Special Topic: Rekindling Economic Dynamism[1]

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- *Moldova's growth has been solid but is losing momentum as productivity[2] has begun to slow down.*
- *While movement of workers to higher productivity sectors has helped productivity growth, firm productivity has stagnated. One reason is that the enterprise sector has a large number of State Owned Enterprises, which are characterized by lower productivity, particularly when compared to foreign firms.*
- *Moreover, competition has failed to drive enterprise productivity growth as more than half of manufacturing markets are monopolies, duopolies, or oligopolies.*
- *Distortions in the tax system and shortcomings in the education sector also affect productivity.*
- *Returning to the high growth rates achieved in the immediate post-2000 period requires: (i) setting in motion polies to unleash private enterprises development and (ii) changing the incentives to foster enterprise productivity.*

Reviving Growth Momentum

Moldova, one of the poorest countries in Europe, has experienced solid economic performance in the last three decades but economic growth momentum has significantly slowed down since the global financial crisis. Since 2010, growth has averaged a respectable 4.5 percent, albeit from a relatively low base. However, these results have fallen substantially short of the 6 percent growth aspirations set in the Moldova 2020 strategy to allow for convergence with European standards. More troubling, the economic dynamism evident in the early 2000s seems to be waning.

Moldovan authorities face the challenge of rekindling the previous growth momentum and accelerating the pace of job creation. Jobs are a concern because young, productive workers are leaving the country at an unusually rapid rate to seek work and fortune elsewhere. Moldova has already lost population over the last two decades and if current trends continue, Moldova will lose another fifth of its population by 2050. While this exodus has brought with it a reflow of remittances that are among the largest in Europe, these cannot be depended on to sustain growth in coming decades.

Sources of lost growth momentum

So why has growth slowed down? A central part of the story is decelerating growth in total factor productivity – the way firms and the economy as a whole combine labor and capital into ever more efficient uses. Dissecting supply side productivity trends reveals that, while labor is migrating toward higher productivity activities from agriculture, productivity growth within sectors is slow and firm-level productivity typically associated with innovation is not improving.

A principal reason is that the size of government for its level of income is unusually large in Moldova and State Owned Enterprises (SOEs) still dominate several sectors. SOEs display much lower productivity levels and growth than their non-state counterparts, and SOEs are present in at least 19 out of 30 sectors.[3] Moreover, the large size of the government[4] is absorbing a large amount of resources from the private sector, which could otherwise go into productivity-increasing private investment.

Foreign firms have productivity levels more than 80 percent greater than SOEs but account for a low share of firms. After reaching a peak in 2007 at 12 percent of GDP, Moldova's Foreign Direct Investment (FDI) inflows dropped substantially since 2009 to 2 percent of GDP in 2016. With less productive firms, Moldova is less able to compete on global markets, and thus, while trade occupies a substantial share of GDP, the country's exports are growing more slowly than in other Eastern European countries.

Competition can be a powerful driver of productivity growth. Yet only 41 percent of manufacturing markets are workably competitive – the remainder are monopolies or shared monopolies.[5] Firms in markets with lower intensity of competition have slower productivity growth, controlling for other factors. That is, firms in industries with minimal competition have limited incentives to innovate, use resources more efficiently, or seek new export markets. If price-cost margins were to become 10 percent lower in manufacturing estimates suggest that labor productivity growth would be 5.1 percent greater (all else equal).

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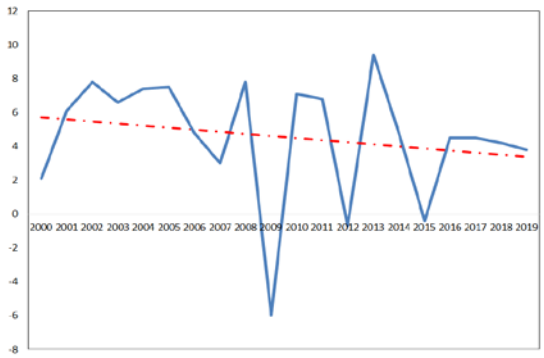
[1] Prepared by E. Gamberoni and R. Newfarmer. The Update is based on World Bank (2019). "World Bank Country Economic Memorandum for Moldova: Rekindling Economic Dynamism."
[2] Total Factor Productivity.
[3] Preliminary data OECD-WB PMR Indicators.
[4] See Table 1 of the economic update.
[5] 2013 World Bank Enterprise survey.

