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The Nexus Between Public Enterprise Governance, Financial Performance, and Macroeconomic Vulnerabilities: An Application to Moldova

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ABSTRACT: Strong governance frameworks for public enterprises have long been an anchor of stability and efficiency underpinning their financial operations and performance. Cross-country experiences with the adoption of robust legal, regulatory and institutional arrangements—in line with international best practices—proved critical in reducing well-known risks and vulnerabilities from such companies, clarifying the role of the state, improving the management of state assets, and ensuring a level playing field for the private sector to prosper. Moldova's large public enterprise sector of over 900 companies faces elevated risks that amplify fiscal and macroeconomic vulnerabilities and undermine market competition, productivity, and private investment. Moldova stands to greatly benefit from strengthening its public corporate governance regime to put its public enterprises on a stronger footing, address vulnerabilities, and improve market structure.

JEL Classification Numbers:	E61, E62, G32, L32
Keywords:	Public enterprise (SOE) governance, SOE financial performance, macro-fiscal risks from SOEs, SOE reforms, public financial management

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WORKING PAPERS

The Nexus Between Public Enterprise Governance, Financial Performance, and Macroeconomic Vulnerabilities: An Application to Moldova

Prepared by Amgad Hegazy and Arturo Navarro[1]

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Contents

I. Background, Context, Motivation

Public enterprises play a central role in many economies and have gained prominence over time. Their significance in many countries' market structures is a reflection of the role they play in the delivery of public policy objectives; namely, the provision of key (essential /useful) public goods and services to society (as an arm of the state). With a heavy presence in systemically important sectors such as utilities, infrastructure, and energy, they contribute significantly to sectoral and overall output. They are also a strategic employer, affecting the lives of many households. The quality of their operations determines net market competitiveness and efficiency as they deliver on the social, economic, and strategic interests of the state.

Yet, governments often face challenges in organizing, managing, monitoring and mitigating their operational risk. International experience shows that the operations of public enterprises pose various well-known risks and vulnerabilities, often attributable to severe underlying weaknesses in their governance frameworks. These include a poorly defined state ownership rationale (objective) behind setting up such companies; a weak legal (regulatory) umbrella that governs their operations; a poor institutional setup; frail checks and balances to ensure that they deliver effectively on their mandates, and undue state intervention (ad-hoc political interference or vested interests). Numerous examples of vulnerabilities are evident in unclear and/or forced policy mandates, complex webs of financial interlinkages with the government, or overly complicated lines of authorities across many agents (internally, e.g., within the companies' management and/or boards, or externally with government ministries, the legislature, etc.). This easily weakens incentives to improve performance and fuels lack of transparency, poor accountability, and corruption.

The result is hampered economy-wide activity and lost growth potential via several channels. Weak financial performance in public enterprises carries significant fiscal and quasi-fiscal risks, inflicts self-fulfilling crises, and underpins a number of negative externalities involving corruption and mismanagement of public sector assets; misallocation of the economy's scarce resources; and undermining market-wide competitiveness and efficiency by weakening the private sector as the main engine of growth (especially in strategic sectors in which public companies operate as natural monopolies/ oligopolies). These challenges weaken the optimal functionality of commodity, services, and labor markets, thereby adversely affecting economy-wide productivity and employment. If left unaddressed, such challenges exacerbate the problem by often forcing governments to continue funding such enterprises despite their poor performance, e.g. via taxpayer money, misuse (abuse) of public funds, or preferential treatment and/or access to government support to sustain a seemingly profitable status in otherwise failing enterprises. Eventually, this culminates in elevated fiscal costs and exacerbates the market dominance of these enterprises.

International best practices reiterate the importance of strengthening corporate governance of public enterprises; guidance from which Moldova stands to greatly benefit. Cross-country experience has shown the extent to which addressing governance-related vulnerabilities stemming from sub-par performance in public enterprises is critical in mitigating their institutional, legal and structural weaknesses. Moreover, strengthening public corporate governance helps to reduce fiscal risks and costs, entrenches macroeconomic stability, and creates a level-playing field for the private sector to develop and prosper, thereby raising overall market efficiency, boosting output, and employment. Moldova need not re-invent the wheel and should rely on international best practices to reform its public enterprise sector, learning from cross-country experiences where relevant (see Annex III).

The paper is organized into the following sections. Section II discusses the importance of strong public corporate governance frameworks and the extent to which weaknesses in such frameworks affect corporate performance, particularly via linkages with the state through possible fiscal costs, and their broader macro-economic implications. Section III summarizes Moldova's public enterprise sector in terms of size, scope, coverage, legal framework, and organizational and institutional set-up. Section IV discusses international best practices and principles related to governance of public enterprises, and how Moldova's existing framework compares. Section V provides an in-depth assessment of the financial performance of—and risks in—326 public enterprises in Moldova (for which data are available; roughly one-third of all public enterprises). Section VI presents results of stress tests for individual enterprises as well as for a cohort of enterprises having the largest liabilities to explore the links between corporate risks, fiscal costs and macroeconomy-wide vulnerabilities. Last, Section VII presents a framework and strategy to reform the governance of public enterprises in Moldova and concludes with key recommendations.[2]

[2] Limitations on data availability and capacity constraints on the part of the authorities have confined the scope of analysis in this paper, which does not aim to provide an exhaustive analysis of all public enterprises in Moldova, nor an assessment of the links between state-owned companies and public banks (non-existent in Moldova) or a comparison between public and private enterprises. Poor data quality and inconsistencies between financial statements required extensive manual data cleansing on the firm level but are not expected to significantly undermine the accuracy of bottom-line results.

