

Moldova
2021 SCD Update:

Building Resilience and Enhancing
Competitiveness

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ACRONYMS AND ABBREVIATIONS

ANRCETI	National Regulatory Agency for Electronic Communications and Information
B40	Bottom 40 percent of the income distribution
BPO	Business Process Outsourcing
CFM	Calea Ferată din Moldova
CIT	Corporate Income Tax
CPSD	Country Private Sector Diagnostic
DCFTA	Deep and Comprehensive Free Trade Area
DRM	Disaster Risk Management
ECA	Europe and Central Asia
EaP	Eastern Partnership
EnC	Energy Community
ES	Enterprise Survey
EU	European Union
FDI	Foreign Direct Investment
FEZ	Free Economic Zone
FTA	Free Trade Agreement
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GPP	Green Procurement Policies
GVC	Global Value Chains
HACC	High Anti-Corruption Court
HBS	Household Budget Survey
IMF	International Monetary Fund
LPAs	Local Public Authorities
LMFS	Labor Market Forecast Survey
MEDT	Ministry of Economic Development and Trade
MICS	Multiple Indicator Cluster Surveys
MSMEs	Micro, Small, and Medium Enterprises
NBCOs	Non-Bank Credit Organizations
NBM	National Bank of Moldova
NBS	National Bureau of Statistics
NCDs	Noncommunicable Diseases
NCFM	National Commission for Financial Markets
NDC	Nationally Determined Contribution
NEET	Not in Education, Employment, or Training
NIA	National Integrity Authority
NPL	Non-Performing Loans
OECD	Organization for Economic Cooperation and Development
OOP	Out-of-Pocket
PEFA	Public Expenditure and Financial Assessment

PFM	Public Financial Management
PIT	Personal Income Tax
PPPs	Public-Private Partnerships
PPP	Purchasing Power Parity
RE	Renewable Energy
SAPO	Specialized Anti-Corruption Prosecutor's Office
SCAs	Savings & Credit Associations
SCD	Systematic Country Diagnostic
SDA	Sustainable Development Account
SDGs	Sustainable Development Goals
SMEs	Small and Medium Enterprises
SOE	State-Owned Enterprises
SPS	Sanitary and Phytosanitary
SSSU	State Statistics Service of Ukraine
T60	Top 60 percent of the income distribution
TVET	Technical and Vocational Education and Training
VAT	Value-Added Tax
VET	Vocational Education and Training
WSS	Water and Sanitation Services
WB	World Bank
WDI	World Development Indicators
WTO	World Trade Organization

TEAM MEMBERS AND ACKNOWLEDGMENTS

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The team is grateful for comments received from Cristian Nacu, Jason Brett Pellmar, Aimilios Chatzinikolaou, Kazumasa Oba (International Finance Corporation, IFC), Olanrewaju Malik Kassim (Multilateral Investment Guarantee Agency, MIGA) and the teams across the World Bank that participated at internal discussions and the decision meeting. The team is also grateful to Peter Kjaer Milne for editing the report.

PREAMBLE

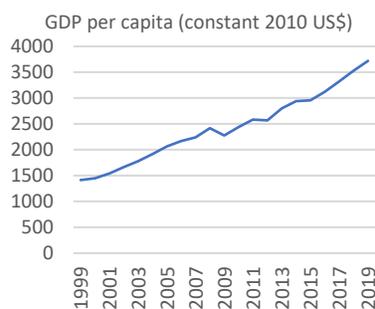
This Systematic Country Diagnostic (SCD) Update was prepared before the start of the war in Ukraine.

Given the uncertainty surrounding the unfolding conflict, the SCD Update does not attempt to assess the medium- and long-term effects of the war on Moldova's development challenges and opportunities. Nonetheless, it is likely that Moldova's near-term prospects will be adversely affected by the war. Over the first weeks of the conflict, Moldova has received a massive influx of refugees, half of whom remain in the country so far and represent over 4 percent of Moldova's population. In addition, Moldova is a small landlocked economy which relies heavily on imports to meet its food and energy needs, and its infrastructure (e.g. roads, railway, electric powerlines, and gas pipelines) primarily uses Ukrainian infrastructure networks to connect with the rest of the world. Even before the start of the war, the price of food had increased by almost 20 percent and the price of gas by about 400 percent in 2021. The disruption in the supply of food, energy and commodity imports from Ukraine and the Russian Federation is expected to put further upwards pressure on prices, which will affect the purchasing power of families, particularly the poor, and the competitiveness of firms. The conflict is also expected to have a significant impact on remittances given that about 70 percent of Moldovan migrants live in the Russian Federation and Ukraine, generating about one quarter of total remittances (about 4 percent of GDP). As a result, the medium-term fiscal position of Moldova is expected to further weaken both from a decline in revenue, due to the weakening of economic activity, and from an increase in social spending to mitigate the impact on increase in food and gas prices and the influx of refugees, squeezing resources for long-term development priorities. Despite these new challenges, we expect that the challenges and opportunities identified by the SCD Update remain valid and will need to be tackled to ensure sustainable growth in the medium to long term. Through ongoing and new advisory services, analytics and TA, the Bank will continue to closely monitor and assess the impacts of the recent crisis, and will explore avenues to address some of these new emerging challenges, including as part of the CPF preparation process

EXECUTIVE SUMMARY

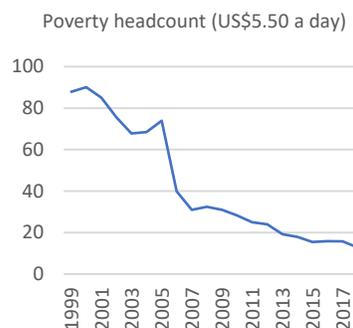
Decades of strong yet volatile economic growth have improved the living standards of the Moldovan population, but the country remains one of the poorest in Europe. Between the late 1990s and 2019, per capita GDP expanded at an average annual pace of 4.9 percent. Solid growth resulted in strong poverty reduction, from close to 90 percent in the late 1990s to 13 percent by 2018 (based on the upper middle-income poverty line of US\$5.50 a day in 2011 purchasing power parity [PPP]). Non-monetary dimensions of welfare improved too, as demonstrated by substantial increases in life expectancy and educational attainment, in particular in tertiary education. However, Moldova, while being a middle-income country, remains one of the poorest countries in Europe, characterized by large urban-rural disparities in living standards¹ and a high degree of inequality of opportunity,² crystalized mainly across the spatial dimension. Poor service delivery, mainly in rural areas, results in lagging human development outcomes and, hence, a lower likelihood for disadvantaged children to acquire the skills necessary for productive employment and upward mobility.³

Figure 1: Solid growth since the late 1990s



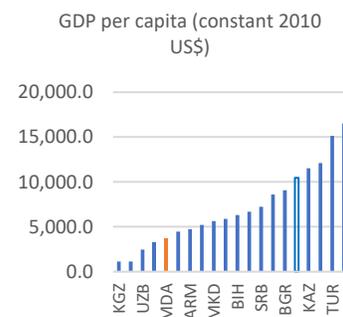
Source: WDI, 2021.

Figure 2: Strong poverty reduction, though slowing in recent years



Source: WDI, 2021.

Figure 3: Moldova remains among the poorest countries in ECA



Source: WDI, 2021.

Moldova's past development and recent performance have been shaped by its unique structural characteristics in terms of geography, demography, and legacy:

- **Geography:** Moldova is a small landlocked country bordering Romania and Ukraine, and centrally located between the European Union (EU) and the Russian Federation. As a result, its economy is highly integrated into global markets, with levels of openness exceeding those of other countries at comparable levels of income per capita (with a trade-to-GDP ratio of 120 percent). However, most of Moldova's trade openness is explained by its high share of imports. High imports are also

¹ While the recent increase in poverty has mainly occurred in urban areas (an increase of 3 percentage points), rural areas remain much poorer (rural poverty rate of 35.3 percent vs urban one of 14.0 percent). As a result, poverty is predominantly a rural phenomenon, with over 82 percent of the poor being less educated and older, and self-employed in agriculture living outside Chişinău or other cities.

² The gap in access to opportunities as measured by the Human Opportunity Index is 34 and 52 percent for urban and rural areas, respectively.

³ The PISA results in science reveal a gap between students living in rural and urban areas that is equivalent to 1.5 years of schooling, while the employment rate in rural areas is, respectively, 14 and 9 percentage points lower for men and women, compared with their peers in urban areas. Moreover, nearly 80 percent of informally employed workers live in rural areas.

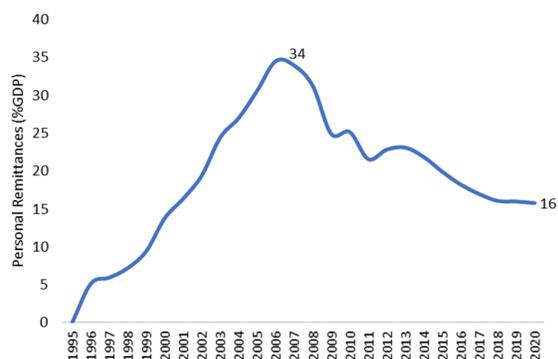
the result of remittances stemming from one of the largest outflows of domestic workers in both Europe and globally, due to the free movement of people both to the EU and to the countries of the Commonwealth of Independent States. Moldova's geographic position also makes it highly vulnerable to the effects of climate change, as recently demonstrated by the 2020 drought. The increasing frequency of extreme weather events is negatively affecting economic performance, in particular in agriculture, posing a threat to poverty reduction and shared prosperity.

- ***Demography:*** Moldova is among the European countries with the largest diasporas, and the most rapidly shrinking and aging populations. Since its independence from the former Soviet Union in 1991, the population has dwindled by almost one-quarter and is expected to shrink by another one-third by 2060. Large-scale migration of the working-age population, combined with decreasing fertility rates, has accelerated the pace of aging in Moldova, despite relatively low life expectancy. The result of such a large diaspora of the most productive segment of the population, combined with a steady decrease in the local working-age population and low labor force participation, is an economy that relies heavily on remittances. In contrast, internal migration and urbanization have been slow, with rural residents still representing the majority of the population.
- ***Legacy:*** Moldova's legacy of being part of the former Soviet Union is reflected in an ethnically diverse population, a highly fragmented local administration, a large economic footprint of the state, and the status of Transnistria, which remains an unresolved conflict. First, Moldova's population comprises, alongside ethnic Moldovans and Romanians, a number of other ethnic groups, including Ukrainians, Russians, Gagauz, Bulgarians, and other ethnic groups, accounting for almost one-quarter of the population. This is one of several factors contributing to a polarized electorate divided between those leaning toward closer integration with the EU on one side, and those favoring the Eurasian Economic Union on the other. Second, Moldova's current administrative-territorial structure is suboptimal given the size of the country and its population (estimated at 2.7 million in 2019), leading to ineffective local governance. There are 35 top-tier local administrative jurisdictions (including two cities, 32 *raions* [districts], and the Autonomous Territorial Unit, Gagaúzia) and 896 bottom-tier jurisdictions with a median land area per municipality of only about 3 square kilometers. Half the rural bottom-tier municipalities have fewer than 2,000 residents, and more than one-quarter have fewer than 1,500 residents. Moreover, the predominant role of state-owned enterprises (SOEs) and entrenched vested interests in various sectors of the economy have limited the development of the private sector, constrained the emergence of new products and sectors, and led to an uneven playing field. Finally, Transnistria, which declared independence from Moldova in 1990, has no international recognition, and the status of the region remains unresolved and subject to ongoing settlement negotiations.

The juxtaposition of these structural characteristics has resulted in a growth model that has yielded growth and poverty reduction but has failed to nurture structural transformation and competitiveness.

The lack of enough good job opportunities in Moldova, combined with large wage differentials with the EU and the Russian Federation, has generated one of the largest diasporas in Europe, which has produced a steady flow of remittances, significantly contributing to income growth and filling the gap of negative domestic savings. However, remittances have mostly fueled consumption, creating a self-perpetuating vicious cycle that is detrimental to productivity, competitiveness, and the creation of good jobs. Remittance-fueled consumption has been met mainly by imports, while the supply response has been limited to the agriculture and non-tradable sectors. The factors that have limited business opportunities and job creation in tradable sectors have also affected the incentives of Moldovans to invest in higher education, their desire for full-time positions in the public sector, informality and underemployment in agriculture, and low labor force participation. Further migration has been the sole valve to release the

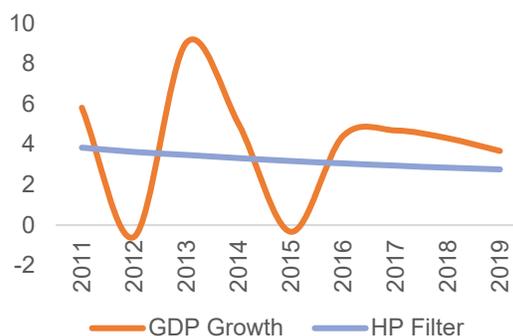
Figure 4a: Remittances as a share of GDP (1995–2020)



Source: WDI, 2021.

labor market pressure and an increase in real wages despite low productivity and high reservation wages have been a byproduct of such a model.

Figure 4b. Steadily declining potential growth (2011-2019)



Moldova’s structural characteristics, coupled with governance and institutional challenges, have supported the persistence of this self-perpetuating vicious cycle. Gaps in the rule of law, state capture by vested interests, weak institutions, political impasses, the predominant role of SOEs, and political pressures to protect privileged pensions or public salaries weigh heavily on the reluctance to update the country’s economic model. Other underlying factors that support the persistence of this cycle are common to small states, including a narrow production base due to high input costs and a small internal market, government revenues that depend on tariffs and indirect revenues, and limited implementation capacity. In addition, Moldova’s vulnerability to natural disasters, as most recently demonstrated by the 2020 drought, results in boom-and-bust cycles that hinder the ability of the Government to implement steady long-term growth strategies. There is an urgent need to tackle long-awaited governance and institutional challenges to lay the foundations for a competitive economy and an inclusive and sustainable growth model and build resilience to shocks.

As pointed out by the 2016 Systematic Country Diagnostic (SCD), the current economic model is unsustainable and unable to support Moldova’s ambitions of attaining a convergence of incomes and standards of living with the EU. With some key past drivers of poverty reduction, such as remittances (Figure 4) and public transfers, displaying a downward trend, poverty reduction is slowing down. Over the past five years, poverty only declined significantly in 2018 as a result of a substantial real increase in pensions and wages, which derailed the needed fiscal consolidation efforts. While the recent growth performance reached an average of about 4 percent per year, this was mainly due to the rebound from the 2015 recession and favorable climatic conditions. However, long-term potential GDP has been on a declining trend and has lost 1 percentage point over the past decade (Figure 5).

COVID 19 and the 2020 drought have exposed the intrinsic vulnerabilities of the current economic model. With a decline in GDP of 7 percent in 2020, the impact of the COVID-19 pandemic combined with the drought has been one of the most severe in Europe. The shock has had a large and heterogenous impact across households, firms, sectors and geographical areas.⁴ Poverty (based on the upper middle-income poverty line) is expected to have increased by 2.7 percentage points in 2020 (from 12.9 percent

⁴ Employment dropped by 4.3 percentage points in 2020, with an estimated 62,000 jobs lost, of which the majority were in trade and hospitality two of the most dynamic sectors in the past decade. Young workers and micro firms have been the most badly affected.

to 15.5 percent⁵), as households faced the impact of the crisis, including loss of employment and earnings, a small reduction in remittance receipts, and the return of vulnerable migrants from abroad who then struggled to find jobs. In addition, food insecurity—already twice as high as ECA average⁶—has significantly worsened by the recent rapid food price increase and the combined impact of COVID 19 and the drought. It is still however too early to capture the long-lasting socio-economic impact of the COVID-19 pandemic given the lack of data.

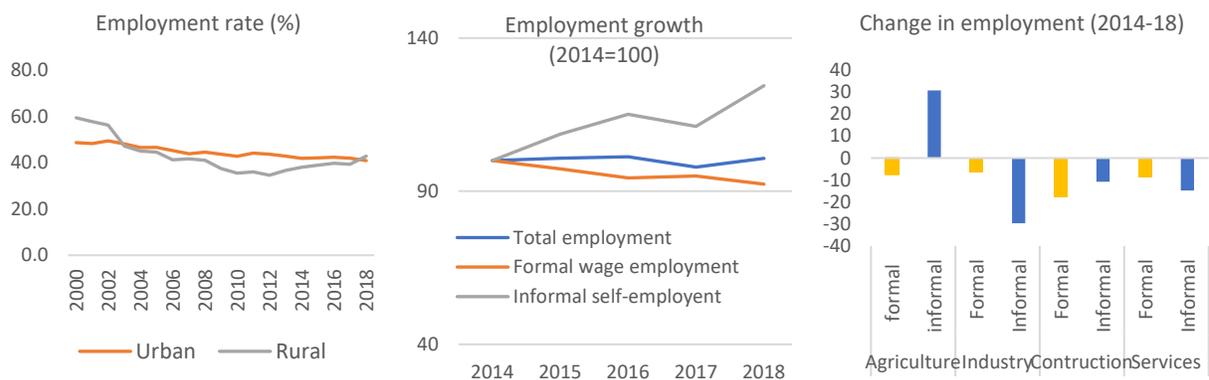
The 2016 SCD called for a new growth model more reliant on private sector growth and less reliant on remittance-financed consumption. The 2016 SCD identified two pathways toward sustained poverty reduction and shared prosperity: (i) creating more and better jobs; and (ii) building up and protecting the stock of assets of the population. To broaden the economy’s narrow production base, boost job creation, and reduce the heavy dependence on imports, the growth model needed to be amended across the board through new governance, macroeconomic, structural, and social policies. The two pathways were thus underpinned by six priorities, of which three were considered “top priorities”: (i) strengthening the rule of law and the accountability of institutions; (ii) improving the efficiency and equity in service delivery; and (iii) increasing the quality, equity, and relevance of education and training systems.

The findings of the 2016 SCD remain relevant to today’s context and its recommendations are even more pressing. Since 2016, the pace and type of growth have not translated into broad-based job creation, particularly in the tradable sector. Despite efforts and progress in a number of reform areas, the failure to address crucial structural challenges related to governance and institutional weaknesses, combined with Moldova’s vulnerability to external factors (i.e., stagnating or declining growth in partner economies and climate volatility), have hampered economic activity. Though employment rates have increased in recent years (until the COVID-19 pandemic reversed this trend), this was exclusively driven by an increase in informal employment in subsistence agriculture, mainly by older people in rural areas. Formal employment in contrast declined in all sectors (Figure 6). As a result, household income growth was driven by an increase in wages among those who were employed, and by public transfers, which underpinned income growth of the poor. The decline in remittances was a drag on household income growth, highlighting the vulnerability of a growth model based on exporting the labor force. At the same time, large spatial gaps in access to opportunities persist, with rural dwellers having far worse access to key services and basic infrastructure, constraining their ability to accumulate human capital and, hence, access good jobs.

⁵ Based on the national poverty line, poverty increased from 25.2 percent in 2019 to 26.8 percent in 2020, with urban areas being most affected.

⁶ High with 4.5 percent of the population living in households classified as severely food insecure Food and Agriculture Organization of the United Nations, 2019

Figure 5: Employment trends in Moldova, 2014–18



Source: LFS, 2000–2018.

Source: LFS, 2014–2018

Source: LFS, 2014–2018

However, high political volatility in Moldova has hampered coherent and sustained reform efforts to support a sustainable and inclusive long-term growth agenda. Since 2015, the country has changed six governments and has undergone a constitutional crisis after the parliamentary elections held in February 2019. As already observed in the 2016 SCD, political instability not only delays reforms, but also feeds into inefficient spending and short-termism. The political instability in recent years has also negatively impacted the population’s trust in institutions. With governance and institutional strengthening at the core of its program, the new reformist Government has the opportunity to reverse this trend.

Moreover, the increased frequency of exogenous shocks has diverted the attention and the efforts away from the long-term agenda. While the COVID-19 pandemic was unexpected, the 2020 drought was the latest in a long and increasingly frequent series of weather-related events that are being exacerbated by climate change. Since 2000, Moldova has witnessed an average of one major natural disaster every three years. Moreover, the 2021 energy crisis has highlighted the country’s untenable energy balance, characterized by expensive, volatile and undiversified energy sources and imports from one single supplier.

Therefore, there is an urgent need to address the structural impediments in order to revert the declining trend of potential growth, increased vulnerability and stagnant standards of living. The small size of the economy and private sector base, the lack of a level playing field, and therefore investment confidence, population aging, and climate change are expected to suppress productivity and constrain future growth, also for the non-tradable services, which have been the key drivers of recent economic growth. Moreover, net exports are increasingly a drag on growth, widening the current account deficit. These are clear signs of a deterioration in the long-term economic prospects of the country and that the current growth model has reached its limit.

With the broad development narrative largely unchanged, the 2021 SCD Update concludes that the previously identified pathways are still valid, but adds more urgency to institutional strengthening and more emphasis on resilience. While Pathway 1 “*Creating more and better jobs*” remains valid, the 2021 SCD Update stresses the importance of not only strengthening human capital but also ensuring equal opportunity in access to key public services (Pathway 2: “*Building human capital and ensuring equal opportunities*”), given the large spatial and socioeconomic gaps in access to important public services and opportunities, including but not limited to education.

