold-Street, 26 June 2018, https://www.mold-street.com/?go=news&n=7682
33. https://economie.hotnews.ro/stiri-energie-22359175-transgaz-nu-vrea-distribuie-90-din-profit-sub-forma-dividende-asa-cum-cerut-guvernul-prin-memorandum-doar-50.htm.
34. Romania planned to develop the national transport system in the North-East Romania by 2020 in order to improve the gas supply in this area, as well as to ensure the transport capacity to/from the Republic of Moldova..
35. https://mei.gov.md/ro/content/guvernul-aprobat-ratificarea-acordurilor-de-imprumut-cu-berd-si-bei-pentru-interconectarea.
36. Law No 34 of 16 March 2018 amending the Legislation on Promotion of Electricity produced from Renewable Energy Sources , http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=374891
37. Moldova becomes first Energy Community Contracting Party to adopt law transposing the Energy Efficiency Directive, https://www.energy-community.org/news/Energy-Community-News.html

POLICY RECOMMENDATIONS:

A number of strategic policies and the enhancement of the energy legislation can help modernize and secure the sector:

Take concrete steps to unbundle supply from transmission in the gas sector.

No measures have been taken to complete the unbundling of the supplier from the transmission system, which make the effective liberalization of the gas market impossible. This favours Gazprom-controlled MoldovaGaz monopoly and risks violating the commitment to implement the 'unbundling' principle, made to the Energy Community, from which a derogation was made until 2019. A detailed action plan must be developed, published and subjected to rigorous public consultations, with the participation of the civil society and foreign partners. The unbundling will facilitate the diversification of supply sources, avoiding similar situations with Moldtransgaz's refusal to allow the Ungheni-Chisinau pipeline building, planned by Transgaz after the privatization of Vestmoldtransgaz.

Exclude any politic interference in the tariff setting policy.

ANRE's identity must be definitively separated from political factors that use the issue of tariffs for political and electoral purposes. The association of ANRE with the Government negatively affects the regulator's credibility in relation to end consumers, as demonstrated by the crisis related to fuel prices.

Improve the electricity procurement mechanism to exclude unfair competition and the line ministry involvement.

The tightening of tender rules (submission deadlines, bids opening etc.) and eligibility criteria for suppliers (exclusion of companies with debts for the raw material consumed for electricity production), as well as clarifying the status of Energocom will enhance the tender transparency, ensure fair competition between suppliers and prevent accumulating more debt for Russian gas.

Finalize the privatization of Vestmoldtransgaz and start the construction of Ungheni-Chisinau pipeline.

In order to start the construction works, the Moldovan authorities are obliged to facilitate the effective privatization of Vestmoldtransgaz by Transgaz in accordance with the law. Any postponement endangers the initial timetable for expanding the interconnection with Romania in 2019. Ensuring that the Romanian investor has sufficient financial capacities is crucial for timely implementation of the investment project of gas transmission from North-East of Romania to Chisinau.

Table 5.
Main indicators monitored regarding environment and energy sector

	2014	2015	2016	2017[38]
Share of country's area provided with water supply system, %[39]	51,7	53,5	58,2	-
Share of country's area provided with sewerage system, %[40]	51,5	53,2	55,8	-
Electricity production,% of gross domestic consumption[41]	16	19,1	15,5	-
Electricity import, % of the total	84	80,9	84,5	-
Gas import, % of the total	100	99,9	100	-
Oil import, % of the total	99,1	99,2	99,3	-

Sources: National Bureau of Statistics, ANRE

INSTITUTIONS AND POLITICS: Justice Deficiencies and the New Electoral System – Sources of Instability

This chapter reports on the state of affairs in the political institutions and the rule of law in the country. It highlights the major issues related to political corruption and slippages noticed in the justice sector, which affect the public trust in the State, but also the country's image in the eyes of potential honest investors. The chapter ends with a set of recommendations, the accomplishment of which will revitalise the institutions and the judiciary.

ANALYSIS OF THE MAIN TRENDS AND DEVELOPMENTS

The credibility of institutions and of the Government as a whole has not improved significantly since 2016-2017. Authorities have not given up on the deficient policies criticised by the civil society, extra-parliamentary opposition and European partners.