II. PUBLIC CORPORATE GOVERNANCE FRAMEWORKS AND CORPORATE PERFORMANCE: THE NEXUS BETWEEN STATE LINKAGES, FISCAL COSTS, AND MACRO-VULNERABILITIES

The Importance of Sound Public Corporate Governance Frameworks

Governance Framework	• Ownership structure (public / private-including foreign) • Mandate; Objective • Management structure; Board composition • Legal framework; Governing regulations • Oversight and supervision (financial reporting, financial audits) • Transparency; public disclosure
Nature of Activity; Size, Dominance	• Fiscal/quasi-fiscal; Commercial/non-commercial; Financial/non-financial • Assets / liabilities; employment; sectoral share & systemic importance; market share (monopoly/oligopoly)

Corporate Finances: Operational Performance (financial viability)	• Key revenue resources and funding:
	  • Own resources → activity revenues, other self financing, domestic borrowing other than from the Government (e.g. stock exchange)
	  • Other resources → government loans, guarantees, issuing own-debt instruments, grants, subsidies, wages, other transfers
	• Key spending, in line with policy mandate
	• Financial interlinkages with the government

Macro-economic vulnerabilities	• Corporate risks→ Profitability, Liquidity, Solvency • Public sector risks→ fiscal, debt, other • Private sector risks→ Business environment; Competitiveness

Source: Author's representation, based on varous reports and studies by the OECD, the World Bank, and the International Monetary Fund.

A strong governance framework for public enterprises establishes the umbrella that determines firm-level, market, and the overall economic performance. Governance frameworks provide clarity to the ownership structure for public enterprises, in terms of their objective (mandates), their management structure, and the composition of their executive board of directors (BoDs). It also helps identify their legal set-up and other governing regulations. A strong framework provides a clear institutional arrangement within which enterprises operate, e.g., with respect to roles and responsibilities of oversight and supervisory functions such as financial reporting and audit requirements and ensures transparency and public disclosures of enterprise performance. As such, the strength of governance frameworks often ultimately determines the nature of enterprise activities (e.g., fiscal or quasi-fiscal, commercial versus non-commercial, or financial vis-à-vis non-financial); their size (assets and liabilities, employment structure, etc.); and the extent of their dominance (systemic importance and market share). This in turn helps shape enterprise finances and operational performance (or financial viability) depending on how the enterprise manages its own versus borrowed resources—through financial linkages with the state—to execute its operations and fulfill its mandate in line with its policy objective. As such, overall enterprise performance (in terms of profitability, liquidity, and solvency) and associated operational risks can feed into public sector risks (e.g., through fiscal or debt exposures) or private sector risks (e.g., through the business environment and competition). Thus, macro-wide risks can be dependent on enterprise-level performance, which is a function of their activity and the nature of their operations, which in turn is traceable to their governance framework.

Corporate performance and the complex financial interlinkages with the state are a direct source of fiscal risks and costs to the state. On one hand, public corporations often rely on the central government for grants, loans, subsidies, extension of sovereign guarantees, and other forms of transfers to facilitate their operations. Such dependence carries contingent fiscal liabilities, and poses fiscal costs and risks to the state, especially from companies suffering from weak financial performance.[3] On the other hand, fiscal policy conduct by the state can itself affect public corporate performance, e.g. cuts by the state to publicly funded companies' capital allocations (e.g. due to countercyclical policy needs) complicates the execution of companies' budget plans, slows down operations, and raises firm-level risks to profitability, liquidity, or solvency. As a result, poor corporate performance can precipitate future adverse feedback loops to the state via lower tax, dividend, and other forms of transfers to the state.

Addressing risks arising from weak operational performance can be costly to the firm, state, and economy. Low-to-moderate risks at the firm level having minimal impact on company performance are often manageable, especially if risks are adequately addressed or dissipate over time. However, elevated risks that materialize and are persistent—depending on their severity and complexity—tend to expose vulnerabilities that further undermine firm performance, necessitating prompt government intervention. And in the event of inaction, firm-level challenges can possibly spill over to fuel systemic (sector-wide) risks, making these costlier to address.[4] Such circumstances inhibit market efficiency and competitiveness and have macro-fiscal implications due to the nature of the state's involvement in the operations of these enterprises (see section VI on stress testing).

[3] The materialization of contingent liabilities has implications on debt sustainability of public companies. A significant shock would increase debt levels notably, though such risks are difficult to quantify precisely owing to lack of adequate data (IMF, March 2020).

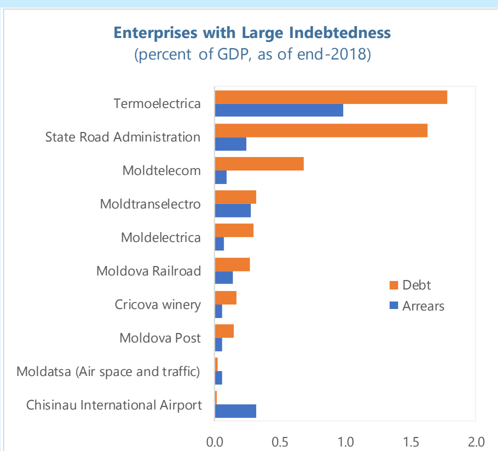
[4] Especially if the companies are part of a chain (e.g., upstream versus downstream) or have horizontal/vertical or forward/backward financial or operational linkages which can be detrimental to the whole sector if one company collapses.

Box 1. Moldova's Corporate Vulnerabilities and Financial Flows to the State – A Two-Way Street

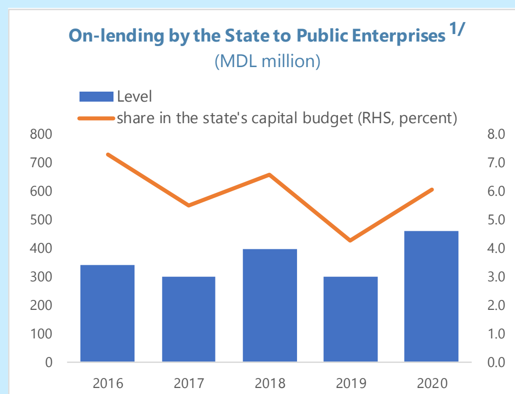
Indebtedness is a clear hindrance to the operational performance and to the solvency of public enterprises and sectors, especially where financial flows to the state are concerned. The total debt and arrears outstanding on companies for which data is available amounted to 7.3 percent and 3.3 percent of GDP, respectively, as of end-2018. A sizable amount of debt is held by a handful of large firms (by size of assets and liabilities) in a number of key sectors that provide essential goods and services, like the energy, public works, telecommunications, and transportation sectors. The elevated (heavy) debt burdens in these enterprises ultimately weighs on their performance and raises their vulnerabilities. High insolvency risks may hamper the ability of such companies to deliver on fiscal obligations to the state (pay taxes, fees, etc.). Examples of companies that have a two-way relationship with the state in terms of financial flows (i.e. receive aid and pay taxes) are the electricity company Termoelectrica (recipient of on-lent loans), the state road administrator (a large recipient of state subsidies), wine company Milesti Mici (a recipient of state guaranteed debt), and Orhei water and sanitation company (recipient of both on-lent loans and subsidies).