Figure 6. 2016 SCD Framework

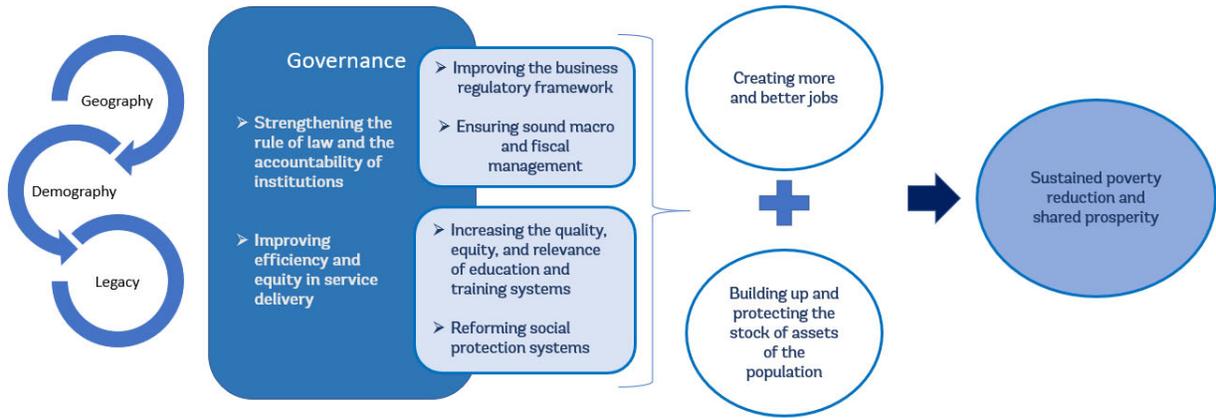
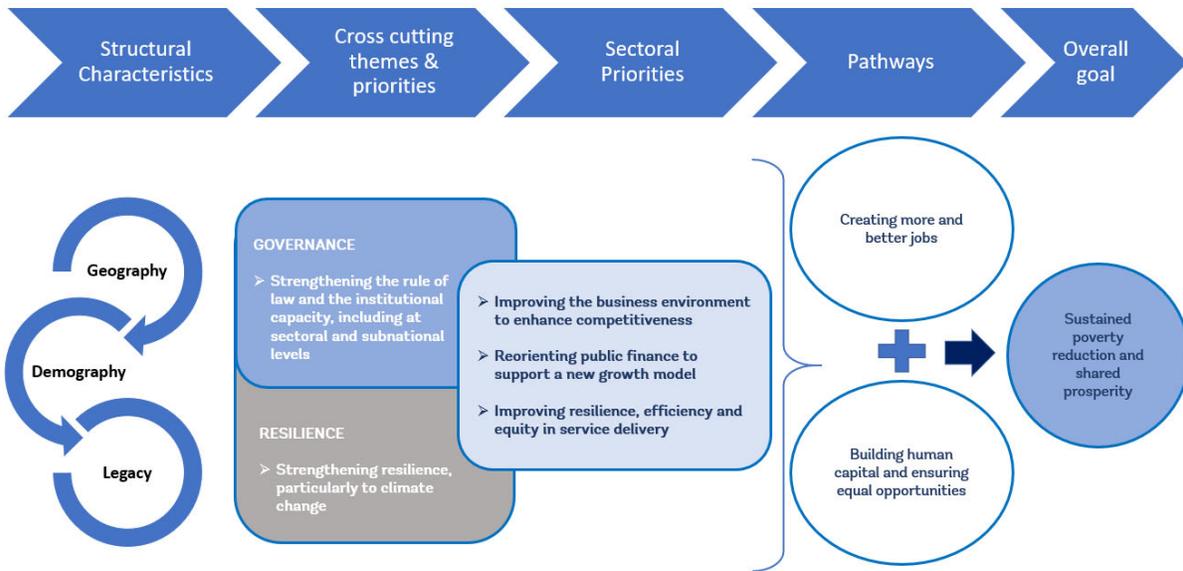


Figure 7. 2021 SCD Update Framework



The 2021 SCD Update revisits the 2016 SCD Framework to help accelerate efforts to support job creation, and strengthen human capital and equality of opportunity. The 2021 SCD Update identifies two cross-cutting priorities and three sectoral ones. The cross-cutting priorities of *governance* and *resilience* are necessary conditions to attain either of the pathways, while the other priorities are more closely linked to one pathway or the other. The *business environment* and *public finance* priorities are linked more to the pathway of creating more and better jobs through facilitating firms’ entry and growth, and creating a stable and predictable environment for private investment, both foreign and domestic. The *public service delivery* priority relates more to the pathway of building human capital and ensuring equal opportunities through improving the efficiency of public spending, strengthening critical services in rural areas, and weakening the link between circumstances (location and households’ economic status) and access to productivity-enhancing opportunities (education, health care, water, etc.).

The 2021 SCD Update is consistent with the ongoing Country Private Sector Diagnostic (CPSD) for Moldova. The CPSD proposes to explore how, in the post-pandemic world, Moldova can reignite economic growth and social inclusion by harnessing private investment in critical enabling activities and tradable sectors. By boosting private investment in those activities, Moldova would be able to create new and better jobs, and thereby reduce outward migration, achieving more sustainable economic growth rates. As the relative importance of remittances declines, Moldova will face the challenge of unleashing new and more sustainable sources of economic growth. Foreign direct investment (FDI) and exports can drive private-sector-led growth, but they require scale. Against this background, the CPSD proposes to carry out three detailed sector assessments: (a) Renewable Energy; (b) High-Value Added Agribusiness and Food Processing; and (c) ICT Services and Business Process Outsourcing (BPO).

The reforms identified by the 2021 SCD Update are congruent with those required to benefit from the EU integration. The road to EU integration is long and challenging but opens the opportunity to unlock growth potential and convergence with EU economic, judicial, social, and environmental standards. Seizing the opportunity of integration with the EU by strengthening the rule of law and democratic institutions, reinforcing public administration and institutional capacity, and reforming economic policies and governance, would lead to more rapid gains in productivity and competitiveness. The country has also the opportunity to take advantage of the EU green deal, increasing efficiency and diversification of energy sources including renewables, and in turn Moldova's overall competitiveness and resilience.

The 2021 SCD Update proposes the following priorities:

- I. **Strengthening the rule of law and institutional capacity, including at the sectoral and subnational levels.** Governance remains a cross-cutting priority. Moldova's development continues to be hampered by systemic corruption, poor governance, political pressures from vested interests, and the politicization of regulatory institutions, as well as the judiciary, and the customs and tax services. An uneven playing field and lack of competition are also prominent due to the presence of a wide group of state-controlled institutions and vested interests in most sectors of the economy. This SCD Update also emphasizes the need to accompany high-level governance efforts with the strengthening of institutional capacity at the sectoral and subnational levels. Most of the attention in recent years has been concentrated on the national/central-government level. Complementing these high-level actions on governance and the rule of law with an agenda of improving institutional capacity and accountability across sectoral ministries, agencies, and local governments is also essential for private sector development, FDI attraction and retention, and improved service delivery. These actions include: (i) strengthening fiscal institutions to enhance fiscal resilience, and strengthening the independence and supervisory authority and capacity of the National Bank of Moldova (NBM) and the National Commission for Financial Markets (NCFM) to enhance financial stability and governance; (ii) developing risk-sharing mechanisms, such as adopting a deposit guarantee scheme for banks and Saving and Credit Associations; (iii) strengthening institutions at the sectoral level to improve their strategic investment planning and implementation capacity; (iv) reforming a number of sectoral agencies and SOEs to improve service delivery (e.g., the National Energy Regulatory Agency [ANRE] in energy, Apele Moldovei in water, and Moldtelecom in telecommunications); and (v) providing a clear mandate to the National Commission for Emergency Situations for facilitating the process of strategy development and overseeing implementation of a national Disaster Risk Management (DRM) strategy, among others. This process should be accompanied by a complete stocktaking of the existing SOEs with emphasis on assessing the rationale for their operations in competitive and contestable sectors, with the aim of reducing the state's footprint in such sectors and enabling greater private sector participation.

- II. **Strengthening resilience particularly to climate change.** Vulnerability to external shocks is an inherent characteristic of small open economies and therefore building resilience is of paramount importance. While resilience was discussed in the 2016 SCD, the recent 2020 drought, COVID-19 crisis, the urban flooding in Chişinău, and the most recent energy crisis have all underscored the urgency for Moldova to build resilience against shocks and increase preparedness to mitigate their major socio-economic consequences. Moldova is highly vulnerable to climate change and scores poorly on the institutional readiness to adapt to the effects of climate change.⁷ Natural disasters, such as earthquakes, are a constant threat to Moldova and some, in particular droughts and floods, are expected to increase in frequency and intensity with climate change. This poses serious risks to the economy—in part due to the lack of adaptation investments in the agriculture sector, a key sector of the economy—weighing on fiscal balances and, most importantly, on the wellbeing of vulnerable populations. While efforts have been made to reduce the agriculture sector’s vulnerability to climate change by improving irrigation services, strengthening the existing agriculture insurance scheme, and promoting climate-smart agriculture practices, the uptake of recently rehabilitated schemes, such as those supported under the Sustainable Development Account (SCA), remains low, leaving most of the sector highly vulnerable to shocks.⁸ The DRM and climate resilience reform agenda will need to comprise multiple elements, ranging from improved risk identification, better risk reduction, and enhanced preparedness, to stronger financial protection mechanisms, and resilient recovery and reconstruction policies. As discussed under *Priority 1*, on the institutional front, providing a clear mandate to the National Commission for Emergency Situations for facilitating the process of strategy development and overseeing implementation of a national DRM strategy are critical for the successful implementation of strategic reforms. Other institutional reforms are also deemed crucial, for example in the water, energy, railway sectors, to name a few. The reform agenda will also need to ensure that priorities are adequately mainstreamed within existing national programs, together with providing incentives to move toward a greener and more carbon neutral new growth model, while carefully assessing and mitigating potential distributional effects to make sure that the transition is fair. A successful transition to a new growth model will also need to consider mitigation efforts by both reducing greenhouse gas (GHG) emissions⁹ and taking advantage of the EU green deal. These aspects will be particularly important for the energy sector where the relatively high energy intensity is matched by volatile and expensive single-source energy imports. Even if ambitious climate policies are adopted, natural gas is expected to remain a substantial part of the energy mix at least until 2040, mainly because of the significant energy demand for heating in the industry and residential sectors where decarbonization will depend on new technologies that are unlikely to become competitive in the near to medium term. Thus, increasing energy efficiency, diversifying energy sources including renewables, and broadening alternative energy suppliers should be important considerations for Moldova’s overall competitiveness and resilience.
- III. **Improving the business environment to enhance competitiveness.** Raising private sector competitiveness is retained as a first sectoral priority, but the 2021 SCD emphasizes that it is not just the regulatory framework that is holding back the private sector but a broader set of issues, including gaps in infrastructure and inputs. The decline in formal employment and large outward migration are consistent with the inability of the private sector to create sufficient good jobs that reduce outward

⁷ As measured by the University of Notre Dame’s Global Adaptation Initiative (<https://gain.nd.edu/>).

⁸ While past efforts focused on infrastructure, there was inadequate recognition of the need for investments in on-farm support, farmer competitiveness, and supply chain development. Other factors include the lack of strategic vision for I&D sector, and previous challenges in ensuring investments are sensitive to the broader operational context of farmers and their needs.

⁹ Moldova committed under the Paris Agreement and, as of 2021, exceeds its targets by 4 percent. Moldova is only a minor contributor to GHG emissions—at less than 0.03 percent of the world total in 2019. The private sector has a strong role to play in climate mitigation while adaptation potential is more complex for the private sector <https://eu4climate.eu/2021/05/20/chisinau-to-glasgow-moldovas-roadmap-to-cop26/>

migration and achieve more sustainable economic growth rates, as firms face multiple obstacles around: (i) access to inputs, such as finance and human capital; (ii) the regulatory environment, including specific sectoral regulations, particularly in the financial and energy sectors, and in trade integration; and (iii) access to quality infrastructure, particularly related to connectivity.

- **Input gap:** A sound financial sector that supports productive investments is essential to increase productivity and employment among firms. Moldova's financial sector primarily serves large firms, while micro, small, and medium enterprises (MSMEs) remain credit constrained, and there are major gaps in financial inclusion. It is paramount to support more efficient financial intermediation and access to finance, especially for MSMEs, including by enhancing the outreach and operations of the Credit Guarantee Fund, introducing a consumer insolvency framework, upgrading the collateral registry, enhancing the credit information sharing system, and strengthening consumer protection. An adequately skilled workforce is also a critical asset in enhancing productivity and competitiveness among firms. However, there is an important skills gap that firms face. More than 30 percent of firms report that skills have become a severe constraint to their growth, a greater constraint than in most peer countries in the region. It is therefore important to address the skills gap, for example by strengthening policies and regulation to motivate training providers to improve their programs for skills formation and upgrading, to nurture private sector contributions to skills formation, and to increase the retention of skills by raising domestic productivity and the return to skills. Severe deficits in the education system, combined with sustained and rising outward migration flows, constrain the availability of skilled labor, especially in science, technology, engineering, and mathematics (STEM)-intensive activities, and hamper innovation.
- **Regulatory gap:** While Moldova has made progress in improving the regulatory framework, the competitiveness of Moldovan firms remains limited by regulatory uncertainty, high transaction costs, and weak competitive conditions and competition policies. The business environment in which firms operate is hampered by the preferential treatment of SOEs, price controls, and anticompetitive regulations. Further improvements in sectoral regulations, especially for energy and financial markets, and to promote trade integration, with particular focus on agricultural products, and the attraction and retention of FDI, are also needed.
- **Infrastructure gap:** As a landlocked country with a small domestic market, but strategically located close to the EU and the Russian Federation, high-quality connectivity is of great importance to reorient the current growth model and successfully integrate firms, consumers, factors, and goods within the country, and with regional and global markets. Regional integration promises lower transaction costs, more trade, access to bigger markets, economies of scale, more competition, and more efficiency. At the same time, despite significant improvements in recent years, especially in the road sector, the state of transport infrastructure and services remains poor. This is also due to large investment backlogs, increased vulnerability to climate-related risks, and the presence of inefficient SOEs that limit the access to key services and economic opportunities, particularly for rural residents. Improving the national road network, promoting a multimodal transport model, investing further in the railway sector, improving the resilience and quality of urban public transport, and reforming the respective regulatory frameworks to support increased private participation through investments and Public-Private Partnerships (PPPs) in infrastructure modernization are key for service delivery, especially in rural areas, and for the competitiveness of the economy. Also strategic for Moldova's competitiveness is improving broadband digital communications, which can pave the way for income growth and job creation, as well as enhance financial inclusion. In an era of rapid digitalization, the reform of digital

connectivity markets toward greater competition would not only contribute significantly to improving international competitiveness, but also help reduce the digital divide, preventing the poor from being left further behind and enabling them to take better advantage of available jobs, most of which require basic digital skill competencies. Finally, ensuring energy and water security, including reliability, affordability, efficiency, predictability, and risk mitigation, also remains a priority not only from the resilience perspective but also for Moldova's long-term competitiveness, as demonstrated by the impact of the recent drought and gas crisis. Further efforts are necessary to address infrastructure gaps and reforms of the respective regulatory frameworks and dominant SOEs. As discussed under *Priority 1*, all these reforms would need to be complemented by the necessary institutional changes, for example, Calea Ferată din Moldova (CFM) in railways, ANRE in energy, Apele Moldovei in water, and Moldtelecom in telecommunications, and an effective Competition Council among others.

- IV. **Reorienting public finance to support a new growth model.** Achieving the proper balance between helping steer the economy towards a new equilibrium and having sufficient space to mitigate the economic impact of climatic shocks is essential for a country highly exposed to natural disasters. At the time of the 2016 SCD, Moldova had started the process of reforming its financial sector to address the deep roots of the 2014 banking crisis to restoring financial stability. However, fiscal space has been reduced in recent years and exacerbated by the impact of the COVID-19 pandemic. A priority going forward is to advance reforms that improve the efficiency and reorient of public spending to tackle the emerging needs and development priorities, rather than being absorbed by pensions and public wages. At the same time, the current tax structure reflects the import-heavy, low labor participation, transfer-dependent nature of the economy. A gradual shift toward domestic revenue mobilization, underpinned by more progressive taxation and by the strengthening of the tax administration, is necessary. As highlighted under *Priority 1*, strengthening fiscal institutions, including the public financial management and the fiscal rules, as well as improving the governance of the financial sector and sectoral SOEs is also crucial to enhance overall fiscal resilience and macro-financial stability.
- V. **Improving resilience, efficiency and equity in service delivery.** The third and last sectoral priority is the need to improve resilience, efficiency, and equity in service delivery across the broad spectrum of public services. While services such as education and social protection were correctly singled out in the 2016 SCD due to their importance for the country's development and poverty reduction objectives, deficiencies in the delivery of other services, ranging from water and sanitation to health, have emerged as equally pressing, either from recent diagnostics, as in the case of the water sector, or from recent developments. For instance, the COVID-19 crisis has uncovered the weaknesses of systems, including education, health and social protection, that are not set up to be resilient in the face of disasters, resulting in significant human capital losses. Major improvements in terms of equity in service delivery are necessary, given the large spatial inequities in access to public services in the country. Efficiency needs to be improved as well: while Moldova spends a similar or a larger share of its budget on health and education than its regional peers, its human development outcomes are lagging. In the health sector, the hospital system needs to be rationalized to increase efficiency and ensure better value for money. Primary health care, including preventative care, needs to be prioritized in light of population aging and the rise of noncommunicable diseases (NCDs). The role of the private sector becomes important in the provision of quality health-care services both through private sector investments and the facilitation of PPPs. Meanwhile, in education it is important to address large inequities in access and improve quality through modernizing teacher training, while continuing network optimization. In the short term, remedial education may be necessary to make up for learning

losses caused by the pandemic, especially among children from vulnerable households. Added to this, the coverage of social safety nets is also limited, and recent policy measures and reversals have threatened the financial sustainability of the pension system, which is particularly concerning given rapid aging in Moldova and the overrepresentation of older people among the poor. If unaddressed, this will eventually lead to almost half of the old-age population being ineligible for old-age pensions. Improving equity in service delivery also applies to other sectors, not least the water sector given large gaps in water and sanitation services (WSS) across rural and urban areas. Moldova's very low level of WSS access, and the stark disparities between urban and rural areas, make it an outlier among European countries. Low levels of access impose a cost on public and environmental health, and limit resilience to future pandemics. Similarly, in the case of urban transport, access is physically constrained by legacy services, which are not accessible to all citizens. This constrains mobility, access, and housing/employment choices for lower income groups in particular. Finally, the digitalization of service delivery and governance has increased during the pandemic and should remain high on the agenda of service delivery, governance, and accountability going forward.

A. INTRODUCTION

Decades of strong yet volatile economic growth have improved the living standards of the Moldovan population, though the country remains one of the poorest in Europe. Between the late 1990s and 2019, per capita GDP expanded at an average annual pace of 4.9 percent—a cumulative increase of over 160 percent. Solid growth resulted in strong poverty reduction, from close to 90 percent in the late 1990s to 13 percent by 2018 (based on the upper middle-income poverty line of US\$5.50 a day in 2011 purchasing power parity). Despite this progress, Moldova—a middle-income country—remains one of the poorest countries in Europe and convergence with EU standards of living has been slow. Moreover, the country is characterized by large urban-rural disparities in living standards¹⁰ and a high degree of inequality of opportunity,¹¹ crystalized mainly across the spatial dimension. Poor service delivery, mainly in rural areas, results in lagging human development outcomes and, hence, a lower likelihood for disadvantaged children to acquire the skills necessary for productive employment and upward mobility.¹² Moldova needs sustained strong and inclusive growth to live up to the aspirations of its citizens.

Moldova’s past development and recent performance have been shaped by its unique structural characteristics: geography demographics, and legacy. The juxtaposition of these structural characteristics has resulted in a growth model that has yielded growth and poverty reduction but has failed to nurture structural transformation and competitiveness. The lack of good job opportunities in Moldova, combined with large wage differentials with the EU and the Russia Federation, has generated one of the largest diasporas in Europe, which has produced a steady flow of remittances, significantly contributing to income growth and filling the gap of negative domestic savings. However, remittances have mostly fueled consumption, creating a self-perpetuating vicious cycle that is detrimental to competitiveness, productivity, and the creation of good jobs. Remittance-fueled consumption has been met mainly by imports, while the supply response has been limited to agriculture and non-tradable sectors. While these characteristics have helped a small country like Moldova to exploit the global economy and steadily improve standards of living, it has come with intrinsic volatility and vulnerability to shocks, as well as declining potential growth and high dependence on external conditions. Coupled with pervasive governance and institutional challenges, Moldova’s structural characteristics have supported the persistence of this self-perpetuating vicious cycle, weighing heavily on the reluctance to update the country’s economic model.

The 2016 Systematic Country Diagnostic (SCD) identified two pathways for Moldova to achieve stronger and more inclusive growth. The pathways (“creating more and better jobs” and “building up and protecting the stock of assets of the population”) aimed to support the transition of the growth model from one based on remittances and consumption to one based on private sector growth and job creation. To navigate these pathways, the 2016 SCD identified six priorities, the top three of which were related to governance challenges: (i) strengthening the rule of law and the accountability of institutions, particularly to unlock the main constraints to firm growth and job creation; (ii) improving the efficiency and equity of service delivery, for an enabling environment for firms and individuals to access better economic opportunities across Moldova, particularly in rural areas; and (iii) increasing the quality, equity, and

¹⁰ While the recent increase in poverty has mainly occurred in urban areas (an increase of 3 percentage points), rural areas remain much poorer (rural poverty rate of 35.3 percent vs urban one of 14 percent). As a result, poverty is predominantly a rural phenomenon with over 82 percent of the poor being less educated and older, and self-employed in agriculture living outside Chişinău or other cities.

¹¹ The gap in access to opportunities as measured by the Human Opportunity Index is 34 and 52 percent for urban and rural areas, respectively.

¹² The PISA results in science reveal a gap between students living in rural and urban areas is equivalent to 1.5 years of schooling, while the employment rate in rural areas is, respectively, 14 and 9 percentage points lower for men and women, compared with their peer in urban areas. Moreover, nearly 80 percent of informally employed workers live in rural areas.

relevance of education and training systems, so that Moldovans can become better prepared to access productive jobs. Priority areas also included: (iv) improving the business regulatory framework; (v) ensuring sound macroeconomic and fiscal management; and (vi) reforming the social protection system, particularly pensions.

The 2021 SCD Update revisits the priorities identified in the 2016 SCD to assess whether any changes in priorities are warranted going forward. The 2021 SCD Update first discusses where Moldova stands in terms of growth, poverty reduction, and sustainability. Second, the SCD Update assesses what factors are holding back poverty reduction and shared prosperity in Moldova. Finally, the SCD Update provides recommendations on potential revisions and amendments to the 2016 SCD Framework, and its pathways and priorities to reflect the changing landscape. Compared with the 2016 SCD, this Update places greater emphasis on climate change adaptation and resilience to withstand increasingly frequent weather shocks, and on digitalization as a key enabler for firms and people, and as a tool to provide certain services more efficiently and make service provision more resilient to shocks. The Update does not intend to deliver an exhaustive analysis at the sectoral level, as did the 2016 comprehensive SCD, and instead only discusses key sectoral issues. Interested readers can refer to the relevant sectoral analytical work for details.