The uninominal voting, the invalidation of Chisinau municipality election, the initiative to attract investments in exchange for citizenship, the endeavour to decriminalise the economic offences[42] emphasized an alienation of the governing party from the agreed and constructive state policies aimed at a democratic system of institutions and rule of law. However, these measures compromise other important actions carried out by authorities, meant to simplify the admission and residence conditions for potential investors[43], with positive effects on combating the small-scale corruption in the respective institutions.

The negative perception of the justice reform outcomes has intensified.

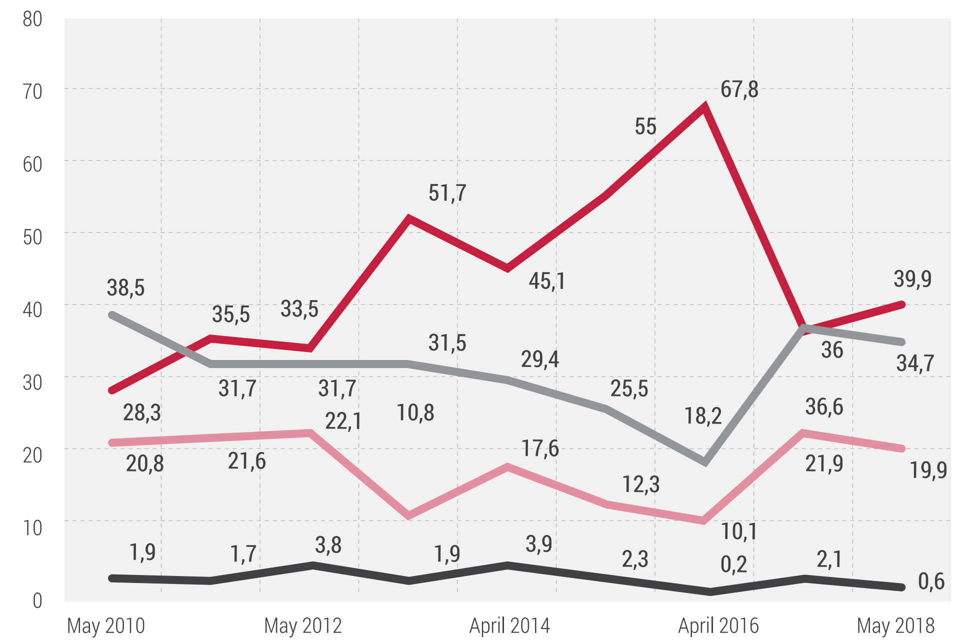
Selective justice in case of the banking system theft (Vlad Filat, Veaceslav Platon, Chiril Lucinschi, Ilan Shor), dismissal of judge Domnica Manole[44], conditions of judges' appointment[45] that lead to their politicization or inefficient disciplinary mechanisms[46], or the amnesty for the judges involved in corrupted schemes related to obtaining the Romanian citizenship[47] illustrate the depth and variety of deficiencies that undermine the security of the act of justice.

Nowadays, the judiciary consists to an extent of 60%[48] of judges that used to work before the justice reform started and, actually, having more younger judges is not necessarily associated with positive developments, which is also proven by the invalidation of the municipal election in Chisinau and upholding of this decision[49]. Survey data show

38. Data for 2017 are not available yet on ANRE and NBS website.
39. Statistical Yearbook 2017, http://www.statistica.md/pageview.php?l=en&id=2193&idc=263.
40. Statistical Yearbook 2017.
41. Calculations based on Energy balance of 2017; http://www.statistica.md/public/files/publicatii_electronice/balanta_energetica/BE_2017_eng.pdf
42. TV8, 14 March 2018, http://tv8.md/2018/03/14/proiectul-privind-decriminalizare-a-mediului-de-afaceri-la-ministerul-economiei-ce-prevederi-vor-fi-excluse/
43. The procedure for admission and residence of investors in the Republic of Moldova will be further simplified, 24 July 2018, https://gov.md/ro/content/procedura-de-intrare-si-sedere-investitorilor-republica-moldova-va-fi-facilitata-continuare
44. Ziarul de Gardă, 6 February 2018, https://www.zdg.md/stiri/stiri-justitie/ultima-ora-csm-refuza-sa-o-restabileasca-in-sistem-pe-ex-magistrata-manole-ati-avut-un-singur-scop
45. Hriptievschi N., Justice Sector Challenges Undermine the Rule of Law in the Republic of Moldova, April 2018, https://www.soros.md/files/publications/documents/Hriptievschi%20USAID_0.pdf
46. LRCM, 'Perception of Judges, Prosecutors and Lawyers on Justice Reform and Fight Against Corruption' Survey of December 2015, pages 42–43, available at: https://crjm.org/wp-content/uploads/2016/01/CRJM_2016_SurveyJustice-ENG.pdf
47. Amnesty of Judge Gavrilita, 24 July 2018, https://www.rise.md/amnistia-judecatorului-gavrilita/
48. Alexandru Tanase: 'The justice reform was a failure'. The Ministry of Justice wants to reduce the influence of SCJ over the judiciary, 31 January 2018, https://anticoruptie.md/ro/special/alexandru-tanase-reforma-justitiei-a-fost-un-esec-ministerul-justitiei-vrea-reducerea-influentei-csj-in-sistemul-judecatoresc
49. https://www.zdg.md/stiri/stiri-politice/doc-cum-motiveaza-judecatoria-chisinau-hotararea-de-invalidare-a-alegerilor