On-lending to public enterprises seems to have added little value to their performance, as evident from their elevated risk profiles, based on available data for four key companies in strategic sectors (energy and transportation).

Net financial flows from the government to public enterprises can be high, constituting a large fiscal drain on state finances. The lack of a comprehensive dataset covering the net financial flows between all public companies and the state prevents such analysis in the case of Moldova. However, the net impact of inter-governmental financial transactions on the state can be sizeable (e.g., in Georgia, these added 6 percent of GDP to general government expenditures over a period of five years covering 2014–18).



Source: Public Property Agency (PPA).



Source: Ministry of finance.

1/ Externally financed net on-lending to SOEs (Termoelectrica, Moldelectrica, Moldovan Railways, and CET-NORD).

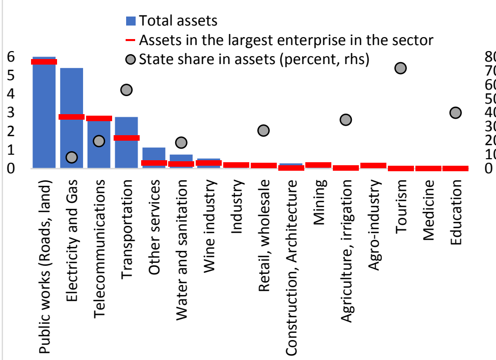
In Moldova, the deficiencies in public enterprise governance frameworks are an important factor in the weak performance of public enterprises. Concerns over shortcomings in Moldova's governance framework for public companies are well- documented and help explain how they undermine financial performance and weaken incentives to improve efficiency. Sub-par company performance has been ascribed to high perceptions of corruption due to mismanagement of corporate portfolios; poor transparency and disclosure practices; political interference in company decisions and forced policy mandates; inadequate supervision and opaque lines of authority; and the prevalence of monopolistic / oligopolistic practices that introduce market inefficiencies (distortions) that weaken the private sector. Such challenges are often linked to a lack of clarity on the state's overall ownership policy and lack of control over the extent to which public corporations adhere to institutional, legal, and operational requirements.[5]

III. Overview of Moldova's State-owned Enterprise Sector

Size, Scope, Coverage

The public enterprise sector has a sizeable footprint of over 900 companies, one-third of which operate at the central government level and the remainder at the sub-national level (municipal or local government). Its combined assets were valued at about 21 percent of GDP (US$2.5 billion), concentrated in four key sectors: public works, energy, telecom and transportation. In 90 percent of the enterprises operating at the central level, the controlling share of the state was 100 percent (full control/ownership); only 44 companies had state participation below 50 percent.[6] In addition, companies at the central level hired almost 40 employees (as of 2018—about 4 percent of total national employment).[7] This dominance and penetration in the economy in terms of employment and shares is reportedly more than twice the average in other Eastern European countries in the region.[8] Companies enjoy a heavy strategic footprint in almost all sectors, with 15 companies reportedly listed on the stock exchange (as of 2016).[9]

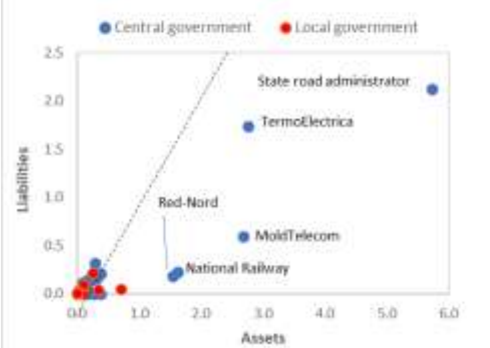
Public Enterprise Assets by Sector, 2019 1/
(percent of GDP)



Source: Public Property Agency (PPA).
1/ State shares shown are for enterprises operating at the Central Government level (2018 data).

Enterprises with the largest assets had the biggest liabilities and operated at the central level of government. The largest five enterprises in terms of assets operate at the central government level in a number of strategic sectors (State road administration, Termoelectrica, Moldtelecom, Moldova Railways, and another electricity company Red-Nord). Their assets (and outstanding liabilities) constituted roughly 6–7 percent of total assets and total liabilities out of the 326 companies for which data is available. By comparison, companies operating at the sub-national (municipal or local) level are much smaller companies, with only three enterprises having liabilities exceeding MDL 100 million (liabilities of the largest company are below MDL 500 million).

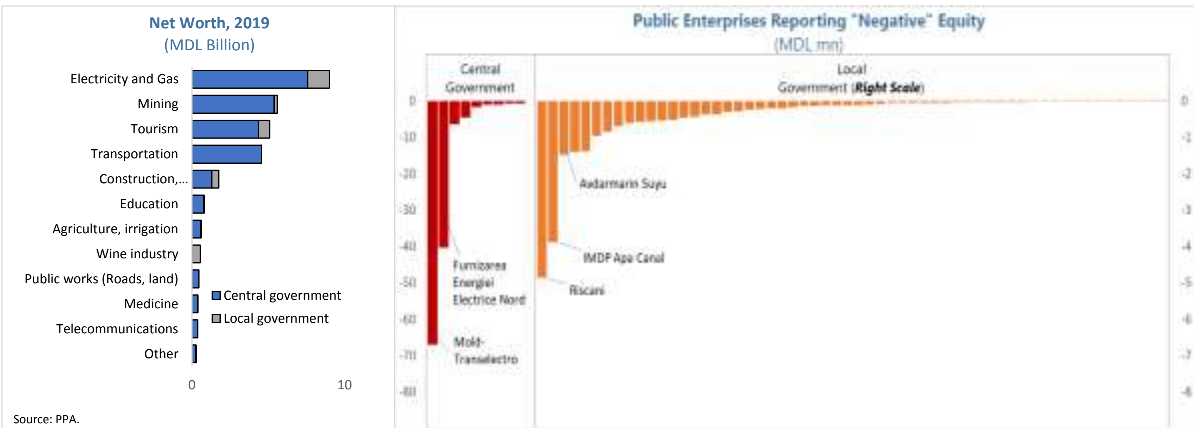
Assets-Liabilities Nexus
(Percent of GDP)



Source: PPA.