Tax policy has also created perverse incentives that discourage productivity growth in two ways. First, the tax system taken as a whole, although capable of mobilizing substantial resources that are necessary to sustain overall revenue, is biased against employment and capital accumulation with high labor taxes (including health and social security contributions), which reduce the incentives of employers to create jobs. Yet reducing the burden of labor taxes would require finding alternative sources of revenue and, therefore, should be accompanied by a systematic review of the entire tax system. At the same time, low taxes on consumption discourage savings. Second, the system of poorly designed tax incentives undermines productivity growth in multiple ways. These incentives are costly, and their impact is not monitored against specific objectives. As a result, some associated expenditures are wasted. Moreover, the resulting foregone tax revenue has to be made up in other ways. Because Moldova has multifarious tax incentives for a myriad of purposes, resources are directed in scattershot directions, with little discernible strategic coherence. Finally, some portion of tax incentives form part of state aid to SOEs with lower level of productivity. This keeps some unproductive firms in the market, which would otherwise exit, and gives other SOEs a competitive advantage over more productive private counterparts.

A final priority to redress low growth in productivity is human capital. In 2017, Moldova's ranking in the World Bank's Human Capital Index was higher than what would be predicted for its income level, and the country has shown slight improvements in recent years. Still firms report a mismatch between job requirements and skills development. But Moldova's higher education system is in crisis. It has lost half of its enrollment in the past decade, as a combined result of ageing population and high level of outmigration[6], and is struggling to recruit young professors and attract fee-paying students. It has never been high on the government's innovation agenda, unlike what happens in with countries keen on developing their knowledge economy, such as the Nordic European countries and many East-Asian nations. The higher education system remains the only education sector without significant structural changes and support for reforms, unlike general education and Technical and Vocational Education and Training.

Figure 1: Growth has been solid—if volatile and losing momentum

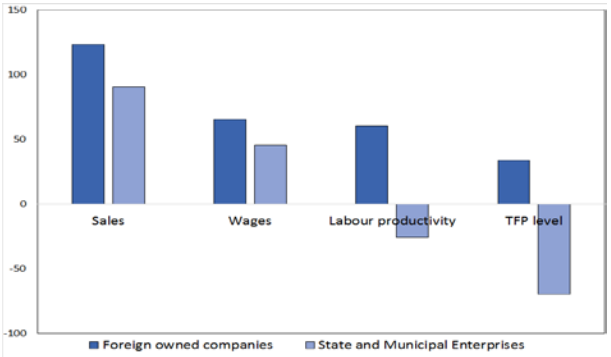
GDP growth historical and forecast



Source: World Bank Country Economic Memorandum for Moldova, forthcoming based on WDI and WEO database.

Figure 2: SOEs have been a drag on productivity particularly when compared to foreign owned firms

Average percentage differences relative to private domestic firms in the economy (2010-2016)



Source: World Bank Country Economic Memorandum for Moldova, forthcoming based on Moldova National Bureau of Statistics Administrative data.

Policies to propel growth

Policies to propel growth should focus on unleashing private enterprises development and changing incentives to foster enterprise productivity. Changing the industrial organization - diminishing the role of less productive state enterprises and increasing the role of more productive private companies, especially foreign investments - is a priority. A second priority is changing the incentives external to firms that drive productivity. Among these, as described above, competition and tax regimes are particularly important. Furthermore, tax policy requires a systematic review of the entire tax system to ensure that overall revenue does not decline. A third priority, for a country like Moldova with limited natural resources and a small market, is to enhance the contribution of the higher education system to economic diversification and growth. The policy challenge is to improve the contribution of higher education to skills development and technology transfer and put in place a long-term sustainable financing strategy. Finally, governance-related indicators have deteriorated, and corruption is cited as the main constraint to firm operations. Therefore, addressing governance challenges remains a priority.[7]

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[6] Indeed, Moldova has already lost population over the last two decades, and if current trends continue, Moldova will lose another fifth of its population by 2050.

[7] See World Bank (2016) Moldova Systematic Diagnostic study.