that trust in the judiciary is fluctuating and the reform of this sector has not decreased the negative perceptions. Thus, during 2016-2017, distrust in the justice sector exceeded 70%, worse than it was before the reforms started *(Figure 25)*. Moreover, Moldova lost access to EUR 28 million of non-reimbursable European assistance meant for the justice reform, which was stopped definitively because no progress was achieved in 2014-2015[50]. During 2016-2017, the Moldovan authorities did not express any interest in recovering this funding. In addition, the negative perceptions were reinforced by EU blocking Moldova's macro-financial assistance, due to the failure to meet the preconditions[51] related to the quality of democratic institutions, which provides for an independent judiciary.

Figure 25.
People's trust in justice, %



A great deal of trust
Somewhat trust
Somewhat distrust
Highly distrust

Source: *Public Opinion Barometer, bop.ipp.org*

There are suspicions about the origin of financial flows to political parties.

The overall financial discipline of the parties improved. In 2017, 93% of the 45 registered parties submitted their financial statements, compared to about 60% in 2016 (only 30 parties). None of the parties exceeded the maximum allowed level of accumulated revenue, which is MDL 101.3 million. At the same time, according to the 2017 data, donations represent the main source of revenue (32%), followed by state subsidies granted proportionally to the parties' results at the last local and parliamentary elections (31%) and revenue from economic activity (20%).[52] The reduction of the ceilings for donations provided by individuals and legal entities for

50. Moldova: EU cuts budget support programme for justice reforms, 11 October 2017, https://eeas.europa.eu/headquarters/headquarters-homepage/33723/moldova-eu-cuts-budget-support-programme-justice-reforms_en
51. P.Michalko: 'The justice reform has not been accomplished and it still expected', 16 July 2018, https://www.europalibera.org/a/p-michalko-reforma-justi%C8%9Biei-nu-s-a-realizat-%C8%99i-e-a%C8%99teptat%C4%83-(-video)/29368300.html
52. Promo-LEX, 2018, https://promolex.md/wp-content/uploads/2018/06/Raport_finantarea_partidelor_RO_21.06.2018.pdf https://www.zdg.md/stiri/stiri-justitie/doc-cine-sunt-judecatorii-care-au-mentinut-invalidarea-alegerilor.

the 'Electoral Fund' enacted by the Law No 154 of 20 July 2017[53], from 200 and 400 average monthly salaries down to 50 and 100 salaries, diminished partially the possibility of massive transfers of suspicious donations to parties. Nevertheless, in a non-electoral period the donations are poorly regulated, having specific ceilings in place for legal entities only (400 average monthly salaries).[54] Out of all parties that, according to surveys, might exceed the 6% threshold and enter the Parliament at the next election, PDM collected around MDL 80.5 million from individuals during 2016-2017 *(Table 6)*. Other parties, such as PAS and Platforma DA, depend on donations to a large extent, but they received almost 40-80 times less donations than the current governing party during the same period of time. Journalistic investigations revealed multiple cases when donations exceeded the annual income of the donors[55], which casts doubts on the origin of this money, while the legal framework is quite permissive and it does not oblige the authorities to fight this phenomenon. The aforementioned highlights the political parties' susceptibility to inflows of shady money, which can be used by some people with specific interests to influence the decisions adopted by the parliamentary parties..