[5] See relevant reports by the World Bank, Moldova's 2020 Article IV Consultation report (IMF), and Moldova's Country Governance Assessment report (IMF).
[6] Based on 2018 data provided by the Public Property Agency (PPA). No information is available regarding the controlling share of the state in municipal companies.
[7] No information is available regarding employment in public enterprises operating at the sub-national level of government.
[8] The Word Bank Group (April 2019).
[9] EBRD (2020).

Total net worth improved in 2019 driven by growth in equity in most sectors at the central government level, but masks worse performance at the sub-national level. While net worth dropped slightly as a share of GDP from 2018 to 2019, it grew 5 percent annually, thanks to the expansion in the balance sheets of four sectors with the largest equity positions. However, one-fifth of all companies suffered *negative equity;* the majority of which are at the local level. Many of these companies incurred sustained net losses that eroded retained earnings, causing their overall equity position to shrink.



A sizeable number of enterprises seem to have breached minimum net asset position requirements relative to their statutory capital. Contrary to the law on Joint-Stock Companies (JSCs) requirements on companies' capital, five enterprises had the value of net assets lower than their statutory capital—besides another 28 state-owned enterprises all at the central government level. This is on top of 92 other enterprises operating at the sub-national government.

Organization, Legal Framework, Institutional Arrangements

State ownership of public enterprises follows a centralized model. Companies are incorporated according to three legal forms: state-owned enterprises (SOEs), joint-stock companies (JSCs) and limited liability companies (LLCs). Enterprises are entitled to participate in the establishment of associations or (going) concerns and to open bank accounts in Moldova and abroad. State ownership follows a centralized model founded (and supervised) by the Public Property Agency (PPA); a central administrative authority subordinated to the Government.[10]

Three key laws govern the operations of public enterprises: Law 246 (2017) on state owned enterprises and municipal enterprises; Law 1134 (1997) on joint stock companies; and Decision 902 (2017) on the organization and functioning of the PPA. Other relevant laws include Law 149 (2012) on Insolvency, Law 183 (2012) on Competition, and Moldova's Civil Code 1107–XV (2002).

[10] The interests of JSCs (operating at sub-national/municipal level of government) are represented by the Congress of Local Authorities from Moldova, a non-governmental organization.

Four management bodies jointly govern public enterprises. The founder (PPA), the board of directors (BoD) of each company, the administrator (executive body), and the board of auditors (BoA, or commission of censors) jointly manage companies in the sector (Box 2).[11]

Box 2. Institutional Set-up of Public Enterprises

Among its key functions, the ***PPA*** approves statutes of enterprises, regulates the BoD and appoints the BoA, appoints and revokes the chairman and the members of the BoD and members of the BoA, and establishes monthly remuneration for senior management. Members of BoDs are appointed by the PPA for 2 years, with eligibility for reappointment.[1] The PPA also decides on the annual deductions from net profits to be transferred to state/local budgets and approves the distribution of annual net profits. It has authority to raise or lower the share capital of companies, and to agree to pledge state assets as collateral for bank loans.[2] The PPA also presents to MoF the auditor's report on SOEs.

For SOEs:

The ***Board of directors*** approves business plans, sets performance indicators of the enterprise and evaluation criteria, approves annual finances including personnel and salary fund, ensures transparency of procurement related procedures, and selects the administrator (by competition) as well as the audit entity. The BoD also presents to the founder (PPA) (i) proposals to improve management, (ii) modify share capital, (iii) streamline the enterprise's activity, and (iv) its annual performance report. Meetings of the BoD are convened by its president and/or at the request of at least 1/3 of its members, not less than once in a quarter. Members of the BoD may sit on boards of other enterprises (not exceeding three). BoD decisions are adopted by majority vote.[3]

The ***Administrator*** is in charge of daily operations, executing and implementing decisions by the PPA and BoDs. S/he is effectively in charge of the "integrity, efficient use and development of the enterprise's assets" and alerts the BoD of deficiencies and proposes remedies.[4] The administrator presents to the BoD quarterly financial reports and to the PPA and BoD annual financial statements and the audit report. S/he also submits for approval to the BoD the proposal on the distribution of annual profits. Administrators are appointed for a term of up to five years.

The ***Board of auditors*** may comprise representatives of the PPA and of the central public administration authorities (at least three people). It undertakes bi-annual audits and may undertake unannounced audits.

The chairman of the BoA presents the audit report to the administrator and to the BoD. The audit report includes an evaluation/assessment of activity/performance relative to the preceding year. Members of the BoA can participate in the meetings of the BoD and have an advisory vote. Members must be qualified in accounting, finance, or economics/jurisprudence. They are appointed for up to 2 years.[5]

[1] Law 246, Article 8.
[2] Law 246, Article 4.
[3] Law 246, Articles 7 and 8.
[4] Law 246, Article 9.
[5] Law 246, Article 10.

[11] Law 246 on SOEs and Municipal Enterprise (2017), Chapter III, Article 6.

Box 2. Institutional Set-up of Public Enterprises (concluded)

For JSCs:

Law 1134 (1997) establishes the framework governing the functioning of companies with respect to their registration procedures, aims and activities, statutory capital requirements, and obligations and rights of shareholders (e.g., owning 5, 10, or 25 percent of company shares).

Members of the ***BoD*** are elected for a term not exceeding 4 years (but with unlimited renewal) and can hold position of a member of a board in no more than 5 different companies at any time. Ordinary board meetings are held quarterly (to examine quarterly performance reports presented by the administration of the enterprise).

The ***auditing commission*** is appointed for 2–5 years and is accountable to the general meeting of shareholders. Members of the audit commission must have qualification criteria in accounting, finance, or economics. Audits are performed at the commission's own initiative, at the request of shareholders holding 10 percent of voting shares, or by a decision by the general meeting of shareholders or by the BoD. Audit safeguards include a prohibition on an auditing firm to be an affiliate of the enterprise or its management, as well as to conclude any other contracts apart from the audit with the enterprise.