B. WHERE DOES MOLDOVA STAND TODAY?

1. Slowing potential growth and deteriorating long-term economic prospects

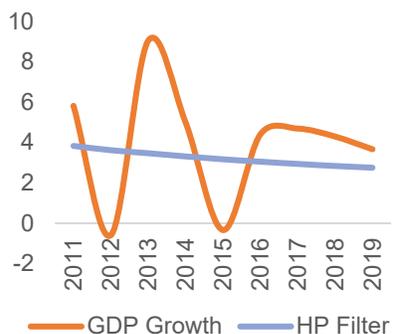
Moldova's growth performance since the 2016 SCD has been strong, but largely driven by temporary factors. Rebounding from the 2014 banking crisis, average growth inched up to 4.3 percent per year between 2016 and 2019—close to 6 percent on a per capita basis—and was less volatile than in the pre-SCD period. The non-tradable services sector, particularly ITC and transport, remained the most dynamic sector, but its contribution to growth was smaller than during the period covered by the 2016 SCD. The manufacturing sector also made a more modest contribution to growth except for the automotive, machinery and equipment and electrical appliances segments, which showed stronger dynamism than before the 2016 SCD. Due to favorable climatic conditions, albeit upended by the severe 2020 drought, agriculture sector performance was overall stronger, but still dominated by low value-added products. On the demand side, Moldova's economic growth was primarily driven by domestic absorption. Due to strong growth in wages after 2016, household consumption is still the most important driving force. While Moldova has diversified its export product base and increased the number of exported goods, high imports dominate the trade account and were a larger drag on growth in 2016–19 than in the pre-2016 SCD period. The contribution from capital formation increased due to the rebound of the financial system after the 2014 banking crisis and more favorable financial conditions.

In contrast, potential GDP growth—a measure of the longer-term productive capacity of the economy—has lost 1 percentage point over the past decade. Structural issues related to a shrinking labor force, rapidly aging population, and low efficiency of investment, particularly in the public sector, have led to a drag on potential growth, offsetting a positive contribution from investment and productivity growth (Figure 9). After 2016, because of demographic changes and the quality of human capital, labor's contribution to GDP growth turned negative, despite an increase in the labor participation rate, albeit mainly driven by self-employment in subsistence agriculture.¹³ Negative contributions from labor are

¹³ The reason for this trend is unknown. The methodology of the LFS did not change between 2014 and 2018. During this period, own-account farmers were only counted as part of the labor force if they worked at least 20 hours per week on their fields. It appears more farmers have been crossing this 20-hour threshold. Though hypothetical, this could be linked to stagnating old-age pensions between 2010 and 2015, and/or the decline in remittances observed over this period.

observed in only a few countries in the region and contributions from productivity growth are at the lower end when compared with regional peer countries.

Figure 8. Less volatile growth, though steadily declining potential growth



Source: Macro Poverty Outlook, WB.

Figure 9. Net exports are a drag on growth

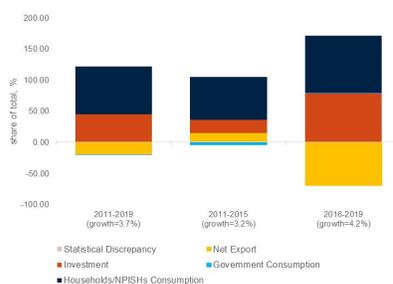
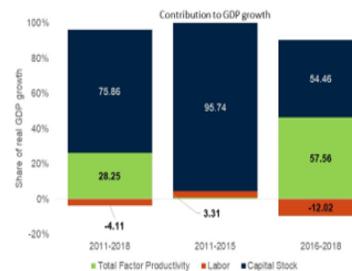
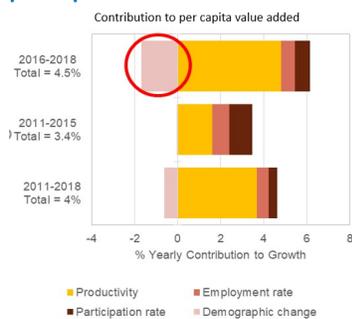


Figure 10. Labor is increasingly a drag on growth



Factor mobility across sectors is not supporting structural transformation. Most of the productivity gains in recent years have been associated with “within”-sector reallocation from low productivity firms toward more productive firms in the same sector, while inter-sector reallocation was negative, as factors moved from high productivity industry and services to low productivity agriculture. At the same time, demographic factors, such as the increasing number of elderly people, are also dragging down productivity (Figure 12). “Within”-sector reallocation in all three major sectors—agriculture, industry and services—was the main growth driver of productivity. The contribution from industry has increased faster than in the pre-2016 SCD period, during which the services sector played a prominent role. The perceived improvement could be attributed to the exit or decrease in activity of unproductive firms and may imply to a lesser extent a more broad-based advance, as there is little evidence suggesting improvements in human capital, large investments in physical capital, or any major technological advances.

Figure 11. Demographic change is offsetting the increase in participation rate



Source: Macro Poverty Outlook, WB.

Figure 12. Factor reallocation is dragging structural transformation and productivity

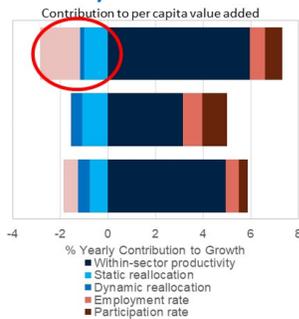
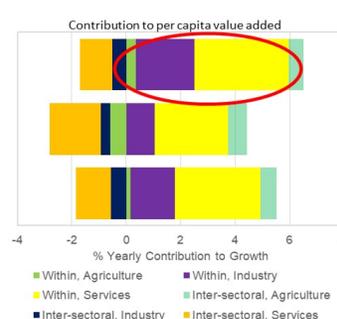


Figure 13. Intra-sector productivity is the main driver of productivity growth



Large companies dominate the economy and are expanding rapidly, indicating a dominant market position. Even though micro and small companies make up almost 96 percent of the total number of firms in Moldova (Figure 15), their density is much lower than in peer countries, while large companies are growing faster than MSMEs both in terms of sales and employment (Figure 16). Medium-sized firms are losing market share and stagnating in terms of employment creation, pointing to the challenge of small and medium enterprises (SMEs) in Moldova upscaling and expanding their business, while creating more and better jobs. Large firms, on the other hand, are increasingly taking advantage of their dominant position, recording the highest volume of sales per employee in 2019, and the strongest growth between 2015 and 2019 (Figure 17). These incumbent firms tend to be about seven years older than other smaller firms, with an average age of 24.5 years, and characterized by the largest presence of government and foreign ownership. At the core of Moldova’s low productivity conundrum lies the relative size of SOEs in the economy. SOEs account for about one-third of GDP, 50 percent of all fixed assets, and 10 percent of corporate sector assets. SOEs display significantly lower levels of productivity than foreign-owned and domestic private firms, dragging down aggregate productivity. Close to 90 percent of large firms in 2019 purchased fixed assets, more than double the average in Moldova. Large firms, however, tend to export, invest in R&D, and provide training for their employees to a greater extent than other firms (Source: World Bank Enterprise Survey, 2019).

Figure 14. Ninety-six percent of firms are micro or small

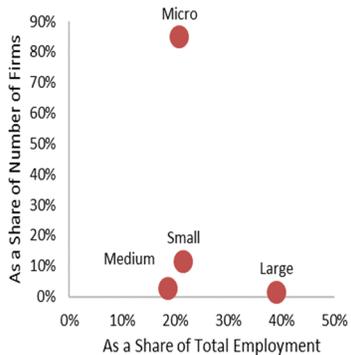


Figure 15. Large firms are growing faster than MSMEs

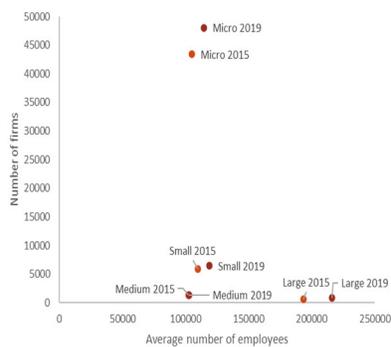
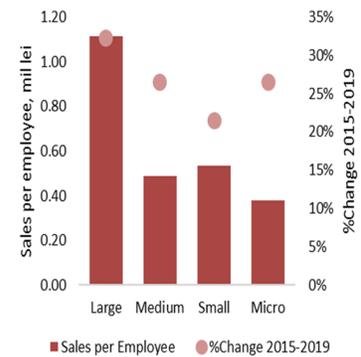


Figure 16. Large firms are taking advantage of their dominant position



Source: Administrative data, NBS.

The challenge of job creation is linked to low firm entry, profitability, and survival rates. Most new entrants are small and face difficulties expanding and surviving. Moldova’s business environment poses substantially higher operational risks to private firms than other ECA countries, emanating from the combination of the anticompetitive practices of market players and restrictive state policies (e.g., discrimination against foreign companies, price controls, and distortive state aid).¹⁴ Between 2003 and 2014, half of all new firms exited the market within three years. Even those that survived and experienced strong productivity growth did not increase their share in total employment. The inability of these more productive young firms to increase their employment share limits the creation of better-paid and higher-productivity jobs. Employment has increasingly concentrated in large and older firms, including in less productive public firms. Because of an uneven playing field and the challenging business environment, not only high-productivity foreign-owned firms face more obstacles to grow and create jobs, but the

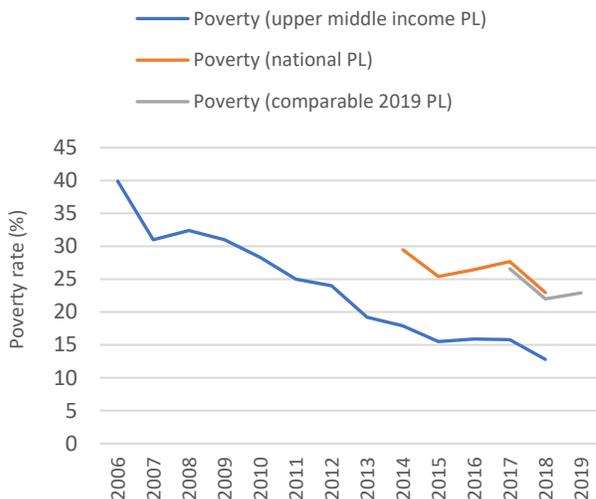
¹⁴ World Bank (forthcoming). Moldova. Country Private Sector Diagnostic (CPSD).

country has also struggled over time to successfully attract FDI, the volume of which remains low. FDI (net inflows, as a share of GDP) has been on a declining trend and eventually experienced a large contraction following the occurrence of the 2014 banking fraud; only in 2019 has FDI recovered to the pre-crisis level, at 4.2 percent of GDP, a level that remains relatively low compared with some peer countries in the region, amounting to only half of the average FDI for Central Europe and Baltics countries, at 8.3 percent of GDP in 2019.¹⁵

2. Weakening poverty reduction and declining formal sector employment

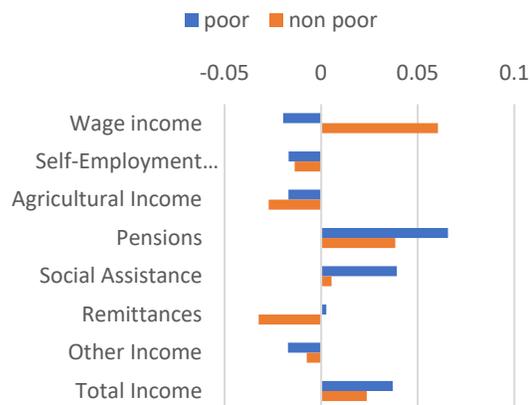
Poverty reduction has slowed since the 2016 SCD, as its main drivers—public and private transfers—have weakened. Poverty inched up between 2015 and 2017 but declined in 2018 (Figure 18). Though poverty indicators in 2019 and 2020 are not comparable with earlier years, due to a change in the sample frame, sensitivity analysis suggests that poverty marginally increased in 2019 and significantly increased in 2020, due to the impact of the COVID-19 pandemic. In the years before the pandemic, income growth among the poor was driven by pensions and social assistance, while incomes of households above the poverty line were boosted by an increase in wages (Figure 19). These were the major drivers of poverty reduction in 2018. At the same time, the downward trend in remittances by over 30 percent in the past decade has had a substantial impact on income growth for all income groups except for the poorest households, highlighting the inherent vulnerability of a development model based on exporting workers. Household income growth was highest in Chişinău, mainly explained by substantial wage increases, which mostly benefited highly educated employees in the capital. As a result, income disparities between urban and rural areas have increased, though inequality remains relatively low, with a Gini coefficient of 0.24 (for consumption) and 0.30 (for income) in 2019.

Figure 17. Weakening poverty reduction since 2015



Source: HBS 2006–19.

Figure 18. Income growth of the poor was driven by public transfers, 2014–18

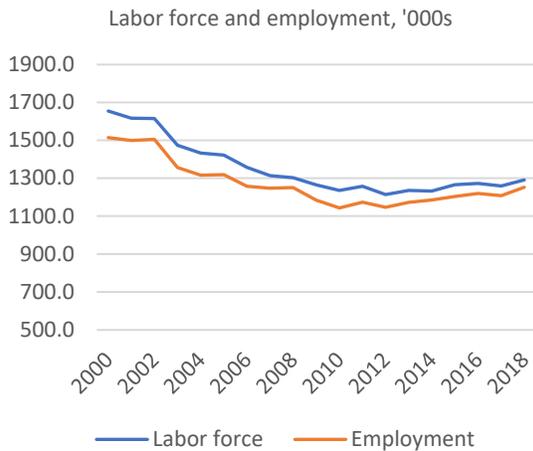


Notes: Decomposition of income growth between 2014 and 2018. Source: HBS 2014–18. WB staff calculations.

¹⁵ This includes Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

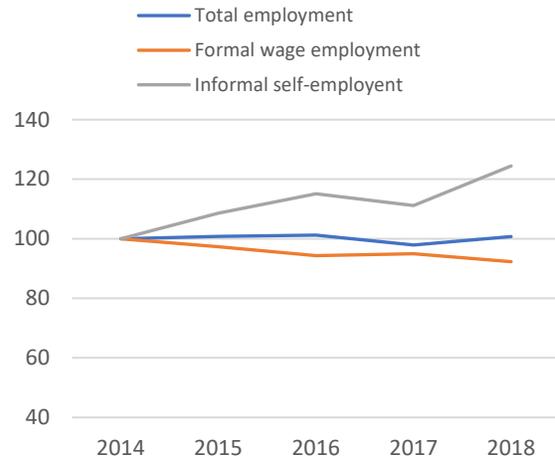
The long-term decline in Moldova’s labor force has stalled over the past five years, with employment slightly increasing, though the labor market remains structurally weak. After having declined by almost 25 percent between 2000 and 2015, the size of the labor force increased modestly between 2015 and 2018 (by 1.4 percent), as did employment (by 2.7 percent).¹⁶ The increase in employment was, however, entirely driven by informal self-employment in agriculture, with older people (55 and over) in rural areas increasingly taking up own-account work on their fields. Meanwhile, formal employment decreased further, even though wages for those who are wage-employed increased by 5.5 percent per year (Figure 21). Labor force participation remains exceptionally low, as does unemployment,¹⁷ while migration intentions are high, symptomatic of an economy with chronically low labor demand and limited availability of good jobs. Though the size of the labor force has relatively stabilized in recent years, Moldova’s population continues to shrink and age rapidly, driven also by large and increasing outward migration flows. The population declined by over 10 percent between 2014 and 2020, and currently stands at 2.6 million. Such a decline has far-reaching implications for future economic prospects, the provision of public services, and the sustainability of the pension system (Figure 23). Furthermore, labor productivity continues to be among the lowest in the region, especially in agriculture, limiting its scope to counteract adverse demographic trends, and low labor force participation and employment.

Figure 19. The long-term decline in the labor force has stalled in the past decade



Source: NBS, 2000–18.

Figure 20. Formal sector wage employment decreased



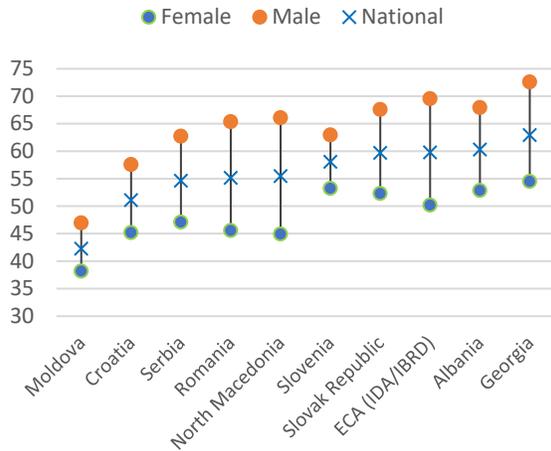
Source: NBS, 2014–18.

Figure 21. Labor force participation remains exceptionally low

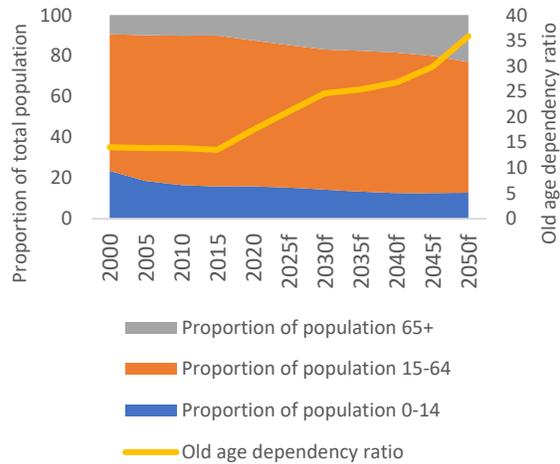
Figure 22. Moldova is aging rapidly

¹⁶ These labor force and employment estimates are based on the *resident population*, a series that was discontinued in 2018. Since 2019, the sample frame of the LFS has changed based on the results of the 2014 Population Census and the reference population now consists of the *usual resident population* (excluding people who have been abroad for more than one year). In addition, as of 2019, Moldova adopted the recommendation of the International Conference on Labor Statisticians (ICLS) to not consider subsistence farmers as part of the labor force if certain conditions are satisfied. As a result, the post-2018 labor indicators cannot be compared with the previous years.

¹⁷ Unemployment stood at 2.9 percent in 2018, 5.1 percent in 2019 and 3.8 percent in 2020, but 2018 cannot be compared with the FY2019/20 due to changes in methodology (Source: NBS).



Source: WDI, 2021.

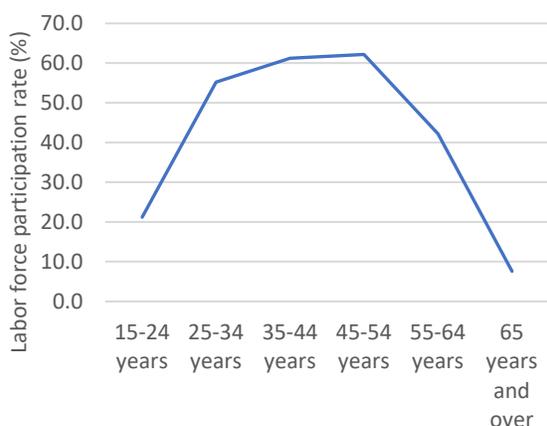


Notes: Old age dependency ratio is the ratio of older dependents—i.e., people older than 64—to the working-age population—i.e., those aged 15 to 64. Data are shown as the proportion of dependents per 100 working-age population. Source: World Bank staff estimates based on age distributions of United Nations Population Division's World Population Prospects: 2019 Revision.

Low labor force participation in Moldova is the result of several factors. First, low retirement ages result in low labor force participation rates of older people (55 years of age and over) which, given the large demographic share of older cohorts, drags down overall participation rates, though employment rates remain relatively low for prime-age adults as well (Figure 23). Second, the labor force of Moldova remains relatively low-skilled, while new jobs are increasingly requiring higher skills. This results in low labor participation rates for workers without tertiary education (Figure 24). Third, Moldovans who have been working abroad for less than one year are still considered part of the inactive population, artificially pushing down participation rates.¹⁸ Finally, labor demand remains generally subdued due to persistent governance and institutional challenges.

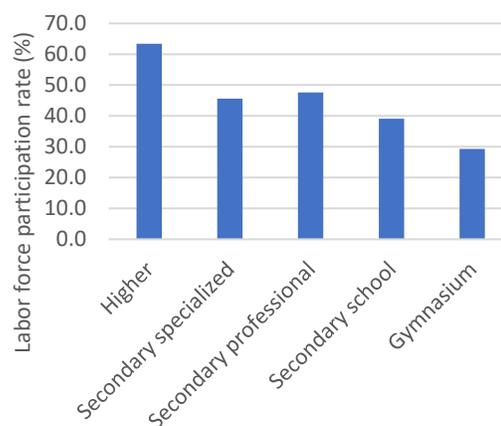
¹⁸ These labor emigrants account for only a small share of the total inactive population (8 percent in 2019).

Figure 23. Labor force participation rate by age group, 2019



Source: NBS, 2019.

Figure 24. Labor force participation is substantially higher for the tertiary-educated



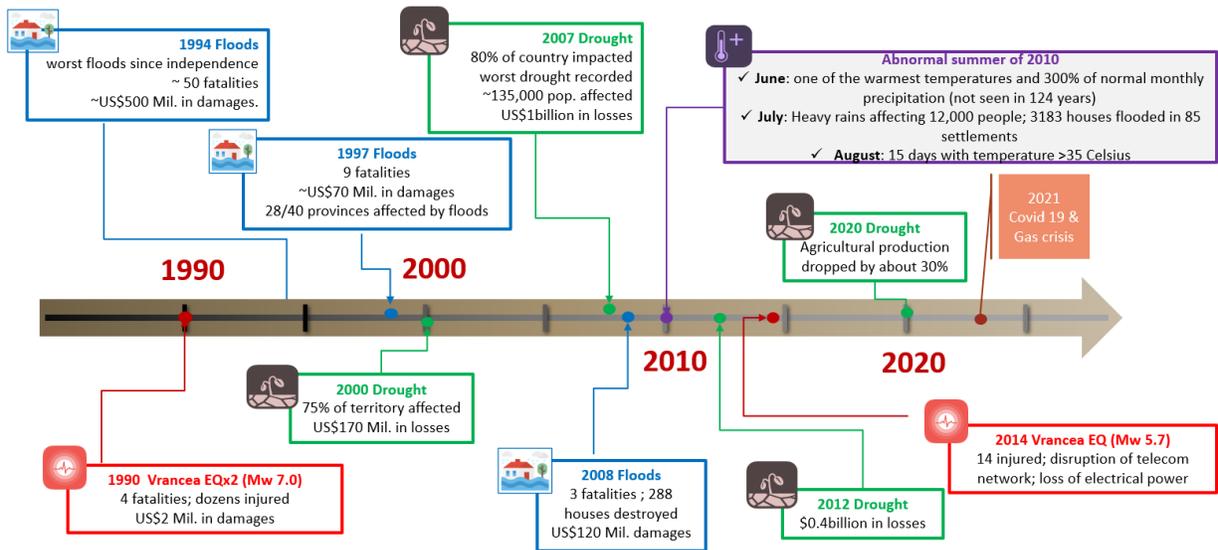
Source: NBS, 2019.