The role of donations received from individuals and legal entities increases when parties are governing the country. This affects the performance of the parties and the decisions adopted by them, which are negatively perceived by the public. The overall trust of citizens in the party system is very low *(Figure 26)*, which affects their attitude towards parliamentary democracy, participation in elections and, respectively, the representativeness of the elected MPs.

Table 6.
Parties with chances to enter the Parliament after elections and cash donations made by individuals, %, MDL

	Survey, July 2018	Donations from individuals, 2016	% of total revenue in 2016	Donations from individuals, 2017	% of total revenue in 2017
Party of Socialists	32%	548,864	4	2,145,630	20
Action and Solidarity Party	15%	1,773,623	93	384,044	69
Democratic Party	8%	42,525,570	79	38,062,550	**63**
Platforma DA	8%	486,000	91	388,265	62

Source: *IRI.org, Central Election Commission*

53. Law No 154 of 20 July 2017 Amending and Supplementing Certain Legal Acts, Article 38, http://lex.justice.md/md/370943/
54. Law No 294 of 21 December 2007 on Political Parties, Article 26, http://lex.justice.md/md/327053%2520/
55. http://www.investigatii.md/ro/investigatii/economic/milioanele-democratilor-ii, https://telegraph.md/investigatie-desi-doneaza-ultimii-bani-la-partid-ion-ceban-isi-procura-bunuri-de-milioane-de-lei/

Concerns about the new electoral system have not cleared up yet.

Adopted in July 2017[56], the new electoral legislation makes it possible for 51 out of 101 MPs to be elected on the basis of single-member constituencies, based on a single round, which benefits PSRM and PDM. The authorities denied the external partners' concerns about the risk of the negative influence 'businessmen' and other personal interests might have over the candidates from single-member constituencies[57].

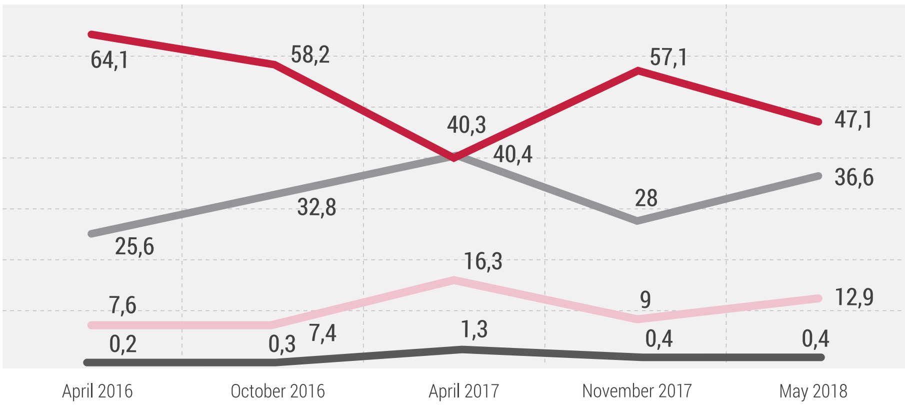


Figure 26.
Trust in political parties, %

Source: Public Opinion Barometer, bop.ipp.org

Moreover, the future composition of the Parliament might not be proportionate to the real popularity of the parties presented in the polls. The current ruling party is a conclusive case when a political formation multiplied its political power in the interval between elections. To be precise, PDM managed to almost double the number of its MPs in the Parliament (from 23 seats[58] after the 2014 election up to 42 seats in 2018) and increase its presence across the country (from 19 district council presidents in August 2017 up to 28 in 2018[59]). For these reasons, it is highly likely that parties with experience in non-electoral political expansion, such as PDM, might attract to their side a certain number of MPs out of the 51 elected based on the uninominal voting. At the same time, severe deviations were committed when the 51 single-member constituencies were established. Thus, around 15-30 constituencies were established with a deviation from the allowed 10% margin per constituency – 55,000-60,000 eligible voters.[60] The consequences of these deviations will influence the stability and functionality of the future Parliament and Government.

The proposal to revise the format of the decentralisation reform risks to degrade the local democracy.