Sources: Law No. 246 regarding the state enterprise and the municipal enterprise, and Law No. 1134 on joint stock companies.

IV. International Best Practices in Governance of Public Enterprises: How Does Moldova's Existing Framework Compare?

International Best Practices

Corporate governance of state-owned companies aims to achieve three broad objectives. According to guidelines by the OECD, the World Bank Group, and others, international best practices broadly aim to *"(i) professionalise the state as an owner; (ii) make SOEs operate with similar efficiency, transparency and accountability as good practice private enterprises; and (iii) ensure that competition between SOEs and private enterprises, where such occurs, is conducted on a level playing field".*[12] These objectives overarch the following key principles:

- **Ownership rationale as an overriding principle.** This calls for the need for governments to provide a rationale for the creation of public companies to carry out public policy mandates, and to ensure that such rationale is enshrined in legislation (and facilitates the termination of companies once the rationale ceases).[13]

[12] OECD (2015).
[13] OECD (2018).

- **Criteria to determine if an entity can (or should) be classified as a state-owned company.** Key criteria here are weather it meets the definition of an institutional unit, charges economically significant prices, and its dependence on regular financial assistant from the government.[14]
- **Grant companies full autonomy** in executing their operations, **respect their independence, avoid intervention, and avoid redefining objectives** in opaque manners.
- **Hold accountable the entity that exercises ownership rights on behalf of the state and ensure its endowment with the competencies and capacity** to carry out its duties effectively.
- **Clarify responsibilities of BoDs.** Company boards should be tasked with a clear mandate enshrined in legislation and held responsible for effectively executing their functions. They should establish company strategy and oversee management and exercise independent, objective, policy judgment.
- **Hold BoDs accountable** for companies' financial performance, especially vis-à-vis deviations from pre-set performance targets. Accountability should include regular impartial performance assessments and reviews of their efficiency and effectiveness in overseeing company operations, as well as ensuring transparency over their participation in the boards of any other companies.
- **Combat corruption and mitigate conflicts of interest.** BoDs should adopt and implement strong internal controls, ethics, and compliance measures including those aimed at combating fraudulent or corrupt activity and ensure compliance with international commitments applicable to the company and any of its subsidiaries. To limit political interference, the legal framework should ensure the independence of members of BoDs to safeguard the enterprise and its shareholders against any material vested interests, as well as guarantee the establishment of necessary mechanisms to avoid conflicts of interest. This includes ensuring that the selection (nomination) of BoDs is transparent, well-structured and merit-based, with appropriate (transparent) remuneration to attract, retain and motivate managers that work in the interest of the enterprise. In addition, public enterprises should be prohibited from being used as vehicles to finance political activities (e.g., from involvement in contributions to political campaigns).
- **Strengthen corporate disclosure and transparency.** Best principles in this area are vital to mitigating all other weaknesses common to any corporate governance framework as far as responsibility, accountability and addressing corruption are concerned. Adhering to standard regular disclosure and reporting requirements applicable to companies' financial statements is key, including any intra-governmental financial flows and transactions that may carry significant fiscal risks (costs) and affect contractual commitments towards the state (e.g. public-private partnerships). In addition to internal audits, best practices call for subjecting financial statements annually to an independent external audit, and to require the "ownership entity" to publish a comprehensive high-quality annual report on public companies' performance. Mandated disclosures of annual appraisals of BoDs' performance, their remuneration (and that for senior management), besides publishing companies' governance, voting, and ownership structures are critical.
- **Safeguard a level playing field with private sector firms.** This broadly refers to the review—and adoption—of principles of non-discriminatory nature or non-preferential treatment of public enterprises to avoid giving public companies undue advantages over those in the private sector. These include granting by the state of exemptions from general laws, taxation or other regulations, reexamination of direct state financial support or preferential (below-market cost) access to finance, or other measures or benefits provided to such companies, e.g. receiving inputs at subsidized prices or under more favorable conditions. Public companies should be subjected to similar rules of the game as far as their

[14] See IMF's Government Finance Statistics Manual (GFSM) 2014, and IMF Georgia TA report (July 2020).

participation in public procurement is concerned (ensuring competitive and transparent procedures). There is also an argument that public enterprises should be expected to achieve rates of returns that are broadly compatible with those attainable in the private sector. Last, due access to legal recourse by shareholders in public corporations to protect their rights in a manner similar to that extended to private firms is an important element of the level playing field.

How Does Moldova's Existing Framework Compare?