3. Increasingly frequent shocks, particularly natural disasters

Moldova ranks among the most climate vulnerable countries in the Europe and Central Asia (ECA) region, and faces several adaptation challenges.¹⁹ Since 2000, Moldova has witnessed an increased frequency of major climate-related events, with an average of one event every three years. With a rank of 84 out of 181, the Notre Dame Global Adaptation Initiative (ND-GAIN) indicates Moldova as one of the most vulnerable countries to climate change in the ECA region, third after Tajikistan and Albania. Seven out of the 10 warmest years in Moldova’s history were recorded in the past 20 years. As a result, the likelihood of multi-year droughts is expected to increase and, if not properly managed, could have devastating impacts on the economy. There is also high exposure to flood risks, with about 659 settlements (42 percent) at risk of flooding (including the capital, Chişinău), with torrential summer rains imposing a recurrent and cumulatively heavy cost, due to the damage to roads, electric power distribution networks, and other infrastructure.

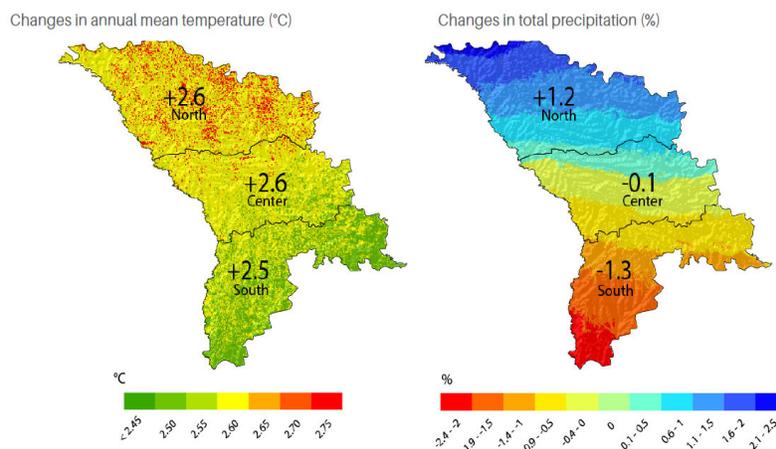
¹⁹ See also World Bank Climate Change Knowledge Portal.

Figure 25. The frequency and the impact of natural disasters have accelerated over the past 30 years



Moldova’s long-term growth and prosperity are increasingly being threatened by climate change and the risks from natural disasters. Average temperatures are projected to rise by 2.5°C or more, while precipitation is projected to decline in the already drier and poorer South and increase in the Northern plateaus (Figure 25), engendering a transition in crop patterns and types as climate change makes certain areas more/less suitable for certain crops. Moreover, Moldova is prone and vulnerable to earthquakes. Sixteen major earthquakes of magnitude 7–8Mw²⁰ have been recorded over the past 200 years and the risk continues to grow with expanding cities, aging, and inadequately maintained public infrastructure, together with the lack of awareness of the potential risks.

Figure 26. Moldova is projected to be heavily affected by climate change
Projected changes in temperature and precipitation in Moldova by 2050



Source: World Bank CIAT 2016; World Bank 2020a

²⁰ Moment magnitude scale (MW) is about the same as Richter magnitudes for small to large earthquakes.

Given its openness and high dependence on imports and remittances, Moldova is also susceptible to external economic shocks. In the second half of 2021, energy prices have reached unprecedented high levels, with the market price of natural gas increasing by more than fourfold during April to October 2021. While Moldova has reduced primary energy imports and has diversified petroleum products supply, its overall energy dependence remains high, at 82 percent in 2019, with implications in terms of sustainability and security. The dependence on gas imports is a challenge, as the scope for diversification is confronted with the decline of more than 70 percent in gas production from mature gas fields in Europe²¹ over the past 10 years. Moldova's high dependence on remittances—accounting for 16 percent of GDP in 2019 and received by one-quarter of all Moldovan households—similarly increases its susceptibility to external shocks. Furthermore, the social security system, which is designed to increase resilience to shocks, is limited in its capacity due to issues with coverage and adequacy, with Moldova having lower levels of spending on social safety nets than its regional comparators.

The COVID-19 pandemic has revealed intrinsic vulnerabilities of the current economic model. With a decline in GDP of 7 percent in 2020, the impact of the COVID-19 pandemic combined with the drought has been one of the most severe in Europe. The shock has had a large and heterogenous impact across households, firms, sectors, and geographical areas. Poverty increased by 1.6 percentage points, rising from 25.2 percent in 2019 to 26.8 percent in 2020, as households faced the impact of the crisis, including loss of employment and earnings, a reduction in remittance receipts, and the return of vulnerable migrants from abroad who might struggle to find employment. Because of the impact of the pandemic on the labor market, poverty increased more in urban areas, rising from 11.2 to 14.0 percent, compared with rural areas which saw a smaller relative increase from 34.5 to 35.3 percent.

C. WHAT IS HOLDING BACK GROWTH AND PROSPERITY IN MOLDOVA?

Moldova has made progress in reducing poverty and boosting shared prosperity, but the sustainability of this progress and future gains are highly uncertain. Moldova's structural characteristics (geography, demography, and legacy) have resulted in a growth model that has yielded growth and poverty reduction but has failed to nurture structural transformation and competitiveness. The pace and type of growth have not been translated into broad-based job creation, particularly in the tradable sectors. Progress that relies on private and public transfers without job creation does not offer a sustainable path for improving the living standards of the population, particularly in the context of an aging society. It also comes with intrinsic volatility and vulnerability to shocks, as well as declining potential growth that is highly dependent on external conditions.

The development challenges identified by the 2016 SCD remain broadly relevant today. Despite efforts and progress in a number of reform areas since 2016, the failure to address crucial structural challenges related to governance, the rule of law and institutional weaknesses, combined with limited resilience and inadequate policies against vulnerability to external factors, is still hampering long-term growth, poverty reduction, and shared prosperity. Amending macroeconomic, structural and social policies, and strengthening institutions across the board are needed to broaden and upgrade the country's narrow production base, boost job creation, reduce the heavy dependence on imports, and build resilience against natural disasters and economic shocks. This would, in turn, create more and better jobs, attract and retain FDI, and nurture human capital accumulation, all key in moving away from a growth model that is less reliant on remittances, which are expected to continue their secular downward trend. At the same

²¹ Primarily the United Kingdom and the Netherlands.

time, it is also key to address large and persistent spatial gaps in access to opportunities, with rural dwellers having far worse access to key services and basic infrastructure, constraining their ability to accumulate human capital and access good jobs.

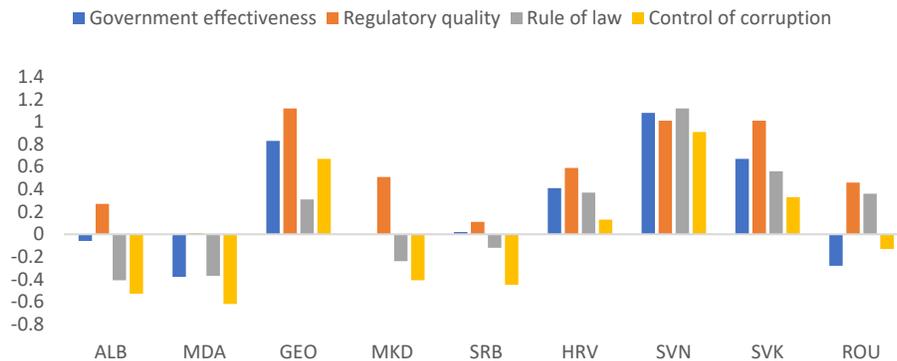
1. Deep-rooted governance and institutional weaknesses

Weaknesses in institutions, the rule of law, and persistent governance challenges remain binding constraints to inclusive growth in Moldova. Corruption, the weak rule of law, and politicized institutions continue to create an uneven playing field, factor misallocation, and unfair competition, undermining the capacity and the incentives for the private sector to innovate, expand, and create jobs. Weak governance and the rule of law, together with political uncertainties, macroeconomic risks, and the challenges of maintaining reform momentum, also represent a major investment climate concern that threatens the FDI attraction capacity of the country. Since 2016, only limited progress has been achieved in strengthening institutions, the rule of law, and the overall governance framework. As evidenced by the World Governance Indicators (Figure 26), both public administration and the judiciary continue to be perceived as inefficient, captured, and politically dependent, and unable to deliver services effectively and tackle high-level corruption. Recent polls show that about half of its citizens and nearly two-third of its business representatives consider the judiciary in Moldova as not independent, while at the same time only one in four judges and nearly half of all prosecutors in Moldova believe this to be the case.²² There has been little to no change in terms of ending impunity for high-level corruption. Out of the US\$0.9 billion in assets stolen during the 2014 bank fraud, only a very small portion has been recovered. Few high-level corruption cases have been sent to court or adjudicated. Even in some of the cases where there is a final verdict, there are concerns about the extent to which the rule of law has subsequently been respected, and some verdicts have been overturned through extraordinary procedures, the legal grounding of which has been questionable. The court map optimization started in 2017, but implementation has been slow and accompanied by disruptions that have affected the quality of judicial service delivery. The introduction of the asset declaration verification scheme has failed to yield any major outcomes. Since its launch, more than 280,000 electronic declarations have become public. Although the number of verifications is steadily increasing compared with the previous periods, outcomes remained limited and are not focused on high-level and high-risk officials. In 2020, the National Integrity Authority (NIA) issued only 210 concluding findings for act violations and the number of cases of detected unjustified wealth is insignificant. As a result, weaknesses in the institutional and governance setup, the rule of law, and control of corruption are widespread. Corruption is identified as the top constraint by more than 27 percent of companies (World Bank ES, 2019)—10 percentage points above the average in ECA—and 80 percent of Moldovans believe that good governance does not apply to their country.²³

²² World Bank (2020). Regional Justice Survey.

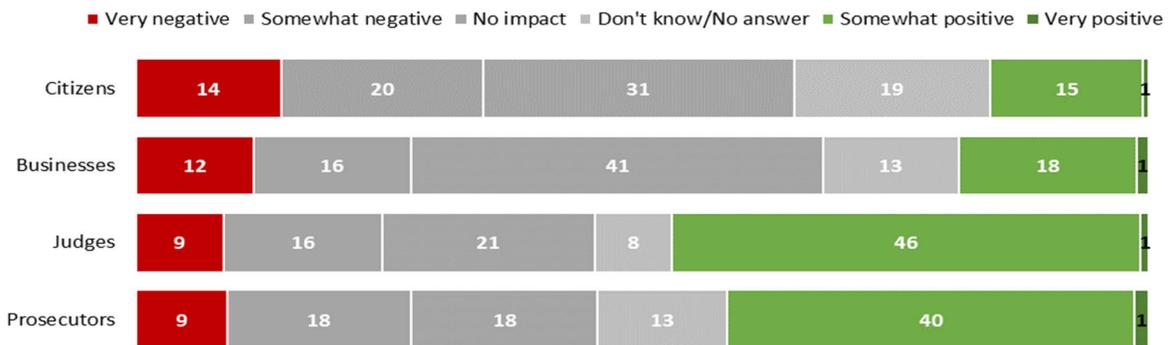
²³ EU Annual Survey Report, 5th wave (spring 2020). https://www.euneighbours.eu/sites/default/files/publications/2020-06/EUNEIGHBOURS%20east_AS2020report_MOLDOVA.pdf

Figure 27. Governance indicators in Moldova continue to lag



Source: WGI, 2021. Indicator scores range from -2.5 to 2.5, with higher values indicating better governance.

Figure 28. Impact of justice reforms over the past 10 years



Source: World Bank.

Governance with respect to the main state functions remains a priority, so is the institutional strengthening at the sectoral and subnational levels. Strengthening institutional capacity and resilience, is needed in a number of sectors, following the improvements²⁴ made to strengthen banking sector governance and supervision after the 2014 banking crisis. The long-awaited reform in water sector would benefit both water management and facilitate the agriculture sector. Similarly, in the railway, energy, and telecom sectors, institutional reforms would not only help these sectors with transparency, competition, service delivery, productivity, innovation, and rising debt but would also be instrumental for the overall competitiveness and resilience of the economy. Addressing the large presence of SOEs, their near-monopoly positions in virtually all basic infrastructure services (e.g., electricity, water, and road construction); dominant or leading positions in sectors that have been opened to private competition in

²⁴ The NBM has improved the legal and regulatory framework in the banking sector. Banking supervision transitioned to BASEL-III standards and a large set of regulations has been renewed. The Centralized Securities Depository was created to centralize operations with securities registration. A new law on non-bank credit organizations (NBCOs) was passed and the regulator shifted from a monitoring regime into a supervision regime. The supervision of non-banks entities to the NBM is expected to start on July 1 2023. However, weaknesses remain in the non-banking sector.

most other countries (e.g., telecommunication, transport, pharmaceuticals, wine, and glass-bottling) is critical but not sufficient. An holistic reform in these sectors beyond SOEs reform is necessary.

2. Limited resilience to shocks and slow adaptation to global trends, particularly climate change and digitalization

Inadequate climate change adaption and disaster risk management have resulted in large socio-economic costs in the aftermath of natural disasters. Increasing climate-related natural hazards have severe socio-economic implications. This is especially the case given the country's high reliance on agriculture, which is mostly rainfed, and accounting for 10 percent of GDP and 36 percent of total employment. Climate shocks have also disproportionately affected the poor, who are more likely to have an agriculture-based livelihood. This was most recently demonstrated by the 2020 drought, which caused a drop of over 26 percent in agricultural value-added and, combined with the COVID-19 pandemic, led to significant job losses. Moldova has demonstrated a commitment to climate change mitigation and adaptation through setting ambitious targets and the ratification of various climate policies.²⁵ Moldova has also strengthened the capacity of its institutions to better prepare and respond to natural disasters through improved weather forecasting, hydrometeorological services,²⁶ and improved irrigation and agricultural insurance schemes, and climate-smart agricultural practices. However, while some of the core institutional and legislative structures are in place, the focus is on reactive disaster response rather than proactive risk reduction or mitigation, and the country remains significantly underprepared for natural disasters. Despite its vulnerability, climate change adaptation is not yet included in the Moldovan budget, although investments in areas such as irrigation and drainage, resilient WSS, etc., are strong drivers of adaptive capacity for a country. The total cost of inaction on climate adaptation is currently estimated at US\$600 million, equivalent to 6.5 percent of GDP, and this is expected to more than double to US\$1.3 billion by 2050.²⁷ While less frequent, major earthquakes could be devastating and affect up to 62 percent of the country's GDP in the future. So far, the average annual losses due to earthquakes exceed US\$35 million per year. However, earthquake risks are insufficiently examined, which hinders the formulation of targeted, strategic risk reduction interventions (and related accompanying measures). Lack of mainstreaming the risk information into urban development and city planning processes continues to constrain the resilience of infrastructure, including commercial and residential buildings, and the road and rail networks.

Poor performance in the water sector is holding back stronger resilience. Moldova's physical water endowments are not a binding constraint for its development: only 5 percent of total average annual renewable water resources are withdrawn on an annual basis. Moldova is, however, far from water secure: current water security is limited by a lack of infrastructure, financing, and institutional weaknesses. Ambiguities and shortcomings in the legislative framework continue to exist, such as on the status of basin committees and the incomplete reform of Moldova's water agency, Apele Moldovei. Environmental degradation stemming from large-scale alteration of water bodies, agricultural pollution, and limited wastewater treatment, in combination with weak water management, are risks to its

²⁵ Moldova has approved a series of documents and policies governing its commitments on climate change including: (i) Climate Adaptation Strategy and Action Plan (2016); (ii) ratification of Paris Agreement (2017); (iii) National Program on Water and Health (2018–2025); National Green Development Program (2018) as well as the updated NDC (2020), which sets ambitious targets of (a) reducing GHG emissions by 70 percent below its 1990 level in 2030, and (b) increasing coverage up to 15 percent of the territory with forests.

<http://www.mediu.gov.md/ro/content/starea-mediului-la-nivel-na%C8%9Bional>

²⁶ Better weather forecasting and warnings save lives and property – Insights from Moldova (blog Daniel Kull, 2019).

²⁷ World Bank. Forthcoming. Moldova Policy Notes 2021. Washington, DC: The World Bank

resilience. ‘Missing’ institutional functions in WSS with respect to national investment planning, project preparation, quality assurance, and sustainability monitoring, pose significant barriers to overcoming low levels of coverage and inequalities in the WSS sector. Hundreds of small WSS providers operate without regulation, or national oversight and technical support, hampering their performance and adversely affecting outcomes of public services. Required levels of funding needed to address the inclusion challenge and deliver on SDGs are inadequate (1.4 percent of general government spending versus the average global benchmark of 5 percent), and funding is fragmented, with low efficiency. SOEs have near-monopoly positions in virtually all basic infrastructure services including water. Removing barriers to entry currently present in some of these markets, especially those with inefficient SOEs, would generate substantial productivity gains for the country.

The agriculture sector is acutely sensitive to weather, and is periodically affected by droughts and floods. Moldova has unique agricultural land resources that are critical to the livelihoods of many, including highly productive black soils (about 70 percent) and a high agricultural utilization rate (more than 75 percent). However, agriculture continues to rely mostly on rainfall, increasing its vulnerability to climate shocks, as most recently demonstrated by the 2020 drought, which caused a drop of over 26 percent in agricultural value-added and significant job losses (although the job losses were also linked to the COVID-19 pandemic). Moreover, low forest coverage and poor land management exacerbate soil erosion, floods, and landslides. As a result, large areas of agricultural land are degraded, agricultural output is highly volatile, and agricultural productivity has seen a significant decline, also due to underdeveloped measures for mitigating weather-related risks, limited access to irrigation, and the low adoption of modern resilient technology and insurance schemes. Seventy percent of the estimated cost of continuous inaction on climate adaptation will be faced by the agriculture sector. Introducing climate-smart agriculture practices, with private sector participation, can help improve sustainability in the agriculture sector and productivity, thus increasing downstream value-added and reducing commercial vulnerability to climate events.

The COVID-19 pandemic has also shown the need for Moldova to adapt to fundamental shifts in global production, trade, and the nature of work. Prior to the pandemic, it was estimated that in Moldova, by 2040, 14 percent of jobs might be lost due to automation, while 60 percent of jobs might change significantly.²⁸ The COVID-19 pandemic has accelerated the transition toward digitalization and automation. The successful digitalization of the economy and governance greatly depends on the availability of a well-equipped workforce and digitally literate population willing to embrace technological change. The public sector will need to continue with implementing GovTech solutions to enhance user-centered service delivery, governance efficiency, citizen engagement, and government transparency and accountability. Adoption of technology is likely to be hindered by further efforts to improve digital infrastructure. While Moldova is well positioned in terms of its telecommunication infrastructure, with mobile penetration well over 100 percent, and the Points of Presence (PoP) of the fiber optic backbone network at 98.2 percent, only 50 percent of households access fixed broadband connectivity, and only 7 percent of all internet connections reach 100 Mbps speed. Similarly, prior to the COVID-19 crisis, only 13 percent of businesses reported engaging in e-commerce,²⁹ though the 2019 World Bank Enterprise Survey showed that 32 percent of business respondents had started or increased their online presence already a few months after the pandemic started, with the percentage increasing to 39.5 and 68.0 percent in six

²⁸ Digital Jobs in Moldova Report, September 2018 (WB).

²⁹ Survey on ICT Usage by SMEs in Moldova, 2019. The sample consisted of 400 SMEs which were representative by geographical distribution, economic activity and size (including MSMEs).

months and one year, respectively.³⁰ While increasing, this nonetheless remains well below aspirational peer countries, such as the Czech Republic and Poland.

The recent steep increase in energy prices has also highlighted Moldova’s vulnerability to energy shocks. Ensuring energy security, reliability, affordability, efficiency, and predictability remains a challenge for Moldova’s resilience and long-term competitiveness, as demonstrated by the recent gas crisis. A successful transition to a new growth model will require both addressing high energy intensity and reliance on a single-source for energy imports, while taking advantage of the EU green deal. However, the decline of gas production in Europe over the past 10 years, together with the lack of competitive new technologies in the near term, is expected to limit the scope for diversification. Natural gas is expected to remain a substantial part of the energy mix at least until 2040, even if ambitious climate policies are adopted.