The central authorities proposed to redesign the consultative group that coordinates the local administration reform. Consequently, the National Council for the Local Public Administration Reform, established in 2015[61], is supposed to take over the tasks of the Parity Commission on Decentralisation. The amendments proposed to the Law of 28 December 2006 were defined without consulting properly the local authorities and the dissolution of the Parity Commission will minimise the participation of local public authorities in the decentralisation.[62] Strengthening the po-

56. Law No 154 of 20 July 2017 Amending and Supplementing Certain Legal Acts, Article 73, http://lex.justice.md/md/370943/
57. Venice Commission, 16-17 March 2018, http://www.venice.coe.int/webforms/documents/?pdf=CDL-AD(2018)008-e..
58. http://www.e-democracy.md/elections/parliamentary/2014/
59. Unimedia, 18 July 2018, https://unimedia.info/stiri/politolog--despre-scrisoarea-presedintilor-de-consilii-raionale-si-a-primarilor-afiliati-cu-pdm-impotriva-uniunii-europene-158118.html
60. Promo-LEX, 23 November 2017, https://promolex.md/11014-circumscriptiile-electorale-uninominale-intre-oportunitate-politica-si-legalitate/?lang=ro
61. GD No 716 of 12 October 2015, http://lex.justice.md/md/361601/
62. Congress of Local Authorities (CALM), Opinion on the draft Law Amending the Law No 435 – XVI of 28 December 2006 on Administrative Decentralisation, 30 January 2018, http://www.calm.md/libview.php?l=ro&idc=6&id=4189&t=/Procesul-legislativ/Avize-Adresari-Declaratii-Note-informative-CALM/Avizul-CALM-la-proiectul-de-Lege-pentru-modificarea-Legii-nr-435-XVI-din-28-decembrie-2006-privind-descentralizarea-administrativa

sition of the National Council for the Public Administration Reform, which is dominated by central authorities, puts at risk the overall quality of the reform and can push LPAs away from the complex process of taking over and implementing policies at the local level. At the same time, assigning a too large role to the Council, which holds meetings sporadically[63] and not in line with the regulatory framework of its establishment[64], could decelerate the reform significantly. Generally, too little effort is made to promote the local-level public service in line with principles of professionalism, integrity, meritocracy and political neutrality.

In circumstances of a poor investment attractiveness, authorities start 'selling' the Moldovan citizenship.[65]

In violation of the legal period for public consultations (only 4 business days) and without taking into account the anti-corruption assessment carried out by the National Anti-Corruption Center,[66] the Government promoted the Law on Citizenship by Investment, which was adopted in final reading on 31 May 2018[67]. This law includes several sensitive issues: i) the names of the people who will be granted citizenship will be confidential; ii) there is no upper threshold for the number of citizenships to be granted (the initial text stipulated the threshold of 5,000) and the file examination period is extremely short (30 days); (iii) the body set up to assess the applications for citizenship will be coordinated by the Government and will thus bypass the duties of the President's Office in matters of citizenship; iv) the areas of strategic investment (real estate or government securities) proposed for the granting of citizenship do not correspond to the real needs of the country's economy (stipulated in the National Strategy for Investment Attraction and Export Promotion for 2016-2020), etc[68]. Although authorities believe that granting citizenship against investments might bring into the country EUR 1.3 billion[69], there are major risks that, despite some revenues, citizenships will be granted to people with shady reputation, whose funds might come from illegal sources (tax evasion, money laundering, etc.). Since 2017, the European institutions have raised more criticism[70] of such non-transparent investment mechanisms in some Member States (Malta), which facilitate the circulation of illicit money and therefore can affect the integrity of institutions and governments of beneficiary countries[71], but also create preconditions for crimes.[72] In the context of the Moldovan judiciary involvement in the Russian money laundering schemes (USD 22 billion) and the theft from the banking system, which is not fully investigated yet, the 'investment for citizenship' mechanism could create preconditions for new illegal schemes. This mechanism can affect the economic security, public order and even endanger the visa-free regime with the EU.

63. Expert-Grup, Monitoring report on the implementation of the Priority Reform Action Roadmap (5 July – 31 December 2017), 1 February 2018, https://www.expert-grup.org/media/k2/attachments/Raport_final_Monitorizarea_foii_de_parcurs_Ro.pdf

64. GD No 716 of 12 October 2015, point 12 'Council's meetings shall be held at least once every three months or more often', http://lex.justice.md/md/361601/

65. The applicants for Moldovan citizenship shall contribute with EUR 100,000 to the Sustainable Development Fund and invest EUR 250,000 in strategic sectors of the country.