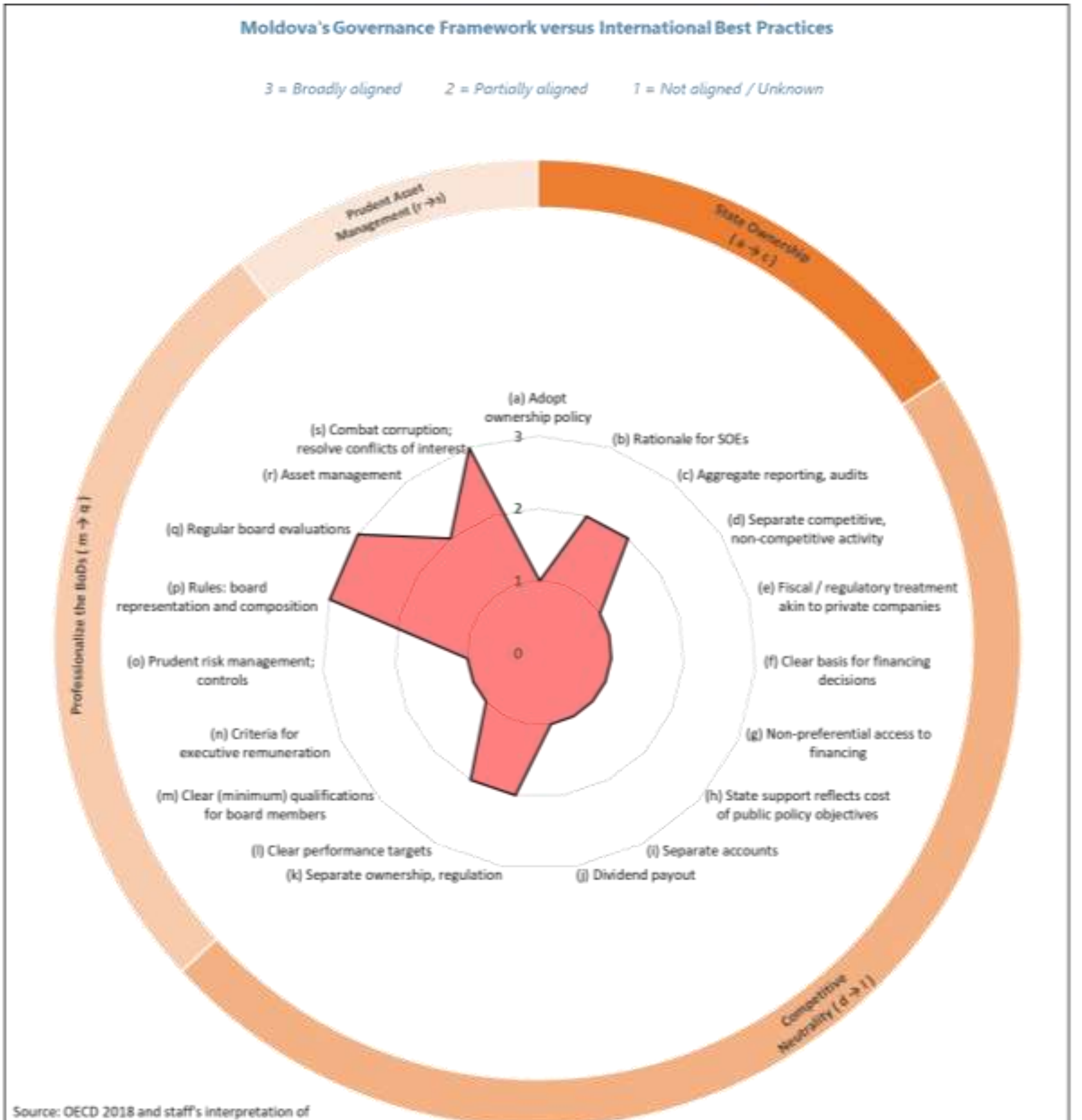
Moldova has elements of a public corporate governance regime. It follows a centralized model with one state body (the Public Property Agency; see section III) that exercises ownership rights on behalf of the state and has adopted laws over time to help guide the regime governing the operations of public corporations. According to a self-assessment survey, Moldova's legal and institutional framework fares above average on an SOE governance index relative to other countries in central, eastern, and south-eastern European economies.[15]

However, shortcomings are evident on several fronts—legal, institutional, and operational—calling for a thorough review of the existing governance framework (Annex II). For example, the lack of a corporate governance code and the lack of independence of company directors; pending clarifications related to internal controls and audit processes in public companies as part of supporting secondary legislations; perceptions of corruption that are at odds with legal requirements; and fragmented institutional arrangements for company oversight (e.g. between PPA, MoF and line ministries) are among many factors undermining Moldova's governance framework.[16] Annex II compares Moldova's governance regime to international best practices and highlights some areas where governance-related weaknesses can be strengthened. In particular:

- **An absence of a comprehensive state-ownership policy and strategy** document that ultimately defines the objective for state ownership and the rationale behind establishment and termination of public corporations (including the criteria to determine their legal form as public corporations versus other general government units, criteria for extension of state aid, etc.).[17]
- **Weak enforcement and less-than-ideal implementation of laws and regulations in practice, despite appearing to be comprehensive on paper.** One example relates to audits, where there appears to be three layers of audit (internal company audit, external expert audit, and audit performed by the court of audit) that are not applicable to all public companies.
- **Legislation that does not clearly safeguard independence of company boards. Heavy participation by the state on company boards** also calls into question their independence.
- **Poorly defined organizational arrangements and institutional set-ups that blur the respective roles and responsibilities between the state (MoF, line ministries), the PPA, and company boards** as far as oversight, managerial, and ownership functions intersect, **and between enterprises and the MoF, external donors, and other levels of government**, adding to confusion over the appropriate lines of authority and hindering accountability.
- **Overly stretched mandate of the PPA amid capacity constraints** that undermine its ability to execute its functions efficiently and effectively.

[15] Moldova ranks 6th highest (out of 20 countries in the region) in a composite index measuring SOE governance that covers ownership policy, financial oversight, and fiscal and policy interactions. See IMF (November 2019).
[16] Moldova's Country Governance Assessment report (IMF).
[17] IMF Country Report No. 20/240.

- **Limitations on the quality and availability of data on all public enterprises at all levels of government** undermine a solid understanding of the complex financial transactions between enterprises and the state and prohibit a comprehensive assessment of fiscal costs (risks). Data constraints also reaffirm concerns over the lack of proper record keeping and accounting standards, fueling perceptions of corruption and poor transparency and disclosure practices.



Source: OECD 2018 and staff's interpretation of relevant laws governing pubic enterprises in Moldova.

V. Analyzing Moldova's Public Enterprise Sector

A. Assessing Financial Performance

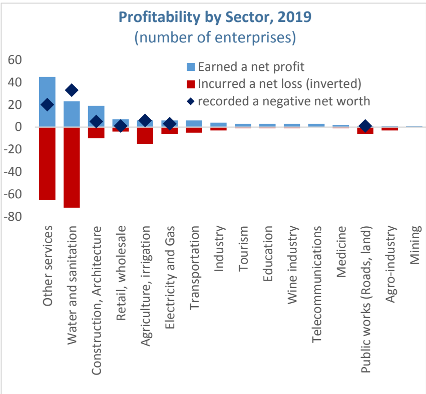
The SOE health check toolkit developed by the IMF's Fiscal Affairs Department (FAD) is used to assess the financial performance of 326 public enterprises in Moldova in 2019, based on official data from financial statements provided by the Public Property Agency (income statements and balance sheets). The toolkit assesses performance through standard financial ratios covering profitability, liquidity and solvency metrics on the company level, which are then aggregated. It assigns risks in each of these metrics using pre-set benchmarks tailored to Moldova (Annex I).