3. Large obstacles for firms to grow and create jobs

The observed decline in formal employment is consistent with the inability of the private sector to create jobs and of the overall economy to attract foreign investment. Firms are not creating jobs mostly because of low entry and survival rates. Most new entrants are small and face difficulties in accessing finance, expanding, and surviving. When they reach medium size, firms tend to stall and are unlikely to become large. Large, incumbent firms exploit their market dominance and the uneven playing field. The inability of more productive new entrants to break through thus limits the creation of better, higher-productivity jobs, and also undermines the link between a rise in productivity and higher wages that has been observed in Moldova. Export-oriented FDI with links to the local economy could have a positive impact on growth and job creation, also through externalities for local firms related to learning opportunities, productivity improvements, knowledge transfer, and access to global value chains. According to the latest World Bank Enterprise Survey (ES) from 2019, firms in Moldova that are export-oriented and foreign-owned, and that innovate, show productivity premiums relative to other firms of similar size, age, and sector of operation. However, despite fiscal incentives, Moldova has performed poorly in attracting FDI. Moreover, while Moldova has become progressively more open to FDI since 2000, extremely weak FDI-local suppliers’ linkages have limited the potential spillovers of FDI to the rest of the economy.³¹ Furthermore, most of the FDI is directed to relatively low productivity services and low complexity manufacturing activities

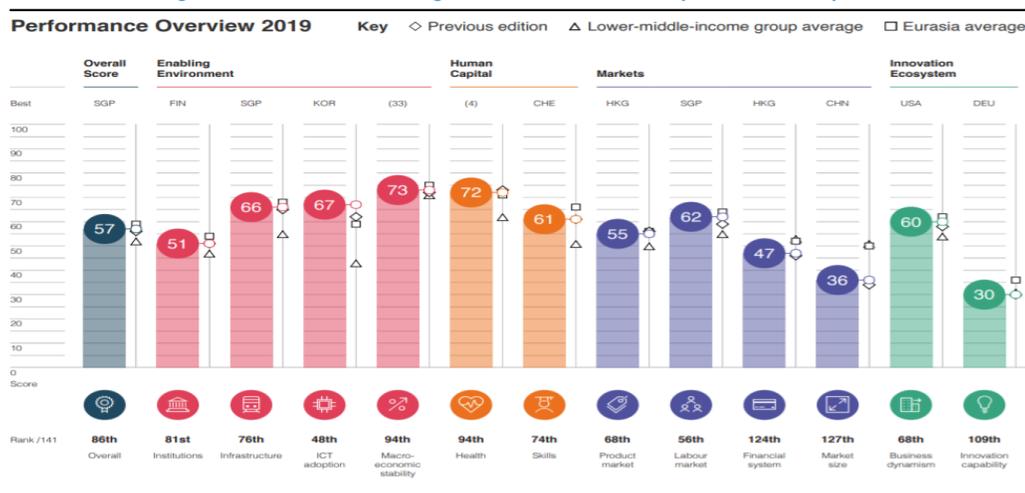
Firms face multiple obstacles to growth ranging from a lack of access to key inputs, such as finance and adequate skills, a weak business environment, and inadequate infrastructure. The environment in which firms operate, particularly the lack of access to markets and finance, and an adequately skilled workforce, is not conducive to productivity and growth. In addition, it is constrained by the dominant and distortive presence of SOEs. Corruption and the weak rule of law are affecting all areas, deterring both domestic and foreign investment, and further contributing to outward migration. According to the Global Competitiveness Index (GCI), Moldova lost ground in terms of product market competitiveness and innovation capability. Investment in transport infrastructure and digitalization is needed to support connectivity and competitiveness. Limitations on physical access constrain both employment opportunities for the population, as well as the access that firms enjoy to the labor they need for growth and competitiveness. This is particularly true in Chişinău, the country’s capital, which attracts about 60 percent of total industrial production, 70 percent of long-term investment, and half of the employment opportunities in Moldova. As a result, the city has a strong inflow of new residents, and this rapid

³⁰ The 2019 World Bank Enterprise Survey sampled 10,089 small, medium and large firms, and is stratified by industry, establishment size and region.

³¹ Tan, S. and Tusha, D. (2019) Buyer-Supplier Linkages in Moldova. The World Bank. Washington DC.

suburbanization is putting pressure on the city’s infrastructure and services. However, urban public transport systems have not been modernized to support this growth in demand and expansion in the city’s geographical footprint, forgoing agglomeration benefits and constraining the ability of firms in Chişinău to access wide catchments of skilled labor that are needed to support growth, particularly in the services sector.

Figure 29. Moldova’s ranking in the 2019 Global Competitiveness Report



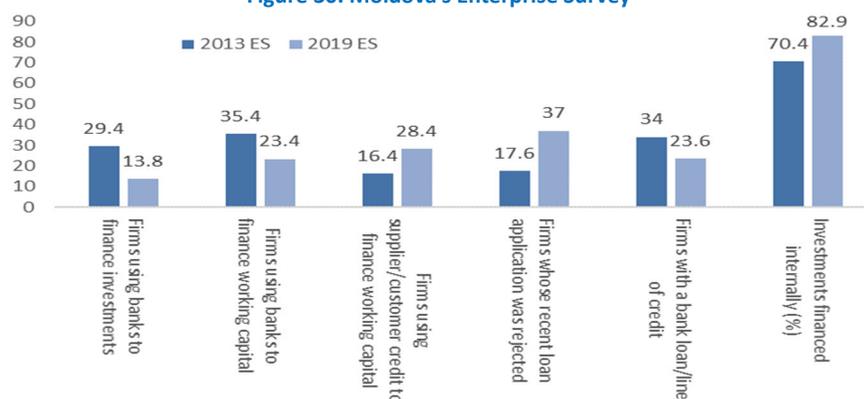
Source: World Economic Forum, 2019.

Note: The Global Competitiveness Index 4.0 from the World Economic Forum measures national competitiveness—defined as the set of institutions, policies and factors that determine the level of productivity.

3.1 Inadequate access to key inputs, particularly finance and a skilled workforce, holds back private sector growth

Despite significant improvements in strengthening banking sector governance and supervision, intermediation remains low and access to finance has not fully recovered after the banking fraud. Following the 2014 banking crisis, the banking sector increased its resilience by becoming relatively well-capitalized and liquid, with the return on assets reaching a peak of 2.6 percent in 2019, an average capital adequacy ratio above 25 percent, well above the obligatory minimum, and non-performing loans (NPLs) on a declining path after the introduction of new prudential norms. The COVID-19 pandemic has clearly put renewed pressure on the banking system, but key soundness indicators have remained intact. However, access to finance is identified as a major constraint by 29.4 percent of surveyed companies, double than the ECA average (World Bank ES, 2019). Similarly, the share of firms whose loan applications have been rejected is more than four times the average in ECA, at 37 percent (World Bank ES, 2019). The situation has worsened recently during the COVID-19 pandemic.

Figure 30. Moldova's Enterprise Survey

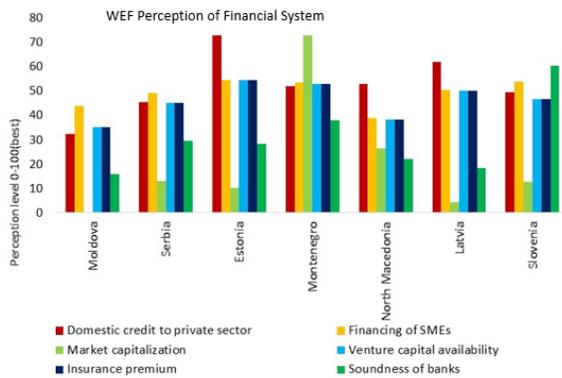


Source: World Bank Enterprise Survey.

Access to finance has become increasingly difficult for the private sector, not only in terms of cost but also in terms of the ability to meet bank standards for borrowers. Moldova's financial sector remains constrained by its small size and low sophistication. While credit to the economy has witnessed an upward trajectory since 2015, it remains below the pre-2009 level and is driven by the household sector. The financial market is still underdeveloped in the provision of products targeted to SMEs (e.g., leasing, factoring and reverse factoring, warehouse receipts, movable collateral, supplier credit, among others), and more sophisticated financial instruments (e.g., climate insurance and other green-related instruments). Partly as a legacy of the 2014 banking crisis, more stringent financial regulations have prevented the emergence of a significant fintech and digital finance sector, despite the presence of a vibrant local ICT sector.³² Financial services providers indicate an insufficient number of bankable firms and projects, in large part due to a high degree of informality in firms' operations. Investments in fixed assets by firms rely heavily on internal financing (83 percent of all investments in 2019), a much larger share than in the 2016 SCD period. The COVID-19 pandemic has further reinforced these trends, with banks refraining from extending new loans to young SMEs, which are regarded as a riskier market segment and therefore could induce a wave of defaults, and lead to further concentration and greater market dominance. Finally, the non-banking finance sector provides limited credit to firms, despite having grown rapidly since 2014 and reaching more than 5 percent of GDP in 2020. Leasing is rare and capital market instruments almost nonexistent. Despite the importance of an efficient allocation of capital, for private sector development, productivity, growth and for poverty reduction in Moldova, the necessary regulatory and institutional reforms for better access to finance, in particular for MSMEs, remain incomplete.

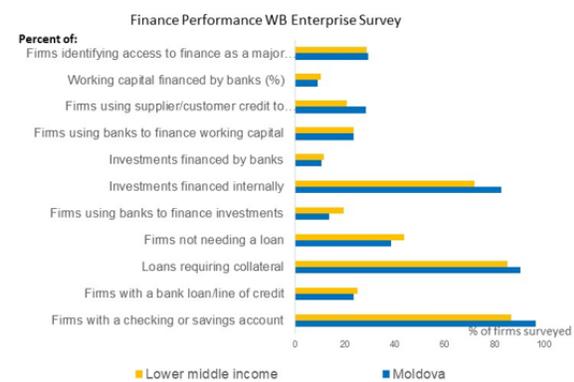
³² World Bank (forthcoming). Moldova. Country Private Sector Diagnostic (CPSD).

Figure 31. Moldova displays weaker financial performance than its peers



Source: World Economic Forum.

Figure 32. Access to formal financing for MSMEs is lower than Moldova's GDP would imply

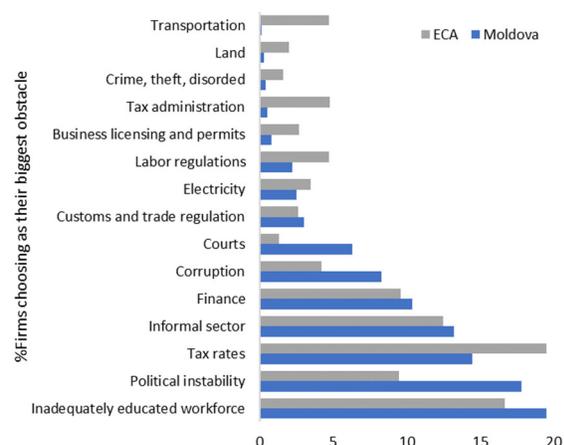


Source: World Bank.

The biggest self-reported obstacle for firms in Moldova remains an inadequately skilled workforce. Almost 20 percent of firms report that their biggest obstacle is linked to skills, with large firms reporting being far more constrained than small ones. Employers report that poor technical, analytical, and problem-solving skills, compounded by poor soft skills, adversely impact the performance of their firms. The education system teaches skills that are no longer demanded by employers, or no longer relevant in a more modern economy. The lack of systematic information on skills requirements means there is no feedback to the educational system that can bring about more informed education and career choices. For instance, the number of graduates in science, technology, engineering and mathematics (STEM) programs and related specialties consistently falls short of labor market needs.³³ Among firms, not all can offer adequate trainings to their workers. Almost 40 percent of companies offer training, but there is a large disparity between large and small firms, with around 60 percent of the former group and only 35 percent of the latter being able to offer formal training to their employees (World Bank ES, 2019). The scarcity of talent is omnipresent, with the IT industry emerging as one of the most badly affected sectors. High levels of outward migration compound the skill shortage, with people migrating to the EU and CIS to take advantage of large wage gaps. Young people with secondary or vocational education are most likely to migrate, while people with tertiary education are least likely to do so.³⁴

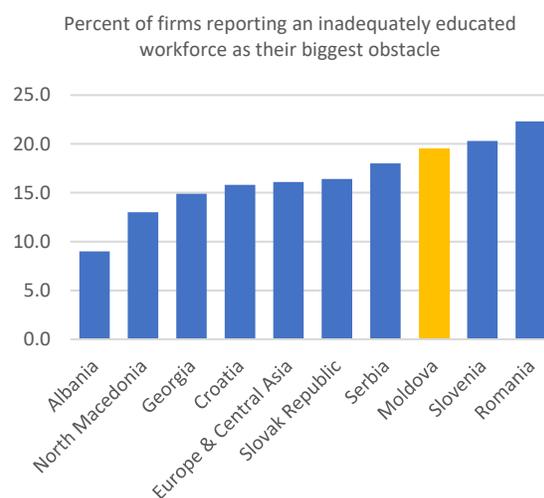
³⁴ ILO, 2017.

Figure 33. Firms in Moldova report an inadequately educated workforce as the main obstacle, followed by political instability



Source: WB Enterprise Survey, 2019.

Figure 34. Relative to its peers, more firms in Moldova report skills constraints as their biggest obstacle



Source: WB Enterprise Survey, 2019.

3.2 A weak business environment limits private sector dynamism

Although there has been progress in upgrading the business environment, it has been uneven. The overall perception of state intervention in business activity has greatly decreased in the past 15 years. Major improvements include: (i) the reform of permits and licenses, with a large decrease in the number of authorizations initially envisioned; (ii) consolidation and streamlining of the inspection bodies; and (iii) the introduction of mandatory risk-based inspections. With the simplification of administrative procedures, including the introduction of one-stop shops for issuing permits, the time that Moldovan firms spend dealing with regulatory requirements, permits, and the frequency of inspections has been dramatically reduced, as have the opportunities for taking bribes and other corruption. Nevertheless, some processes are still cumbersome, including company liquidation, construction permits, phytosanitary certifications, and inspections, in particular by the state tax service. In addition, some restrictions exist within the regulatory framework toward foreign investors, which may contribute to the low observed level of FDI.

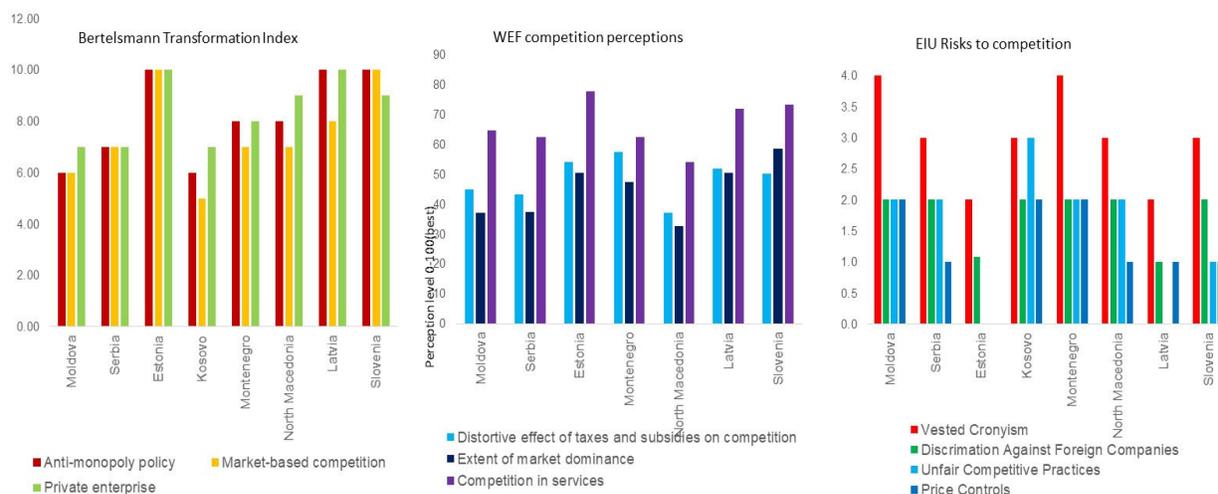
The competitiveness of Moldovan firms is affected by limited competition and weak competition policies, including the preferential treatment of SOEs and price controls. According to the GCI, Moldova scores very badly on the effectiveness of its antimonopoly policy, with a few companies dominating the internal market. Market dominance, together with favoritism and the preferential treatment of SOEs, results in weak and unfair domestic competition. In addition to the significant use of state aid,³⁵ which is frequently allocated on an individual basis, including to SOEs, the Government also adopts a range of price control, for example by regulating retail margins and prices in several sectors, such as essential foods, fuel, and pharmaceuticals. Despite this price regulation, the average prices of these products are about 53 percent higher in Moldova than in peer countries.³⁶ This uncompetitive environment has yielded a

³⁵ On average, for 2014–16 total Moldovan state aid constituted 4.3 percent of GDP, while it declined below the 1 percent of GDP target in the most recent years (Source: Competition Council). In addition, there is considerable indirect state support to SOEs through exemptions, rebates, deferrals, and rescheduling of tax payments which together amount to another 3 percent of GDP (Moldova Policy Notes, 2019).

³⁶ World Bank. 2019. Moldova CEM.

private sector in which employment is concentrated in older and less productive firms, survival rates for young firms are low, and existing firms are more likely to shed rather than add jobs.³⁷ This results in an incentive for informality, with a decreasing share of formal wage jobs and a higher share in informal self-employment.

Figure 35. Moldova's competition indicators in regional perspective



Source: WB staff calculations based on WBI, WEF, EIU.

Large SOEs in Moldova create distortions and exercise market dominance. SOEs in Moldova employ up to 24 percent of the labor force, have assets that are valued at about one-third of GDP, and are active in at least 40 sectors where private participation is economically viable, compared with the OECD average of just 14 sectors. Their performance is weak, with SOEs registering lower turnover per employee and slower productivity growth, while foreign-owned firms are 80 percent more productive than SOEs. Low productivity and high inefficiency of SOEs in utilities have an impact on inequality of opportunity and private sector competitiveness. In sectors where the private sector operates, SOEs continue to benefit from more than 7 percent of GDP in state aid,³⁸ affecting the investment climate and leading to an uneven playing field.^{39, 40} Despite some progress in enhancing SOE governance, oversight, and transparency, the proximity of political factors in SOE governance creates a favorable environment for corruption, vested interests, and illicit procurement.

Trade regulations and poor logistics are holding back trade development, despite numerous free trade agreements, including the Deep and Comprehensive Free Trade Area (DCFTA). Almost 14 percent of surveyed companies identify customs and trade regulations as a major constraint to trade, far higher than the ECA average of 8.5 percent. This constraint constitutes a bigger obstacle than in other countries, as Moldovan companies relies more on imports and trade than other companies in the region (World Bank ES, 2019). When it comes to exports, businesses encounter major obstacles, particularly related to documentary compliance for exporting. Despite WTO requirements, the application of the residual valuation method (method 6) is common and not properly explained to companies by customs, making

³⁷ World Bank Jobs Diagnostic for Moldova, 2016.

³⁸ SOEs receive both direct and indirect support through exemptions, rebates, deferrals, and rescheduling of tax payments

³⁹ World Bank. Country Economic Memorandum, 2019

⁴⁰ World Bank. Moldova Policy Notes, 2019.

the costs of trading less predictable. The ineffective food safety system for animal products, including laboratory infrastructure and enforcement of regulations by Moldova's National Food Safety Agency, prevents export accreditation for the EU and other foreign markets.

3.3 Infrastructure gaps and limited digitalization weaken connectivity and market access

Despite a large investment in road maintenance, the poor quality of road transport and declining railway use limit overall connectivity. Since 2016, around one-quarter of Moldovan roads have been repaired (2,103 km out of 9,344 km), and almost half of them have been transferred to Local Public Authorities (LPAs) to allow for better management, complemented by the transfer of more than a 40-percent share of the Road Fund to LPAs. Nonetheless, the percentage of the overall road network assessed as being in good or fair condition was only around 44 percent in 2019, and much lower for local roads. With almost two-thirds of the Moldovan population living in rural areas, and with only about half of the small rural towns having an organized transport service, this has critical consequences not only for competitiveness but also for inclusion. Meanwhile, Moldova's railway network has lost significant transport volume during the past two decades. This has been driven by the change in geopolitical circumstances, first with the dissolution of the Soviet Union, and then followed by fluctuations in production and export of grain and vegetable oils, which are traditionally rail market products, but primarily by the lack of public funding and inefficiency of the state-owned railway company, Calea Ferată din Moldova (CFM). CFM has failed to maintain and renew its physical assets due to prolonged inefficiencies, providing a boost to alternative transport systems in the form of road transport. Since 2012, CFM's average cost per unit of operation has been constantly higher than the average revenue per unit. Its current transport operations do not generate sufficient revenues to cover operating costs, causing the company to keep accumulating financial losses on an annual basis. The planned reorganization of CFM presents the opportunity to enhance competitiveness, develop a green transportation system, and provide safer and affordable transport services. Insufficient supply of quality transport infrastructure is a major drag on private sector development in Moldova and further prevents Moldova from fully reaping the benefits of a closer trade integration with the EU.

The performance and financial sustainability of urban public transport systems are poor. Urban public transport in Moldova is constrained by legacy assets and operating practices, and is now facing the additional impacts from the COVID-19 crisis.⁴¹ As the country recovers from the COVID-19 pandemic, there is an acute need to target financial and operational improvement in public transport services, as fiscal constraints pose a formidable challenge to service sustainability. Expanding the use of technological solutions to modernize operations, and reorganizing service delivery, together with the modernization of assets to reduce further operating costs, can all be part of the solution.

Digital connectivity is also a constraint, despite significant improvements in recent years. Digitalization of SMEs is low, constrained by limited infrastructural investment, market and regulatory barriers, and low digital literacy. According to World Bank-LinkedIn research based on 2017–19 data, computer software, telecommunications, IT and services are among the top four skills that Moldova is losing due to talent migration. The weak regulatory environment and physical digital investment gaps place Moldovan firms at a competitive disadvantage in an era of rapid digitalization, accelerated by the COVID-19 pandemic.

⁴¹ For example, during the first two waves of the COVID-19 pandemic, Chişinău decided to keep public transport operating to preserve vital mobility services to segments of the population that were economically unable to remain in isolation at home. To mitigate the risk of infection, the city implemented two critical measures: (i) reducing levels of crowding by expanding the number of vehicles serving the highest density routes; and (ii) eliminating the role of conductors/fare collectors on vehicles to reduce the exposure of frontline operational staff and cash operation-related infection risks. This resulted in higher operating costs due to increased vehicle-kilometers, in addition to forgone fares revenues.

Although the market for connectivity has few regulatory entry barriers, it is in fact highly concentrated: two of the three mobile operators own almost 85 percent of the market; and the fixed broadband market is affected by the distortive presence of the SOE, Moldtelecom, which owns more than half of the market. Regulation and sector governance remain weak due to the political economic challenges, continued market power of the SOE, and the inadequate independence and limited mandate of the sector regulator, the National Regulatory Agency for Electronic Communications and Information Technology (ANRCETI).