66. Expert-Grup, Citizenship for investment or investment for citizenship?, 18 August 2017, https://www.expert-grup.org/en/biblioteca/item/1471-cetatenie-pentru-investitii-sau-investitii-pentru-cetatenie/1471-cetatenie-pentru-investitii-sau-investitii-pentru-cetatenie.

67. SAgora, 17 June 2018, http://agora.md/stiri/46661/legea-cetateniei-prin-investitii-este-inoportuna-si-paguboasa--sustin-deputatii-din-primul-parlament

68. Besides, the amount of money needed to be invested in order to obtain the citizenship is quite low (between EUR 100,000 and EUR 250,000), which is a negative signal for the value of investments in the country. At the same time, the requirement to invest in GS will create more debt for the State, which will have to reimburse the value of the investments to the 'new citizens'. Moreover, a testing period (1-2 years) is missing, for the authorities to be sure that investments are true, similarly to how it is done in other countries where such investment attraction mechanisms exist.

69. Timpul, 17 July 2018, https://www.timpul.md/articol/opinie----obinerea-cetaeniei-prin-investiii-lucru-benefic-sau-nu-pentru-r--moldova-133218.html

70. European Parliament Mission to Malta, December 2017, http://www.europarl.europa.eu/cmsdata/135961/report-mission-malta.pdf

71. http://www.independent.com.mt/articles/2018-06-22/local-news/European-Commission-urged-to-investigate-Malta-visa-racket-6736192231

72. Murdered Maltese Journalist was Investigating Island's Golden Visas, 18 April 2018, https://www.occrp.org/en/thedaphneproject/murdered-maltese-journalist-was-investigating-islands-golden-visas

POLICY RECOMMENDATIONS:

Authorities together with civil society and external partners must develop an 'action plan' for justice reform.

The situation in the justice sector does not only erode the trust of local and foreign investors in the act of justice, but also erodes the citizens' trust in all state institutions. An 'action plan' might include the new 2019-2020 Judiciary Reform Strategy and other related activities that might raise the accountability of the justice sector towards citizens. This plan must include measures meant to combat corruption and restore the integrity of the people working in this system, particularly judges' integrity.

Improve the record-keeping tools and lower the ceiling for cash donations from individuals to political parties.

It is imperative to revise the ceilings for donations from individuals and legal entities, which were decreased in 2017, but also to have more robust reporting on the origin of donations, in order to prevent the flow of illicit money to political parties. This includes amending the CEC Regulations on Political Parties' Financial Reporting and the legislation on political parties.

Enhance as much as possible the existing electoral legislation in order to clarify and improve the procedures for independent candidates and political parties.

Although the ruling party rejects the recommendations of the Venice Commission and of the civil society, efforts must be directed at removing the obstacles that might further diminish competition among candidates and, respectively, increase the degree of non-representativeness of the future Parliament. This relates to the procedures of issuing integrity papers, establishment and operation of electoral councils in single-member constituencies, electoral funding for candidates and parties, etc.

Strengthen the structure that ensures the participation of local authorities and give up on the proposal to dissolve it.

The participation and consultation of local authorities on the decentralisation of public administration is critical, that is why the Parity Commission must be strengthened, not annihilated. At the same time it is necessary to toughen the rules on the operation of the National Council for the Local Public Administration Reform, which today is a passive platform of interaction among the stakeholders involved in the reform. It is also crucial to invest massively in the institutional and operational empowerment of LPAs, because they need knowledge and resources to be able to deliver high-quality public services.

Revise urgently the Law on Citizenship by Investment in order to embed in it additional anti-corruption filters.

The regional context points out that such investment mechanisms are used by doubtful people involved in unlawful activities (tax evasion, money laundering, etc.). For the security of economy and public order, on which the visa-free regime with the EU is dependent, authorities must amend the law and: i) consult additionally the Venice Commission about the text of the law; ii) include the President's Office in the citizenship granting procedure; iii) introduce the residence permit as an intermediary stage instead of granting the citizenship immediately; iv) extend the examination period for citizenship application files up to 3-6 months; v) fix a limit for the number of citizenships to be granted; vi) revise the areas that can benefit of investments (agriculture, energy, road infrastructure, education, textile production, etc.).