Profitability

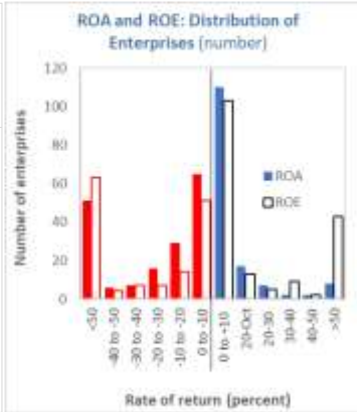
Profitability was very poor; 60 percent of public companies incurred net losses and seven sectors faced recurring losses. Net income was negative in 195 companies out of the 326 under study, dragged down by over 150 companies that posted losses at the sub-national level (particularly in water, other services and agriculture activities). The net profits achieved by enterprises at the central government level were wiped out by losses incurred by sub-national companies, driving the sector as a whole to suffer a minor loss in 2019 (compared to a slight net profit in 2018). Out of a total of 16 sectors, four at the central government level and 8 at the sub-national level posted overall losses, and seven sectors carried over persistent losses from 2018.[18]

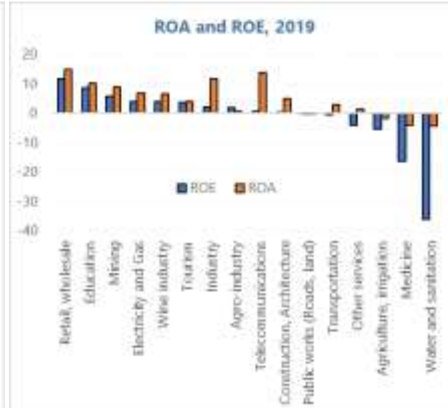
- ***ROA averaged 5 percent overall but exhibited considerable variation across sectors and government levels.*** Despite achieving a 5 percent average return on assets (ROA), great disparities prevailed at the sectoral level; the strong ROA performance in the retail, education, mining and energy sectors was starkly diminished by much poorer performance in a large number of companies operating in two other strategic sectors (water and agriculture). ROA averaged 5 percent at the central government level where large companies in terms of asset size operate—suggesting somewhat efficient asset management to generate earnings in some companies—but recorded negative 2 percent for the much smaller sub-national companies (returns on public assets should ideally equal the government's cost of borrowing plus a risk premium to be commercially sustainable).
- ***ROE performance came in much worse,*** visibly lower than ROA across all sectors, and much worse in the case of activities with the poorest net-income bottom-line. ROE was low at 1.3 percent for companies at the central government level, but averaged negative 10 percent at the sub-national level, a reflection of companies' severe negative equity positions (equity erosion). ROE is best examined in the context of company indebtedness (see *solvency* assessment and Box 3).[19]

[18] There are no indications in the data to suggest that larger companies benefit from economies of scale, or that companies posting the largest profits are consistently the largest in terms of asset size.
[19] EBRD (2020).



Source: PPA, and author's calculations.

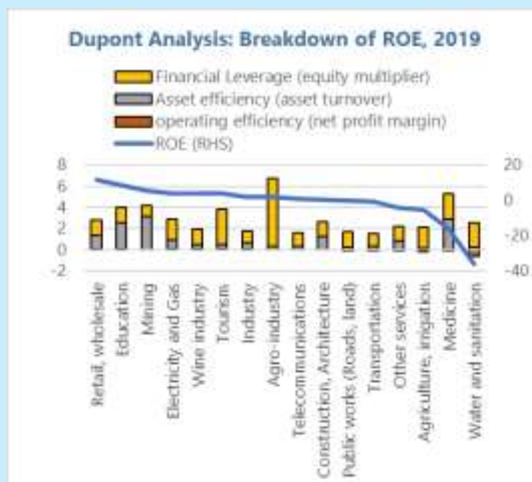




Box 3. Breakdown of ROE

Return on equity can be deciphered into its key sub-components using common *dupont analysis* to determine the driving forces affecting financial performance. This is achieved by breaking down ROE into the product of three explanatory elements: financial leverage; asset efficiency; and operating efficiency.

Financial leverage is high in Moldova in many companies and a key contributor to overall ROE. Commonly known as the equity multiplier, the ratio of company assets to equity is an alternative measure of indebtedness indicating the degree of aggressiveness of funding of company operations through "own" versus "borrowed" funds. Financial leverage is high in many public enterprises across many sectors (yellow bars in box figure). High ratios of the equity multiplier typically point to a larger balance sheet gap between assets and own capital, reflecting bigger company liabilities (e.g. long-and short-term debt) to finance operations.

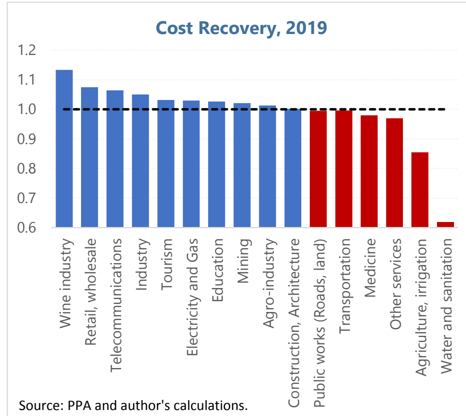


Asset efficiency is a strong driver of profitability*.* An indicator of asset turnover—defined as sales revenue to assets—it measures the extent to which a company's assets generate sales revenue. The better an enterprise manages its assets, the more efficient it operates and can generate revenue streams. In Moldova, this is a key driver behind ROE performance in many sectors, in particular education, mining, construction, medicine, and retail activities (grey bars in box figure).

Operating efficiency in Moldova is hampered by loss-making enterprises. Measured by net profit margins—defined as net profit to total revenue—it reveals how much each dollar in revenue collected translates into profit, helping to assess if enough profits are generated from sales and if overhead and operating costs are being contained. Loss-making companies suffer from operational "inefficiencies" which drag down ROE ratios, as is clear for six sectors in Moldova, especially in the water sector.