Figure 36. Moldova displays in particular weaker water infrastructure performance compared with its peers

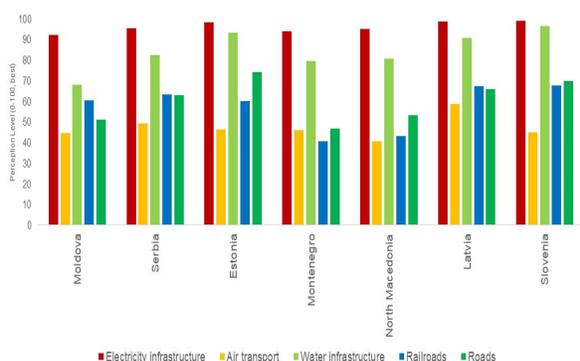
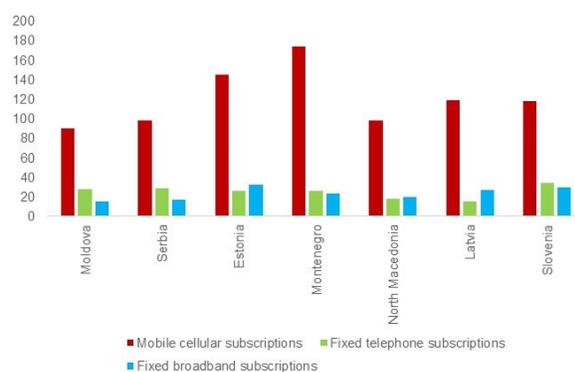


Figure 37. ICT adoption, as proxied by mobile cellular subscriptions, is low compared with its peers



Source: HBS, 2019; WB staff calculations.

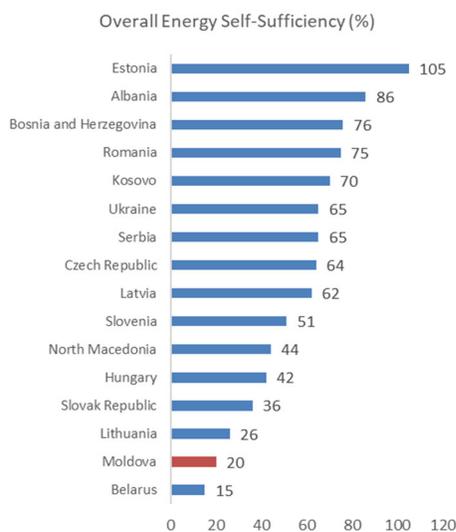
As already observed in the 2016 SCD, inadequate access for firms to core services such as electricity, and to a lesser extent water, exerts a negative impact on the productivity of firms. Energy security, defined as the uninterrupted availability of energy sources at an affordable price, remains a challenge for Moldova’s development, as clearly shown by the 2021 energy crisis. In addition, the country’s energy self-sufficiency is particularly low, the 16th lowest in the world and the 2nd lowest, after Belarus, in ECA, as it relies entirely on imports for oil and gas. Only around 20 percent of the country’s energy demand is covered by domestic production, mostly biomass from agriculture. Energy efficiency and intensity remain key issues. According to the International Energy Agency (IEA), energy intensity defined as energy consumption by unit of GDP in Moldova is double the EU average and among the highest in the ECA region (2019). Unreliable electricity provision and electricity outages hinder particularly the productivity and competitiveness of businesses. The World Bank ES (2019) shows that the percentage of firms reporting power outages is still above the ECA average (36.8 vs 31.5 percent), with an average duration that is four times longer than the ECA average, but that can last for more than 12 days. Moreover, the number of days needed to obtain an electricity connection is 99, more than double the ECA average.

Despite recent progress, reliance on a single import source, governance challenges, and slow reform implementation combine to impede energy security. Despite the participation in the Energy Community (EnC) and the plan of asynchronous interconnection with Romania (EU/ENTSO-E), Moldova remains de facto dependent on one source—a gas-fired power plant in the disputed Transnistria region. Similarly, despite improvements in energy sector functioning, pricing, competition, and regulatory alignment with the EU, procurement continues to be affected by political influence, a lack of competition and transparency, and the potential for collusion between traders and generators due to the role of Energocon, the SOE supplier of electricity for all the regulated electricity companies. As a result, electricity prices for households are higher than regional or structural peers (e.g., Ukraine, Kosovo, North

Macedonia, Albania). The situation in the gas sector is similar. Currently, Moldova has no gas storage capacity, and the gas sector is dominated by a single company, Moldovagaz, in which Gazprom has a controlling stake (50 percent plus one share). Finally, while Moldova has a high potential for renewable energy (RE) and has been diversifying its energy mix since 2010, RE comprises only 20 percent of total energy supply.

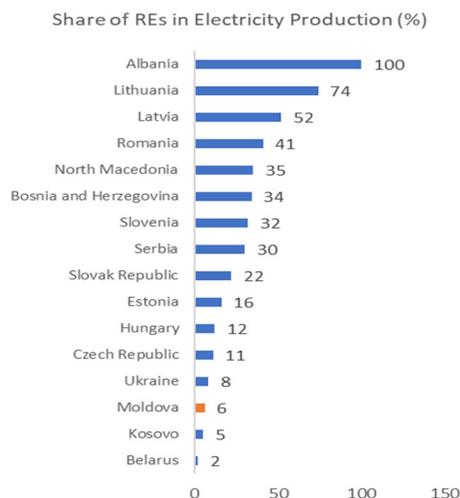
Power generation from renewables remains limited despite the great need to diversify supply sources and improve energy access. The main barrier for investments in RE projects is the scarce availability of capital. There are no national or municipal funds for development of energy efficiency projects, and high interest rates on bank loans hinder the formation of a market for private companies involved in development of energy projects. From the institutional and administrative point of view, one of the barriers to the energy efficiency investments is the fact that so far development and implementation of all energy efficiency and RE projects have been done by state institutions. Lack of a public tendering process has hindered the formation of a competitive environment for private companies. Funding available for RE projects is mainly restricted to international financial institutions. Only foreign-owned banks have financed a limited number of RE investments, whereas local banks are reluctant to provide funding for RE projects as they are deemed as extremely risky.

Figure 38. Overall energy self-sufficiency



Source: IEA, 2018.

Figure 39. Reliance on renewables

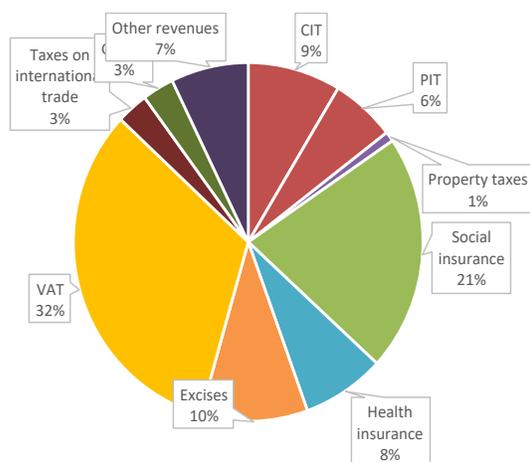


4. Limited room for fiscal policy to support recovery and long-term growth

Moldova is confronted with the challenge of declining revenues, mounting contingent liabilities, and increasing social pressures, while at the same time it seeks the resources necessary to support the economic recovery and steer the economy toward a new growth path. The COVID-19 crisis has strained public finances due to weak revenues and rising COVID-19-related spending, on top of already limited fiscal space affected by the reversal of consolidation efforts in 2016. Volatility due to discretionary policy changes along the political cycle, vulnerability to external shocks, a lack of access to capital markets, and high reliance on external financing remain a challenge. At the same time, budget rigidities reduce the space for countercyclical responses or long-term development priorities associated with the new growth

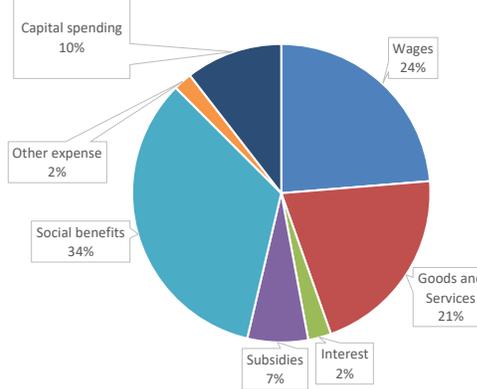
model. Over the past decade, social spending was the key driver of overall spending, crowding out other priority spending. Moldova spends almost 70 percent of its total general government spending on social sectors (social protection at 35 percent, education at 18 percent, and health at 13 percent). Based on the economic classification, spending in social benefits accounts for 34 percent of total spending, followed by wages (24 percent), goods and services (21 percent) and capital spending (10 percent). Further fiscal pressures are expected from the aging of the population and the recent changes in pensions related to the contribution rate cut, lower retirement ages, and an increase in the minimum pension.

Figure 40. General government revenues, 2019



Source: WB calculations based on MoF data.

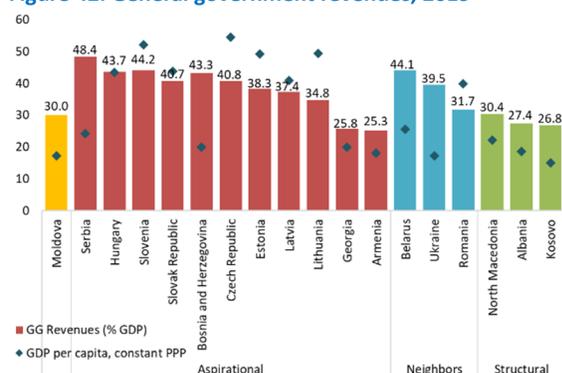
Figure 41. General government spending, by economic classification, 2019



Source: WB calculations based on MoF data.

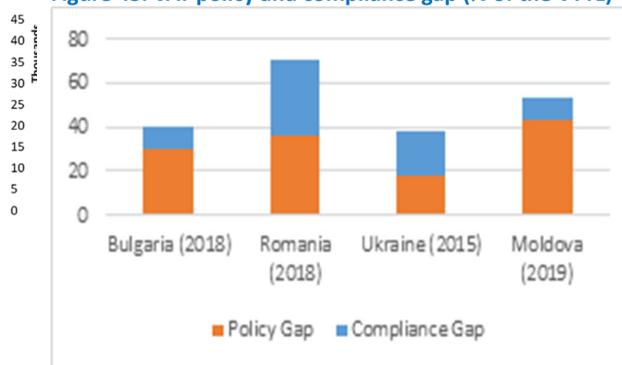
Declining tax collection, inefficiencies, and distortions are constraining private sector-led growth. While Moldova collects similarly to its peers, its tax collection is on a mild declining path. The efficiency of the tax system is relatively low, due to a narrow base, multiple tax preferences, deductions and exemptions, differentiated rates across sectors, and income sources. For instance, the tax gap is estimated to be around 5 percent of GDP, with a large part of this revenue coming from value-added tax (VAT), which is estimated to have a tax gap of over 50 percent. Moreover, unnecessary complexities exist in terms of tax preferences across sectors and labor taxation, discouraging formal employment, and creating an uneven playing field across sectors and firms. Personal income tax (PIT) collection is weaker than in peer countries due to multiple exemptions, large informality, and poor management. Moreover, differentiated rates across sectors and informality make the agriculture, mining, energy and gas, construction, and financial sectors contribute less than their shares in the economy. Finally, Moldova’s collections of corporate income tax (CIT) are increasingly reliant on large taxpayers, while individuals conducting entrepreneurial activities, micro and small businesses, and the agriculture sector enjoy preferential treatment.

Figure 42. General government revenues, 2019



Source: WB calculations, GFS and WEO.

Figure 43. VAT policy and compliance gap (% of the VTTL)



Source: WB staff calculations, GFS.

5. Large gaps in public service delivery and persistent inequality of opportunity

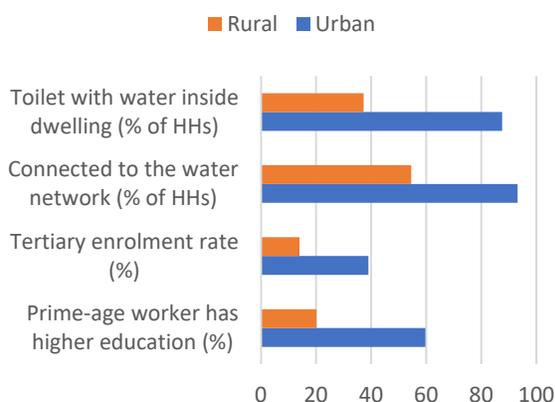
Persistent inequality of opportunity results in stark disparities in access to public services and human development outcomes across the spatial dimension and socio-economic groups. Inequality of opportunity in Moldova is among the highest in the ECA region, with access to services that are important for human capital accumulation and productivity substantially lower in rural areas and among lower-income households.⁴² In 2019, 37 percent of rural households in Moldova had access to a toilet with water, compared with almost 90 percent in urban areas. Similarly, only 14 percent of rural 18 to 24-year-olds were enrolled in tertiary education, compared with 39 percent in urban areas.⁴³ Urban vs rural location is also the main source of inequity in access to improved water and sanitation, and tertiary education, with the economic status of the household and regional location being other important sources of inequity (Figure 9). The digital divide is also important, with only half of rural households and one-third of households in the bottom 40 percent of the income distribution having an internet connection in their dwelling. Affordability remains a challenge, with the entry-level broadband plans costing over 5 percent of GNI per capita—the highest among Eastern Partnership (EaP) countries,⁴⁴ and much higher than the UN Broadband Commission’s proposed target of 2 percent of GNI per capita. As a result, young Moldovans from rural areas and low-income households are not well-equipped to enter the labor force and obtain higher-quality employment, leading to chronically low labor force participation rates and high outmigration.

⁴² According to a regional study by the EBRD, over 40 percent of income inequality in Moldova is due to inequality of opportunity. This share is among the highest in ECA (EBRD, 2016).

⁴³ Based on calculations on the 2019 HBS.

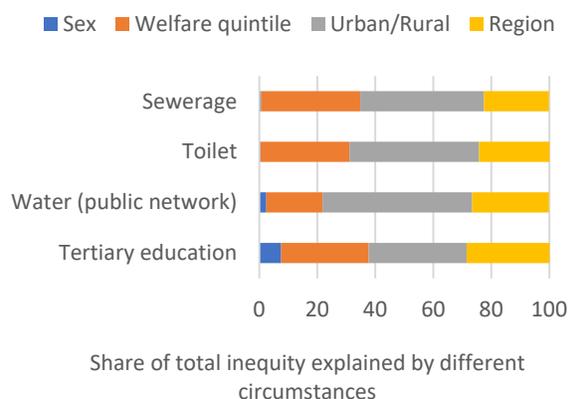
⁴⁴ The Eastern Partnership includes six partner countries: Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine.

Figure 44. Stark disparities in access to public services and human development outcomes across urban and rural areas



Source: HBS, 2019; WB staff calculations.

Figure 45. Location is the main source of inequity in access to important services



Source: HBS, 2019; WB staff calculations.

While Moldova scores relatively well on laws and regulations that affect women’s economic inclusion, significant disparities remain, particularly in the labor market. Moldova scores 84.4 out of 100 on the 2021 Women, Business and the Law Index, higher than the ECA regional average of 83.4. Girls perform better in school than boys, both in terms of enrolment and test scores.⁴⁵ The gender pay gap, however, remains significant at 14.4 percent in 2019, largely on a par with the EU average (14.1 percent), but lower than many regional peers. The pay gap is in large part driven by women being overrepresented in lower-paying sectors. Women are also far less likely to participate in the labor force, with female labor force participation standing at 38.2 percent in 2019, compared with (a still low) 47 percent for men. Low female labor participation rates are largely driven by care-giving duties: the labor force participation rate among women (20–49) without pre-school children is 22 percentage points higher than that of women with young children, and indeed higher than men’s labor force participation rates.⁴⁶ Women are also overrepresented among the poor, though this is the result of having more women than men in the population, rather than higher poverty rates among women.

Institutional weaknesses at the sectoral level, the slow pace of reform implementation and, in some sectors, underinvestment result in substandard and cost-ineffective delivery of public services. In the education sector, for instance, despite Moldova spending a higher share of GDP on education than the ECA average, learning outcomes are lower, and significant disparities continue to exist in rural areas and among disadvantaged groups. In the health sector, outcomes are also lagging despite public health spending that is comparable with other countries on similar income levels. A large share of the health budget continues to be absorbed by spending on oversized existing infrastructure rather than spending on primary health care, resulting in suboptimal health outcomes. The water sector is characterized by funding gaps, weak sector governance, and missing institutional functions,⁴⁷ resulting in large access gaps with only one in eight rural households having access to a flush toilet and almost 1 million Moldovans relying on often polluted wells. In energy, Moldova is entirely dependent on imports from one single supplier, and procurement is affected by political influence, and a lack of competition and transparency.

⁴⁵ According to the 2018 PISA assessment, girls score better than boys in each of the three subjects (reading, math, and science).

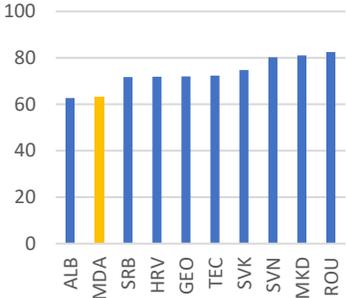
⁴⁶ In the 20 to 49 age range, 61 percent of women without children participate in the labor force vs 56 percent of men without children.

⁴⁷ Funding for the water sector amounts to 1.4 percent of general government spending, compared with the average global benchmark of 5 percent.

In the transport sector, and despite significant investments in recent years, only about half of the towns in rural areas have an organized transport service, while accessibility and connectivity in urban areas are constrained by obsolete assets and organizational approaches. Funding for the transport sector remains low and lacking in transparency. In agriculture, the provision of extension services to farmers, including technical advice on agriculture to farmers, the supply of the necessary inputs, services, and information to support their agricultural production, has significantly declined since 2018. While the future plans foresee relying on existing education and research institutions for their delivery, these entities currently lack the physical presence, resources, and skills to actually provide agricultural extension services.

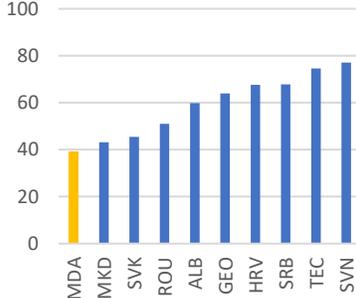
As the issues with service delivery permeate all sectors, education and social protection reforms remain key for Moldova to sustainably achieve higher standards of living for its population. The 2016 SCD singled out issues in the education and social protection sectors as binding constraints to sustained poverty reduction and shared prosperity. While low labor demand—linked to pervasive institutional and governance weaknesses—is the main reason behind the observed poor jobs outcomes in Moldova, evidence that insufficient skills in the workforce are also a key constraint is accumulating. The relatively low supply of workers with advanced education and low tertiary enrolment rates, combined with high (though stable) returns to tertiary education,⁴⁸ low unemployment among graduates, rapidly rising wages, and the identification by firms of an “inadequately educated workforce” as the single main constraint to their operations, all suggest that a lack of relevant skills has increasingly become a constraint. It is important to note here that the much better job outcomes for workers with tertiary education do not necessarily imply that the skills issue primarily resides in a short supply of tertiary education. According to Moldovan employers, missing skills mainly relate to insufficient occupation-specific technical knowledge, a poor work ethic, and a lack of motivation and initiative skills (Rutkowski et al., 2017). Low access to higher levels of education among the youth in rural areas and lower-income households is currently a binding constraint for shared prosperity, constraining upward mobility of poor households given the high returns to tertiary education. Worryingly, efforts to improve the employability of the youth through recent vocational education and training (VET) investments have not paid off, and the proportion of the youth not in education, employment, or training (NEET) remains high.

Figure 46 : The share of the labor force with advanced education is low



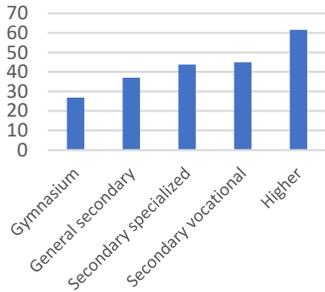
Note: Advanced education includes vocational training. Source: WDI, 2021.

Figure 47 : Gross tertiary enrolment rates are low compared with peers



Source: WDI, 2021.

Figure 48: Employment rates are higher for higher-educated workers



Source: NBS, 2019.

⁴⁸ A Mincerian wage regression with a Heckman correction for labor force participation shows that, between 2014 and 2018, tertiary-educated workers earned about twice as much relative to workers that have not completed secondary education and 40 to 50 percent more than workers with specialized vocational training. Household disposable incomes show a qualitatively similar pattern, with per capita disposable income being 60 and 100 percent higher for households headed by a tertiary educated head relative to households headed by a person who completed specialized vocational and general secondary education, respectively (NBS, 2020).

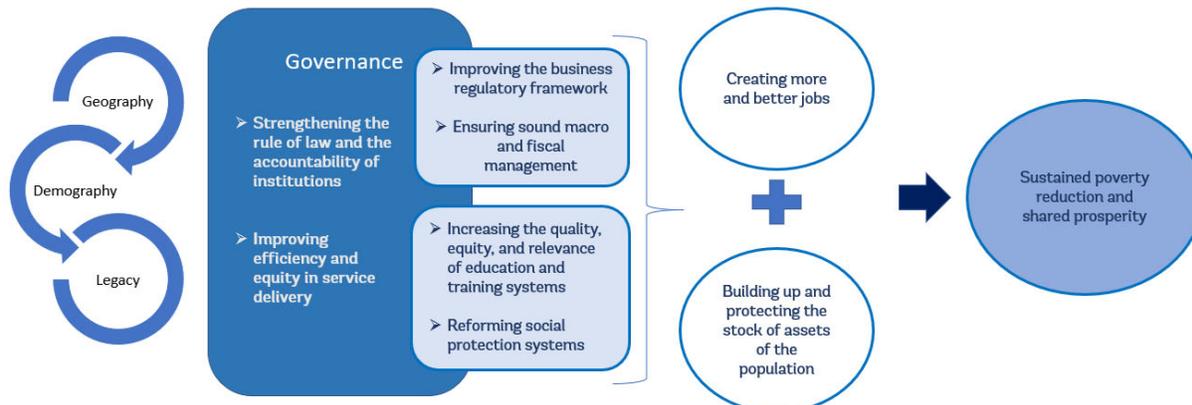
Given its demographic profile, old-age pensions constitute the main part of the social protection system in Moldova; recent policy measures and reversals have, however, significantly affected the financial balance of the pension system. While prior reforms strengthened the fiscal and social sustainability of the pension system and would have resulted in higher replacement rates, the subsequent contribution rate cut and lowering of the retirement age have led to substantial deterioration of the pension system deficit and a projected drop in the replacement rate, especially for women. In addition, there is a small but growing number of people who reach retirement age without having enough of a contributory period to earn an old-age pension. This category mostly consists of farmers, whose participation in social insurance was made voluntary in 2009 (and, as a result, most farmers quit the system). As a result, simulations show that almost half the people above retirement age would eventually be ineligible for pensions, with a devastating impact on old-age poverty. Addressing the policy reversals, re-integrating farmers into the social insurance system, and improving the equity in the system (convergence of the military pension scheme with the general one, unification of contributions between self-employed and employed workers, etc.) are crucial to setting the pension system back on a path of fiscal and social sustainability.