Table 7.
Main indicators monitored with regards to the situation of political institutions

	2015	2016	2017
Value of the irregularities and deviations in public finance management (MDL) [73] [74]	**17,38**	**20,83**	**-** [75]
Verdicts on corruption cases, %	**85**[76]	**84**	**90**
Corruption Perception Index, Transparency International	**103** (of 168 countries)	**128** (of 176 countries)	**122** (of 180 countries)
Draft laws discussed in public consultations, % [77]	**81**	**-**	**72,4**
Global Competitiveness Report, Institutions	**123 of 140** countries	**128 of 138** countries	**119 of 137** countries

Surces: *NAC, Court of Accounts, Transparency International, World Economic Forum*

73. *Court of Accounts, Activity Report for 2016, http://www.ccrm.md/storage/upload/reports/postari/139/pdf/5907c1ba3b2cb54029cc3e54cc61a307.pdf.*
74. *Audit of public institutions: 378 entities - in 2013; 355 entities - in 2014; 495 entities - in 2015; 575 entities - in 2016.*
75. *The Court of Accounts did not publish the Report on the Management and Use of Public Financial Resources and Public Property in 2017 until 24 July 2018, http://www.ccrm.md/rapoarte-anuale-1-20*
76. *NAC Activity Report for 2015 indicates the percentage for 2010-2012*
77. *Data collected based on the State Chancellery Reports, https://cancelaria.gov.md/ro/advanced-page-type/rapoarte-0*

ABOUT EXPERT-GRUP

WHO WE ARE

Expert-Grup is a Moldovan non-government and not-for-profit organisation that specialise in economic and policy research. Expert-Grup does not represent any economic, corporate or political interests. As an independent organisation, Expert-Grup reflects the ideals of young intellectuals from Moldova, who set up the institution with the purpose of contributing to the development of the Republic of Moldova. Among other types of organisations in Moldovan civil society, Expert-Grup positions itself as a politically and ideologically neutral think-tank.

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Our core activities are economic analysis and making forecasts, as well as public policy research. In this area, we provide a wide range of analytical products and services that help our beneficiaries to take decisions supporting the development path of the Republic of Moldova. Our key competence consists in the ability to provide professional, objective and high-quality research in such areas as:

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- *political economy;*
- *public finance;*
- *human development and poverty reduction;*
- *labour market and consumer behaviour;*
- *foreign trade;*
- *financial markets;*
- *economy of European integration;*
- *economic analysis by sectors;*
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- *energy and economy of environment.*

PARTNERS AND DONORS

During the period 2006–2016, Expert-Grup implemented over 100 research and advocacy projects in different areas related to economic research and public policies. Over 130 experts, both affiliated and not affiliated to our institution, from the Republic of Moldova and abroad, were involved in these projects. We have worked with such international institutions as Soros Foundation-Moldova, East Europe Foundation, Konrad Adenauer Foundation, Balkan Trust for Democracy, Black Sea Trust, Friedrich Ebert Foundation, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for Development and Cooperation, UK Department for International Development. In 2010 and 2012, Expert-Grup was selected as a 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.

WHO WE ARE

FES is a German political social-democratic foundation, which aims to promote democracy, peace, international understanding and cooperation. FES performs its tasks in the spirit of social democracy and participates in public debates to identify social-democratic solutions to current and future issues in 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 the following:

DEMOCRATISATION AND POLITICAL PARTICIPATION

The Republic of Moldova faces challenges related to strengthening its democratic institutions and developing a democratic culture that would make the country fully compliant with the standards of the EU. FES contributes to this by promoting political participation in civil society organisations, political parties and local public administration bodies. In this area, FES puts a particular focus on building the capacities of citizens in the regions. Citizens should be trained to follow critically and participate in public debates in order to monitor decision-makers, express their views and act in their own interests. Therefore, through its activities, FES has committed itself to promoting participatory democracy and citizens' civic and political culture at the local level.

EUROPEAN INTEGRATION

The Republic of Moldova is a part of the European Neighbourhood Policy and the Eastern Partnership. FES aims to support the European integration process of the country. Through a number of tools, such as radio debates, news bulletins, policy papers, publications and conferences, FES focuses on the main challenges related to European integration, facilitating people's access to up-to-date and reliable information on the topic, improving the dialogue between the civil society and decision-makers as regards the requirements for successful European integration, and strengthening, in this way, the efforts of Moldovan authorities to integrate into the EU. Additionally, FES supports non-government organisations in contributing to a peaceful resolution of the Transnistrian conflict, as a precondition for successful European integration in the long run.

ECONOMIC, SOCIAL AND ENVIRONMENTAL POLICY

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

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