While old-age pensions are an important contributor to disposable income growth in Moldova for all households, targeted social assistance is a significant source of income growth for the poorest households, but its poverty-reducing effect is limited due to low coverage. While targeted social assistance to poor families is the most efficient way to reduce inequality and has the best targeting results—almost 87 percent of Ajutor Social program’s budget goes to the poorest quintile, while 0 percent goes to the top quintile—its coverage is low at about 3 percent of the population. In view of this, the continued low coverage of Ajutor Social represents a missed opportunity for further reductions of poverty and inequality, and a higher risk of intergenerational poverty traps among the poorest households.

D. PATHWAYS TO THE TWIN GOALS

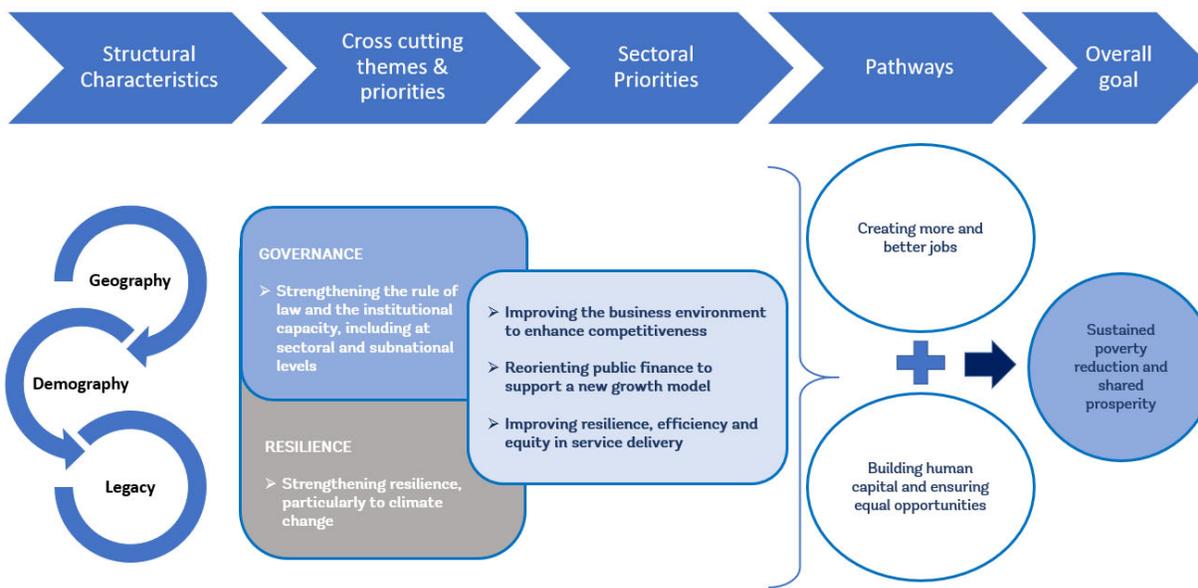
Against the background of an increasingly unsustainable growth model, and shifts in the global economy in terms of digitalization and the green economy, there is even more urgency to support institutional and policy changes that are conducive to a more balanced growth model. To consolidate and accelerate inclusive growth and poverty reduction, the 2021 SCD Update confirms the overall recommendation of the 2016 SCD: the need to rebalance Moldova’s increasingly unsustainable growth model from one based on remittance-fueled consumption toward one sustained by private sector growth and job creation. The 2016 SCD identified two pathways underpinned by six priorities that sought to alleviate the most binding constraints to private sector-led growth and job creation, and broad-based accumulation of productive assets (Figure 49). Within each of these six priorities, the 2016 SCD underlined the need for potential solutions to consider Moldova’s specific structural characteristics, chief among which are the country’s openness and proximity to two large markets (“geography”), its rapidly aging and shrinking population (“demography”), and its legacy as a largely rural and administratively fragmented former Soviet republic (“legacy”). Since 2016, the pace and type of growth have not resulted in broad-based job creation, particularly in the tradable sector, despite efforts and progress in several reform areas. Moreover, demographic and employment trends have deteriorated, while remittances have steadily declined, highlighting the unsustainability of the current growth model and the need to urgently tackle the most binding constraints to private sector-led growth.

Figure 49. 2016 SCD Framework



With the broad development landscape unchanged, the 2021 SCD Update concludes that the previously identified pathways are still valid, but adds more urgency to institutional strengthening and more emphasis on resilience. While Pathway 1 “*Creating more and better jobs*” remains unchanged, the 2021 SCD Update stresses the importance of not only strengthening human capital but also ensuring equal opportunity in access to key public services (Pathway 2: “*Building human capital and ensuring equal opportunities*”), given the large spatial and socio-economic gaps in access to important public services and opportunities, including but not limited to education. If Moldova is to navigate the two pathways—which is necessary for a gradual rebalancing of growth, and more reliance on productivity and competitiveness—it needs to: (i) strengthen the rule of law and institutional capacity, including at the sectoral and subnational levels; and (ii) strengthen resilience, particularly to climate change. Other top priorities are: (iii) improving the business environment to enhance competitiveness; (iv) reorienting public finance to support a new growth model; and (v) improving the resilience, efficiency and equity in service delivery (Figure 50).

Figure 50. 2021 SCD Framework



Priority 1: Strengthening the rule of law and institutional capacity, including at the sectoral and subnational levels

Governance, the rule of law, and accountability remain the most pressing priorities in Moldova, representing significant constraints to firms across all sectors. Challenges related to strengthening the rule of law and institutional capacity are the main constraints, and are holding back productivity growth across all sectors of the economy. Moldova scores poorly in terms of trust in the courts and the judicial system, and competition, all of which undermine business performance and productivity and, thus, job creation. The political instability of recent years has affected the speed of implementation of the reforms and impunity related to high-level corruption threatens the country's prospects. Institutional failures across the board that conspire against a healthy business environment should be eliminated. Addressing weak governance and rule of law will also help Moldova retain and attract FDI. Addressing these challenges requires action on many fronts.

Reform of the judiciary remains the highest priority. The judicial and prosecution governance bodies (the Supreme Council of Magistrates and the Superior Council of Prosecutors) need to undergo profound reform to achieve independence, integrity and accountability, and facilitate an effective judiciary system in which the rule of law prevails. All senior prosecutors, including members of the Superior Council of Prosecutors and their boards, need to be selected through credible processes with an emphasis on professionalism and integrity, while the jurisdiction of the anti-corruption prosecution office needs to be refocused on high-level corruption and its independence strengthened. The same selection principles should be applied to the judicial system, particularly to ensure a transparent and fair mechanism for selecting and appointing judges. In parallel, there is a need to evaluate the integrity of both judges and prosecutors. Along with this, the consolidation of the court map and the use of IT solutions could result in faster case processing, a more efficient configuration of courts, and a reduced workload on judges. In parallel, special attention should be given to the enforcement bodies (bailiffs), for which there is a need to introduce accountability measures and independent governing bodies that would limit discretionary and abusive actions, particularly to benefit poor and vulnerable groups.

Reforms to strengthen the asset declaration system by implementing risk-based verification should continue. The introduction of the asset declaration verification after the 2016 SCD failed to yield major outcomes in terms of tackling integrity issues among high-level and high-risk officials. The asset declaration agency needs to implement a risk-based approach to the verification of asset declarations and maximize the use of the electronic verification system. There is a need to strengthen the asset declaration legislation by further clarifying and expanding the categories of information that are disclosed, introducing a risk-based approach to verification, including automatic cross-checks with registries and databases, making information that is now publicly available accessible in machine-readable format, and abolishing integrity certificates.

Similarly, addressing deficiencies in tax administration capacity is key to supporting progress against informality and corruption. Administration remains weak in detecting major tax evasions and catching various fraudulent schemes, which over time have become increasingly sophisticated. A complex structure of fiscal incentives across sectors and regions, combined with multiple tax rates and exemptions, increases the risks of fraud, bribes and corruption. Some aspects of the taxpayer interface have been improved through the introduction of an e-declaration system, the online payment for some taxes, and a reduction in the number of tax declarations. However, there is considerable scope to enhance taxpayer services, increase voluntary compliance and address the weaknesses in tax administration. This includes adequate attention to large taxpayers, a focus on compliance, the integrity of taxpayer registration, and developing risk management throughout the tax process to promote the formal economy.

Strengthening the capacity and enhancing the quality of sectoral and subnational institutions are key. Most of the attention in recent years has been concentrated at the national/central government level. Complementing these high-level actions on governance and the rule of law with an agenda of improving institutional capacity and accountability across sectoral ministries, agencies, and local governments is also essential for private sector development and improved service delivery. These actions include: (i) strengthening fiscal institutions to enhance fiscal resilience, and strengthening the independence and supervisory capacity of the National Bank of Moldova (NBM) and the National Commission for Financial Markets (NCFM) to enhance financial stability; (ii) enhancing the capacity of the banking system’s deposit guarantee fund (FGDSB), and strengthening institutions at the sectoral level to improve their strategic investment planning and implementation capacity; (iii) reforming a number of sectoral agencies and SOEs to improve service delivery (e.g., the National Energy Regulatory Agency [ANRE] in energy, Apele Moldovei in water, Moldtelecom in telecommunications); and (iv) providing a clear mandate to the National Commission for Emergency Situations for facilitating the process of strategy development and overseeing implementation of national Disaster Risk Management (DRM) strategy, among others. This process should be accompanied by comprehensive stocktaking of the existing SOEs at central and subnational levels, and defining the rationale for their continued operations in competitive and contestable sectors, with the aim of reducing the state’s footprint in such sectors, reducing distortions and enabling greater private sector participation. Where the state decides to keep strategic SOEs in its hands, incentives for better performance and improved governance structures are required.

Priority 2: Strengthening resilience, particularly to climate change

Strengthening resilience, in particular to climate change, has been identified by the diagnostic as a pressing cross-cutting priority. The increasing frequency, intensity, and impact of climate-related natural disasters such as the recent drought have underscored the need for building resilience against shocks and preparedness to mitigate the major socio-economic consequences. Climate change is expected to amplify some natural disasters, posing serious risks to the economy, given the continued importance of agriculture, with implications for fiscal balances and the wellbeing of vulnerable populations. Other non-climate change-related natural hazards, such as earthquakes, also pose significant socio-economic risks to the country. It is paramount for Moldova to strengthen disaster risk preparedness and response, and invest in resilience, prevention, and risk reduction, as it scores poorly on the institutional readiness to adapt to the effects of climate change.⁴⁹ Successful adaptation builds on systematically taking into account both present day and future climate risks from the start, and requires data-driven adaptation planning and decision-making in areas such as DRM, water security, forests and landscape management, financial protection and human development (World Bank Group Action Plan on Climate Change Adaptation and Resilience, 2019).

A comprehensive DRM and climate resilience agenda should support a shift from a “reactive” to “proactive” approach. The DRM and climate resilience reform agenda will need to comprise multiple elements, building on a comprehensive and clear DRM framework that should be laid out to facilitate inter-agency coordination, decision-making, and risk-informed development planning. Reform priorities include: (i) scaling up investments in risk reduction, with a particular focus on seismic risk mitigation and flood protection; (ii) upgrading the emergency response and preparedness (including early warning systems), and expanding disaster risk financing and insurance options; (iii) building spatial data infrastructure and improving data-sharing among relevant institutions for informed decision-making in land management, DRM, spatial planning, and environmental monitoring; and (iv) clarifying the roles of

⁴⁹ As measured by the University of Notre Dame’s Global Adaptation Initiative (<https://gain.nd.edu/>).

land sector institutions and revisiting the 2018 institutional reorganization. Rural resilience is also about financial protection through access to liquidity following shocks, and risk reduction through insurance, but also financial instruments that help farmers invest in risk mitigation, for example, in irrigation equipment or drought-resistant seeds.

Significant efforts have been made on assessing flood risk and identifying priority measures. Flooding imposes high costs on Moldova's economy, estimated to be at least US\$62 million annually, with increasing impacts due to climate change. Strategic options to address these costs include the rehabilitation and improvement of the existing dike system, new and rehabilitated flood storage dams, the enlargement of river channels, the restoration of watersheds, and the use of nature-based solutions, together with improved flood forecasting and early warning systems. However, financing has not been identified and implementation remains severely limited. An integrated approach at the basin level, informed by River Basin and Flood Risk Management Plans, is needed to mitigate water-related risks. In the context of climate change, urban flooding is increasingly a challenge in Moldova's cities and towns, and efforts are required to improve stormwater management infrastructure.

The reform agenda would need to be mainstreamed within key sectors and supported by adequate institutions to ensure effective implementation and effective use of resources. The DRM reform agenda should be integrated with sector-specific reform agendas, in particular in key sectors for the country's development, such as urban planning, natural resources and water, agriculture, and infrastructure, particularly energy and transport, among others. Moreover, institutional reforms and capacity building across the board are needed toward a more resilient Moldova. As highlighted by the current energy crisis, diversifying energy sources including renewables, and broadening alternative energy suppliers are important considerations for Moldova's overall resilience.

Among the top priority sectors, forestry reform is essential to protect Moldova's natural assets and promote a more resilient agriculture sector. In the forestry sector, a division between regulatory, management, and control functions is necessary. Strengthening the regulating and monitoring capacity of the central authority, and implementing a unitary policy for forest development and conservation are also needed. These should be supported by increased efficiency in the management of forests and non-state forest assets, and by adapting forestry products and services to the market economy, hence supporting the private sector's involvement in specific forestry sector activities. The professional capacity of the foresters should be strengthened through education, training, and a career management system.

Water resource management is also a top priority and should be strengthened. A number of reforms are needed, including (i) modernizing water resource management information systems, including the water cadastre; (ii) operationalizing river basin management plans, including the consolidation and the optimization of various national funds; (iii) increasing green/grey infrastructure, including investment in flood management; and (iv) ensuring the capacity and mandate of the water agency. Reforms in the area of irrigation and drainage include the elaboration of a comprehensive irrigation investment plan and financing framework, liquidation of state irrigation enterprises, support for the uptake of rehabilitated schemes, and further prioritizing the rehabilitation of irrigation and drainage infrastructure. As discussed under *Priority 1*, reform of the underlying institutional framework, with particular focus on Apele Moldovei, is a precondition for successful reform of the water sector.

Green transport and connectivity are a key priority. There is an urgent need to begin decarbonization of the transport systems in Moldova, for three reasons: (i) to enable timely alignment with a zero-emission pathway; (ii) to avoid a widening of the technological and regulatory gap with the EU; and (iii) to realize the significant economic and social benefits that green policies would deliver. Road freight improvements, rail modernization, electric vehicle promotion, and urban transport enhancement are among the top

priority policy areas for ensuring green transport and connectivity across the country.⁵⁰ As discussed under *Priority 1*, underlying institutional reforms, for example through the reorganization of the national railway company (CFM), are critical.

These reforms will contribute to a stronger and more competitive agriculture sector. Programs for the rehabilitation of irrigation systems should be integrated with the development of intensified production of high-value agricultural products (agri-clusters around irrigation systems). The promotion of on-farm adaptation should be supported through knowledge dissemination and financial incentives on improved on-farm water management, soil management, risk management technologies, and adjustments in the crop mix. Finally, the restoration of degraded forests and pastures would also increase agricultural productivity through their improved watershed function and greater protection from harsh weather.

Building capacity and strengthening institutional frameworks are necessary to help underpin many of these infrastructure, information, and finance gaps. For example, the institutional reorganization that occurred between 2017 and 2018 left the land sector without clear institutional roles and responsibilities. The geospatial agenda is led by the Agency of Land Relations and Cadastre (ALRC), but the work on integrated spatial data management and the establishment of national spatial data infrastructure is at a very early stage. There is currently no interoperability between, for instance, the Public Services Agency, which is responsible for the Real Estate Cadastre and the address registry, the Institute of Geodesy, Engineering Research and Cadastre (INGEOCAD), which creates and manages orthophotos/satellite imagery, and the Planning Institute of Land Management (IPOT), which is responsible for the delineation of state and municipal lands. These institutions used to operate as SOEs coordinated and supervised by the Agency of Land Relations and Cadastre (ALRC). In the forestry sector, institutional changes are necessary and can be implemented within the current State Forestry Agency, Moldsilva. These changes would involve transforming Moldsilva into a state authority dealing with the regulatory and monitoring function, and creating a new state forestry enterprise in charge of forest administration, including forest conservation, protection and regeneration, harvesting, and wood processing. Finally, in the water sector, a dedicated national WSS development entity should lead the preparation of the strategic investment and coordinate investment implementation, while also providing oversight on project implementation, and the use of funds and outcomes. However, to achieve this it will require appropriate and adequate human resources, and a clear mandate for the new agency to lead reform. The slow pace of the long-anticipated reform of Apele Moldovei, the state water agency, is key to improving Moldova's water resource management. An integrated approach at the basin level, informed by River Basin Management Plans, and aligned with national and regional development plans, is needed to prioritize investments, manage water across users, and mitigate water-related risks.

On the mitigation front, a successful transition to a new growth model will also need to consider mitigation efforts by both reducing GHG emissions,^{51 52} and by taking advantage of the EU green deal. While the main country priority remains adaptation, given that Moldova is only a minor contributor to GHG emissions—at less than 0.03 percent of the world total in 2019—mitigation will be particularly important for the energy sector, which is likely to be the most affected by the Paris Agreement and the EU green deal. Efforts are needed to finalize the climate legislation and the directive on energy efficiency in buildings. These reform efforts need to be supported by an enabling regulatory environment for renewable sources, and by reviewing the residential energy tariffs and the Heating Allowance Program—

⁵⁰ World Bank (2020b). Greener Transport Connectivity for Eastern Partnership Countries. World Bank, Washington, DC.

⁵¹ <https://eu4climate.eu/2021/05/20/chisinau-to-glasgow-moldovas-roadmap-to-cop26/>

⁵² A commitment the country has taken under the Paris Agreement and, as of 2021, exceeding its targets by 4 percent see <https://eu4climate.eu/moldova/>

a major safety net to mitigate the poverty impact of energy tariff increases—to accompany the energy transition.

The private sector has a strong role to play in climate mitigation. The private sector has a prominent role to play toward greening manufacturing, transportation mobility, buildings, and cities; climate smart agriculture; clean energy and resource efficiency; and strengthening national taxonomies to adopt and promote green asset classes and security issuances, including green, blue and sustainability-linked bonds and other financial instruments. De-risking tools and various forms of credit enhancement to crowd in the private sector can be applied with some modifications in many climate-relevant areas.

Priority 3: Improving the business environment to enhance competitiveness

Increasing private sector competitiveness continues to be the first sectoral priority, and a necessary condition to the pathway of creating more and better jobs. The decline in formal employment and large outward migration are consistent with the inability of the private sector to create sufficient good jobs. Although national competitiveness has improved, Moldova still lags in many dimensions and has recently lost ground in a number of dimensions. Firms face multiple obstacles in creating jobs and actions are needed to: (i) facilitate the access to inputs, finance, and human capital; (ii) improve the regulatory environment, including specific sectoral regulations, particularly in the financial and energy sectors, and in trade integration; and (iii) ensure access to quality infrastructure, particularly related to energy and connectivity. The CPSD for Moldova proposes to explore how in the post-pandemic world, Moldova can reignite economic growth and social inclusion by harnessing private investment in critical enabling activities and tradable sectors. By boosting private investment in those activities, Moldova would be able to cradle new good jobs, and thereby reduce outward migration, achieving more sustainable economic growth rates. As the relative importance of remittances declines, Moldova will face the challenge of unleashing new and more sustainable sources of economic growth. FDI and exports can drive private sector-led growth, but they require scale. Against this background, the CPSD proposes to carry out three detailed sector assessments: (i) Renewable Energy; (ii) High-Value Added Agribusiness and Food Processing; and (iii) ICT Services and BPO.

a) Input gap

Providing adequate access to finance and a sound financial sector remain essential in increasing productivity and employment among firms. As highlighted in the 2016 SCD, and further aggravated by the COVID-19 crisis, there is a need to close the gaps in access to finance in terms of quality and variety of financial services/products available to firms and households. The development of innovative financial services/products, and financial widening and deepening remain essential contributions of the financial sector to private sector growth, particularly for MSMEs, as well as climate solutions. More efforts to enhance financial inclusion and literacy, using digital means, are needed, as well as strengthening consumer protection. In key sectors such as agriculture, access to financial products can be a catalyst for innovation and resilience. Despite being small and fragmented, the non-banking financial sector, specifically insurance companies and non-bank credit organizations, poses governance risks, such as non-transparent shareholding and related money-laundering risks.

Investing in education will help overcome one of the biggest constraints facing businesses in Moldova— inadequately skilled workers. Training institutions need to strengthen the links between training and jobs and education, and training policies need to place greater emphasis on the development of skills demanded by employers. These skills include not only sector-specific technical skills, from managerial to IT-related ones, but also soft skills, demanded across all different sectors and in everyday life. Soft skills

development should build on dedicated interventions at different stages, from early childhood to school and post-school based on international best practice. At the same time, it is also important to provide information on the demand for skills to students and jobseekers by leveraging on, and strengthening, the already existing infrastructure, namely the Labor Market Forecast Survey (LMFS), implemented annually by the Moldovan Public Employment Service (ANOFM). This can in fact be used to assess current shortage occupations, forecast short-term changes in employment by occupation, and identify skills shortages (Rutkowski et al., 2017). Closing the skills gap will not only help toward private sector development, but in general boost productivity, attract investment, raise people's standards of living, and reduce labor migration. Addressing the skills shortage needs to go hand-in-hand with the overall agenda of raising domestic productivity and, hence, returns to skills to lower the propensity of skilled workers to migrate.

b) Regulatory gap

While Moldova has made progress in improving the regulatory framework, more efforts are needed to reduce regulatory uncertainty, high transaction costs, and weak competition. The priority going forward remains to improve competitive conditions and competition policies, including the rationalization of price control and SOEs in markets where there is no evidence of market failures. Public-private partnerships and other alternatives to SOEs could be explored in markets where the state's presence may be justified. In general, it will be necessary to develop a state ownership policy, finalize SOEs restructuring and corporatization, and apply corporate governance principles to SOEs aligned with best practices. Within public procurement, efforts to reduce corruption should be intensified to allow all firms open access to government contracts, and promote the use of digital procurement and open contracting to increase transparency in the awarding of contracts and commercially attractive conditions of public tenders. More investment is needed in cybersecurity, data protection, and privacy measures to increase the use of public sector platforms, e-services, and citizen feedback mechanisms. High-level commitment and leadership are needed to implement a whole-of-government approach, removing inefficiencies, and reducing fraud and corruption risks.

Significant improvements to strengthen financial sector governance and supervision were implemented after the 2016 SCD, but additional measures are needed to promote sustainable development of the sector. Ensuring a smooth transition of supervisory authority in non-bank/insurance from NCFM to the NBM is a key priority. The authorities should focus on enhancing the financial safety net framework, including the introduction of Savings & Credit Associations (SCA) and operationalizing the new Bank Resolution framework. In addition, the procedures of coordination and communication between the different authorities in the banks' crisis management framework need to be streamlined (i.e., Ministry of Finance, the NBM, and the FGDSB). Key legal reforms in the insurance sector should continue. At the same time, a comprehensive solvency review of all insurance companies, followed by regulatory action to ensure compliance with solvency requirements, will be key to restoring the health of the insurance sector. The authorities should also strengthen the overall regulatory and supervisory environment, and foster consolidation of the NBCOs and the SCA sector. Proper implementation of the recently enhanced legislative framework for NBCOs, strengthened consumer protection, and the development of appropriate secondary legislation are critical in ensuring sustainability and mitigating over-indebtedness. Finally, especially in the post-COVID-19 recovery period, it will be critical to strengthen the insolvency framework to address the needs of those segments of the economy that have experienced the greatest difficulties in accessing the insolvency system. For example, this could involve the introduction of a consumer insolvency system and thereby support indebted segments of the economy to successfully restructure their debts.

The trade regime, along with quality infrastructure and logistics, could be improved to promote higher-value exports, especially in agriculture, and to favor e-commerce. As highlighted in the 2016 SCD, deepening trade and investment integration is crucial for Moldova's development prospects. The trade regime should be improved by: (i) cutting the remaining tariff peaks; (ii) eliminating the restrictions to trade in services, particularly in the form of barriers to the mobility of high-skilled workers; and (iii) reforms in customs toward greater automation of cargo processing, a reduction of the number of paper-based documents required, systematic use of risk management and selectivity, greater transparency in customs document requirements, and closer collaboration between customs and other border agencies. Full implementation of the 2014 DCFTA, and at the same time negotiation of new FTAs with new partners, would contribute to widening the potential export destinations. The dynamism of the free economic zones (FEZs) shows that extending effective and supporting institutions and policies to the rest of the country, especially those related to customs and business facilitation, may boost productivity. In general, increasing the transparency of FEZs, as well as strengthening the link between companies operating in the FEZs, exporters and Moldovan companies can help boost productivity leveraging on knowledge and technology spillovers. Moreover, as highlighted in the Moldova CEM (2019), the Government could put in place other reform options to further attract FDIs, spanning from: widening the scope of access of FDIs; upgrading investment promotion office and its strategy; assessing current system of incentives; strengthening investor protections; and removing existing barriers against foreign investors.

Upgrading the quality and standards of exports is key to accelerate food exports to the EU. Progressively replacing national standards with EU and international standards, strengthening the National Food Safety Agency, and developing and accrediting national sanitary and phytosanitary (SPS) laboratories are all priorities. These should be coupled with raising the level of value-added, as agro-food exports to the EU remain primarily low-value products despite their increasing volumes. Regulatory reforms and investments to comply with EU food safety and quality requirements, and in general to increase the productivity of farming, are key to boosting the quality of the export basket and hold significant potential for improving the incomes and living standards of rural Moldovans. Finally, with e-commerce increasingly gaining traction, especially recently due to the COVID-19 pandemic, and with Moldovan companies increasingly moving their businesses online, it is important to ensure an enabling regulatory framework for e-commerce going forward.

c) Infrastructure gap

Connectivity reforms—both physical and digital—are needed to favor competitiveness and tap into EU markets. Despite considerable progress in improving transport infrastructure, connectivity is still poor and this affects the competitiveness of the economy, particularly for agriculture and industry. Moreover, climate change is increasingly testing the resilience of transport networks, and investments to enhance resilience and promote a multimodal transport model are urgently needed. The modernization of infrastructure needs to go hand-in-hand with an improvement of services and the strengthening of institutions. Leveraging regional collaborations would help achieve stronger and greener connectivity. For example, as a member of the EaP joint policy initiative,⁵³ Moldova aims to improve its regional connectivity, which includes the extension of the Trans European Transport Network (TEN-T) to the EaP region. Within the reform agenda, institutions play a key role. For the road sector, it is essential to: (i) improve fiscal management, including with an amendment to the legislation, enabling a dedicated Treasury account exclusively for Road Fund transfers; (ii) allocate Road Fund resources based on a long-term maintenance plan; (iii) modernize maintenance practices by using medium-term and performance-based contracts; and (iv) build up the capacity of the local construction industry. For the railway sector, the institutional unbundling of CFM could be undertaken by putting into place subsidiaries for the

⁵³ The EaP includes Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

management of infrastructure, and for the provision of freight and passenger transport services. For a successful reform implementation, several issues should be taken into account, including, but not limited to: (i) the role of the state in its relationship with the new railway company(ies); (ii) the historical debts of the railways; (iii) management of core and non-core activities; and (iv) policies related to tariffs, financing, and costing.

Road safety remains a challenge for the country. Moldova registers one of the highest crash fatality rates in the region, equal to 9.2 fatalities per 100,000 population, which is 55 percent higher than the EU average. The victims of road accidents comprise 78.8 percent of the economically productive age group (15 to 67), thus having a highly negative impact and carrying a huge socio-economic cost. In 2020, the total socio-economic cost associated with road crash fatalities and injuries has been estimated at 3.1 percent of the country's GDP. A holistic approach, in line with the Safe System recommendations, will allow Moldova to improve the road safety management of the country. The role of the private sector in modernizing transport infrastructure, also at the municipal level, is key and policies need to be supportive of relevant private sector investments and facilitation of PPPs.

With a declining population, the impact of the COVID-19 pandemic, and global trends on the future of work, Moldova will need to invest more in the digital economy. Increasing competition, reducing the market power of the SOE, Moldtelecom, and fostering the independence of the sector regulator, ANRCETI, are key to strengthening sector governance. Similar to the recent successful experience in neighboring countries, including Albania, Kosovo, and the Baltic countries, an infrastructure-sharing law, through the definition and enforcement of associated regulations, could help to allow greater competition.⁵⁴ To fully embrace digital development, however, Moldova will need to support investment in connectivity and access to the network, with policies aimed at not only promoting the generation of digital content and services, but also aimed at enhancing literacy and digital skills to enable innovation and stimulate usage. One of the areas impeding efficiency and equity in service delivery is data infrastructure and related structural and governance reforms that would improve data collection, management, governance, feedback loops, foundational IDs, interoperability and integration, and cybersecurity. This data infrastructure is specifically relevant for improving service delivery, especially in education, health and social protection.⁵⁵

Access to both electricity and water remains a burden to private sector competitiveness. In the energy sector, it is paramount to promote diversification of energy sources. There has been progress on the asynchronous interconnection with the Romanian (EU/ENTSOE) power systems, which is expected to be completed by end of 2024 and will help Moldova diversify its energy sources.⁵⁶ Once at full capacity, the pipeline is expected to supply almost all the gas that Moldova consumes (excluding Transnistria). In addition to strengthening links with the European power and gas networks, Moldova should upgrade and increase its local power generation capacities, further implement comprehensive reforms in the area of sustainable heating, and promote the development of RE markets. Reforming the water sector will help Moldova enhance its economic water security, namely the productive use of water as a driver of economic growth and as a key input for industry. This is particularly apparent in the decline of irrigated agriculture, a sector that can, if sustainably and strategically developed, provide Moldova with opportunities for significant increases its competitiveness and value creation. However, a strategic vision is required to develop the water sector, including clarifying institutional capabilities, along with accelerated efforts to encourage the uptake of rehabilitated schemes and an expansion of services linked to the broader operational context of farmers. Water is central to Moldova's economy, driving higher-value agricultural

⁵⁴ Regional Broadband Legal and Regulatory Study between the European Union and the Eastern Partnership Countries - PART II EU2020 PROGRAMMATIC SINGLE-DONOR TRUST FUND – Report 2020

⁵⁵ WDR, 2021.

⁵⁶ https://ec.europa.eu/eu-external-investment-plan/projects/moldova-romania-interconnection-phase-i_en

productivity, powering industry, and contributing to the country's energy production through thermal cooling and small-scale hydropower. Meanwhile, efforts should also be made to ensure that development is undertaken in a climate-smart manner.

Priority 4: Reorienting public finance to support a new growth model

A reorientation of public finance is a necessary condition to help steer the economy toward a new growth model while ensuring sound macroeconomic management. Aligning the budget more closely with development needs, and improving the allocation and efficiency of public spending, will be key to steering the economy toward a new equilibrium. Achieving a proper balance between fiscal discipline and development objectives will also be important for long-term sustainability. While public investments remain fragmented, lack strategic vision, and suffer from significant delays in implementation, there is an increasing need to upgrade the infrastructure, including scaling up the digitalization agenda, and this will necessitate a prolonged fiscal effort. So far, debt levels have been maintained at sustainable levels and are broadly in line with the average for lower middle-income countries. However, fiscal sustainability may be challenged going forward by the lack of market access, the shallow domestic market, and the risk of contingent liabilities from the SOE sector and the pension system. Advancing reforms to create more durable fiscal space, reduce fiscal risks, increase counter-cyclicality, and reduce budgetary rigidities are essential to support the pathway of creating more jobs. As highlighted under *Priority 1*, strengthening fiscal institutions, as well as the governance of financial sector and –sectoral SOEs, is also crucial to enhancing overall fiscal resilience and macro-financial stability.

Efforts are needed to improve the efficiency of spending while ensuring equity and progressivity. Recent increases in the fiscal deficit mainly stem from social and salary programs that were implemented after the 2016 SCD but exacerbated by the COVID-19 pandemic. More than 90 percent of all spending is recurrent and, according to the 2016 PFR, Moldova should attain the same level of performance using only 60 percent of the funds that it currently spends. Against this background, improved efficiency would free up resources for other human and physical capital needs. The pension system could be further reformed by strengthening its fiscal sustainability. A steady shift from public consumption to efficiently executed investment is important to anchor the long-term growth perspectives. For instance, the Public Investment Management framework could be amended to include all public investments, including those from various funds that cover the largest share of all public investment. Reinforcing public procurement is another priority area. Further development of the e-procurement system will ensure that the corresponding functionalities of this system fully match the requirements of the public procurement legal framework. Measures could be identified to generate, collect, compile, analyze, and publish a full range of data on what happens in public procurement, in particular, through an up-to-date e-procurement system. Detailed and reliable data on actual procurement processes could be used for improving policies and procedures, and could help the Government in taking informed decisions on required reforms in the sector.

A gradual shift is also needed toward domestic revenue mobilization, and direct and progressive taxation to support the rebalancing of the growth model. Moldova could make the tax system simpler, more efficient, and revenue-enhancing by reducing tax preferences, increasing the nontaxable amount of personal income tax, improving property valuation, increasing excises, improving tax administration, reducing compliance costs, and simplifying the tax structure. Most importantly, the Government needs to deal with tax expenditures and tax evasion, both with significant costs for the budget.

Finally, given Moldova's vulnerability to shocks, particularly from natural disasters, relying on a stronger countercyclical stance and more effective fiscal rules will also be necessary. Moldova is highly exposed

to volatility due to continuous discretionary policy changes along the political cycle, external shocks, a lack of access to capital markets, and its over-reliance on external financing on top of demographic and environmental challenges. Even if Moldova has improved its fiscal stance since its banking crisis in 2014, it remains procyclical, as the fiscal rule introduced in Moldova in 2014 does not reflect the business cycle. Going forward, it is important to anchor the fiscal stance with a fiscal rule that would account for the business cycle, and to keep contingent liability risks under control, namely SOEs, and the pension, financial and insurance sectors. The development of the domestic debt market could also support debt sustainability, especially considering the country's developmental needs, and significant dependence on foreign assistance in the form of grants and concessional loans. Finally, it remains important to increase local governments' own-source revenues and improve intergovernmental transfer formulas.

Priority 5: Improving resilience, efficiency and equity in service delivery

The focus of Priority 5 is to increase social resilience, and promote inclusion by investing in and protecting people. Years of underinvestment in critical areas, and large structural vulnerabilities and access gaps in several sectors (e.g., education, water and sanitation, health, social protection, etc.) need to be addressed to bolster resilience and reduce the gap in access to opportunities that is currently preventing many Moldovans, especially those from rural areas and low-income households, from reaching their full potential. Successful reforms in service delivery would not only help cushion the poor from short-term shocks (and support a stronger and more inclusive recovery thereafter), but also enable them to take advantage of economic opportunities arising from, for instance, deepening trade and economic ties with Europe and increased digitalization. In this regard, the ability to re-skill, adapt, and relocate toward expanding sectors will support resilience at the household level, and contribute to structural transformation and resilience at the economy-wide level.

A key priority in Moldova is to reduce inequities in access to education, and improve educational quality and relevance, while improving resilience to future shocks. Going forward, the priorities are to continue and deepen the reforms in education that have been initiated in recent years, and establish the foundational environment for digitalization of education, as well as identify, adopt and scale up relevant digital solutions that can have a transformational impact on the sector to meet the needs of a sustainable private sector growth model. The efficiency of the school network has improved but further optimization is required given the continuously declining number of students and teachers, which negatively impacts system efficiency and service quality. At the same time, access to quality education at all levels, including pre-school, needs to be substantially expanded in underserved remote rural areas, and among Roma and vulnerable groups, in light of persistent inequities. Greater engagement with the private sector and industry can help to improve the overall quality and relevance of the education curriculum to make sure future workers are equipped with the skills required by firms. As a new priority, the COVID-19 pandemic has highlighted the need to build the digital education ecosystem, including in governance, data and technology infrastructure, skills, and analytics, as well as innovative business models to make education fit for 21st century purposes and more resilient to future shocks. A national lifelong learning strategy needs to be developed to promote continuous learning to keep pace with the changing demand for skills. In the short term, remediation programs may be necessary to tackle the impacts of the pandemic, especially among the most vulnerable students.

In health, with public funding on a par with countries at a similar stage of development, Moldova needs to prioritize the more efficient use of resources and do so using an evidence-based approach. The hospital segment needs to be rationalized from its current state of oversupply to increase efficiency and ensure higher value for money in public health spending, while primary health care services need to be

prioritized (and increase their share in public spending) to reduce the burden of disease. Selectively contracting health-care providers based on predefined criteria could immediately optimize resource use, as well as increase the technical efficiency of public spending. Private sector investments and participation in PPPs, under an enabling policy framework, can increase access to quality health services. Given the high incidence of NCD risk factors, such as tobacco and alcohol consumption, unhealthy diets, hypertension and obesity, tax instruments could be introduced to reduce the affordability of unhealthy behaviors. Out-of-pocket (OOP) expenditures on health are high, at 40 percent of total health spending in 2018, disproportionately affecting low-income households. Improving drug coverage is crucial in combating high OOP expenditures.

In the transport sector, further improvements in rural roads connectivity will ensure better access of the local population to jobs, to markets, and to social and education facilities while improving road safety. The efficiency of public spending for road maintenance could be further improved, by introducing a road asset management system to guide the prioritization of investments in the road sector, and by enhancing Road Fund efficiency.

In the water sector, coverage of rural areas needs to be improved for all citizens to live healthy and productive lives. This will require additional funding for the sector, as the current funding levels are less than half of the estimated requirements to reach the SDG basic service targets. In addition, a dedicated WSS sector development entity should be assigned with the task of championing universal access to WSS services, and be put in charge of developing a national investment plan, financing framework, and consolidating funds into a national WSS program. Inclusion can be strengthened by adopting a so-called portfolio approach for investments and service delivery, consisting of: (i) regionalization (expanding services by licensed *raion* operators and introducing a staged approach toward mandatory licensing and consolidation of service providers through legislative changes and investment incentives); (ii) oversight and support to local municipal operators in the interim; and (iii) the design of self-supply solutions (not networked) in remote villages. To support the poorest, mandatory connection policies can be developed, combined with social support mechanisms to address affordability concerns. At the municipal level, independence of borrowing is key to increase infrastructure modernization and private sector engagement through both investments and the development of PPPs to improve access to water supply and wastewater services.

In social protection, key priorities are to address gaps in coverage and low adequacy of safety nets, and put the pension system back on a path of fiscal and social sustainability. In 2019, 53 percent of the population and 64 percent of the bottom quintile were covered by at least one social protection program, leaving over one-third of the poorest quintile uncovered by any form of social protection. Given Moldova's demographic profile, the bulk of the social protection budget is allocated to old-age pensions and the elderly are currently well covered, even though benefits are low. Coverage of social safety nets is, however, much lower compared with immediate neighbors and the regional average, reflecting relatively low expenditures on social safety nets.⁵⁷ Moldova's main means-targeted social assistance program, *Ajutor Social*, covered only 3 percent of the population in 2019 and, as a consequence, only had a small impact on poverty reduction, despite it being the best targeted and most efficient program in Moldova's social protection architecture.⁵⁸ Improving the efficiency of social expenditures in protecting the poor will require tackling Moldova's strong preference for categorical benefits, which are perceived as "fairer", to create the fiscal space to expand means-tested social assistance. Improving social protection delivery

⁵⁷ Moldova spends about 1.1 percent of GDP on social assistance, lower than any of the peers except Slovenia.

⁵⁸ Close to 86 percent of the benefits of *Ajutor Social* go to the bottom income quintile and its benefit-cost ratio in reducing the poverty gap is higher than any of the other social protection programs (own calculations on 2019 HBS).

systems through measures, such as leveraging technology, continuing education for social workers, and streamlining the process for new and existing applicants, is another priority.

While the 2017 pension reform strengthened fiscal and social sustainability of the pension system, subsequent policy reversals have severely undermined it. The priority now is finding a mechanism to maintain the main goals of the original pension reform, such as strengthening the link between the contributions, benefits and equity in the pension system, while improving the adequacy of benefits and ensuring the system's financial sustainability. Reintegrating farmers into the social insurance system is required to prevent a large future increase in old-age poverty, as many farmers exited the system once it became voluntary. However, understanding how to achieve this remains an outstanding and pressing knowledge gap. In addition, benefits that are social assistance in nature (e.g., pension top-ups to pensioners receiving small pensions) should be disentangled from the social insurance benefits that are based on contributions, and be integrated into the Ajutor Social program.

Finally, investments in synergistic and integrated digital platforms across health, education, social protection, and other related sectoral areas would likely enhance and speed up the ongoing service delivery reforms in an equitable and efficient manner, equip the workforce with the skills needed in a modern economy, and improve the innovation capacity of firms. The COVID-19 pandemic has prompted quick adjustments in terms of digital adoption both in the public and private sectors, leveraging the already ongoing digitalization progress and raising attention to this cross-cutting sector. It is essential, however, to accompany the digitalization of the economy with enabling policies, starting with education. While providing support to promote rural broadband connectivity and addressing last-mile challenges will help close the digital divide, the real social and economic benefits of digitalization in education and beyond can only be reaped when combined with the enabling ecosystem, including but not limited to a strategic vision and governance for citizen-centered service delivery, better and relevant data infrastructure and management, sectoral capacity building in digitalization to develop a well-equipped workforce, and a data and technology literate population. The Government of Moldova, with support from the World Bank-financed Modernization of Government Services and GovTech Global Partnership Multi-Donor Trust Fund, should continue with the implementation of whole-of-government digital solutions, and the modernization of administrative services through their re-engineering and digitalization, as well as the deployment of the digital centers for assisted service delivery in rural areas for the disadvantaged and vulnerable, and in consular offices abroad for the diaspora.

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ANNEX: KNOWLEDGE AND DATA GAPS

The 2016 SCD identified three priority data gaps. The first gap concerned the 2014 Census, results of which were not yet available during the drafting of the 2016 SCD. The uncertainty surrounding the population count severely affected the reliability of economic and labor market statistics. Results of the census were finally released in 2017, showing that the population was not only substantially smaller than projected but also declining at a faster rate than expected. The 2014 Census data were used as the new survey sampling frame since 2019, as a result of which the surveys since 2019 are no longer comparable with the previous years. The second gap consisted of the lack of any data on the breakaway region of Transnistria, which substantially limited what can be said about economic growth, poverty, and shared prosperity at the national level. This remains a key data gap. Lack of data on ethnic and language minorities was the third gap, given their relatively small size and, hence, underrepresentation in national household surveys. While the 2014 Census has to some extent addressed this, more comprehensive data on minorities' living conditions are still required to better inform social policy.

Of the knowledge gaps identified in the 2016 SCD, some were addressed while others, including new ones, remain outstanding. The impact of competition policies and state aid on productivity and job creation have been assessed in the 2019 Country Economic Memorandum (CEM) and the 2019 Policy Notes. These same products have also conducted diagnostic work on the education system and proposed recommendations to strengthen market-relevant skills in Moldova. On the other hand, while several studies have touched upon potential reasons behind the low labor force participation rates in Moldova, a comprehensive assessment of the factors constraining male and female participation in the labor force remains an important knowledge gap. A new knowledge gap in light of the COVID-19 pandemic is an assessment of the long-lasting economic impact of COVID-19 due to the lack of currently available data. Similarly, lack of knowledge concerning the state of digital skills and infrastructure in education currently limits the ability to increase the resilience of the education sector to potential future shocks. Finally, the best way to re-integrate farmers into the social insurance system remains an outstanding knowledge gap that needs to be addressed as soon as possible to avoid large increases in old-age poverty going forward.