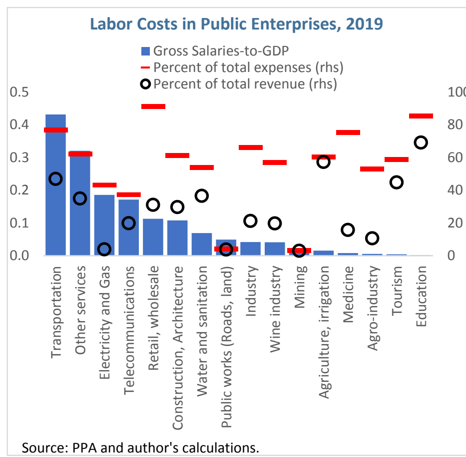
Source: PPA and author's calculations.

Cost recovery in many public companies was subpar, especially at the sub-national level. The ratio—which measures the ability of companies to generate adequate revenue to cover operating expenses—hovered only mildly above "1" in 10 sectors, indicating the ability of companies in these sectors to maintain their assets and operate sustainable in the absences of supplementary funding (although with a high degree of variation across companies and industries). Nevertheless, six sectors home to numerous enterprises had poor cost recovery ratios; significantly below 1 in agriculture and water activities. More sectors at the local level struggled to achieve cost recovery in their operations relative to those at the central level of government.

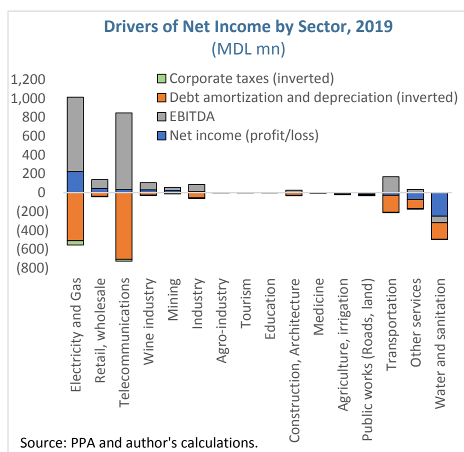


Key factors affect profitability

High labor costs in many companies significantly curtail profitability. Data shows that a third of the 326 enterprises pay salaries that exceed 75 percent of their total expenses, with 47 enterprises paying salaries comprising over 90 percent of their total expenses. Labor costs also absorb almost 15 percent on average of total enterprise revenue; 14 companies are burdened with salary costs that exceed their revenue intake. Labor costs are particularly high in sectors such as transportation, electricity and gas, telecommunications and other services that are also large employers, indicating potential challenges in their cost structures, cost (mis)management, and/or adverse impact from overstaffing due to targeted employment policy mandates in some companies.[20] The salary burden is costlier in companies operating at the sub-national government level (the share of salaries to expenses and to revenue are over 60 percent and over 40 percent, respectively, compared to 36 percent and 15 percent at the central government level, respectively).



Large, directed state subsidies mask actual financial performance. Profitability in a number of cases is dependent to a great degree on direct state support. Total subsidies extended to only four public enterprises (operating at the central government level) reached 1.5 percent of GDP, of which the overwhelming amount was granted to one state company managing roads (the state roads administration). That subsidy exceeded the enterprise's operating revenue by 20 percent; implying that the company would have otherwise incurred sizeable losses in the absence of such support (Box 4). Two of the other companies had in fact realized losses despite being



[20] The PPA annual report 2019 points to significant variation in salary structures across sectors and enterprises; from the highest average salary of almost 33 thousand Lei to the lowest average salary of less than 1,400 lei.

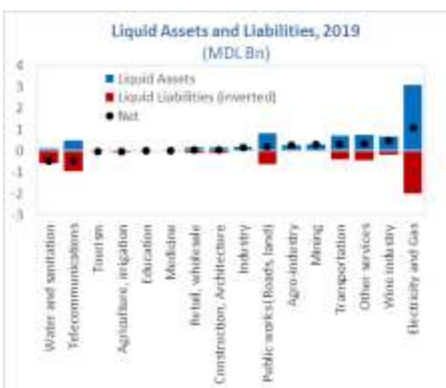
directly subsidized by the state. Such examples point to severe operational weaknesses and inefficiencies and highlight the extent to which company finances can be hampered without the state's involvement in their operations.

Sizeable depreciation and amortization costs in key sectors dampen profitability prospects. While corporate taxes paid by companies are not inhibiting, three sectors bear the brunt of depressed profit margins due to significant debt amortization and depreciation costs, resulting from the high debt burden facing enterprises in these sectors (Box 1).

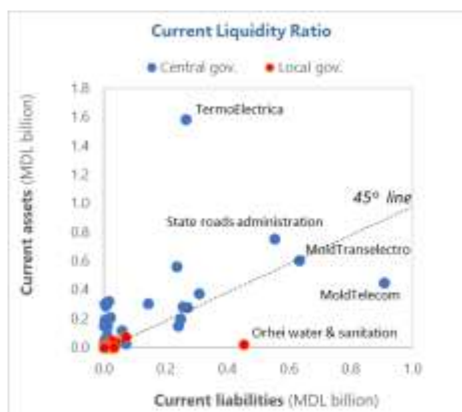
Liquidity

The *net liquid assets position* of public enterprises was broadly adequate overall, but masks underlying discrepancies. Net liquid assets—defined as the ratio of liquid assets to liquid liabilities—measures the "immediate" liquidity status of a company and its ability to both pay off short-term obligations as well as weather sudden downturns in activity without the need for excessive additional financing to sustain its operations. All sectors appear broadly liquid except for two sectors facing liquidity shortfalls (telecommunications and water). However, the net liquid assets position at the sub-national level was negative, much weaker than at the central government where liquid assets more than covered liquid liabilities by a large margin.

- **The current liquidity ratio in all but four sectors was adequate, albeit with weaker performance at the sub-national level.** The current ratio—defined as current assets to current liabilities—is an indicator of short-term liquidity of a company that measures its ability to meet short-term liabilities (falling due within a year) from selling short-term assets. On average, all sectors had current ratios above "1", implying good short-term liquidity. While some sectors had ample liquidity exceeding "2" (such as transportation, construction, industry and trade), other sectors had insufficient liquidity (telecommunications, agriculture, tourism and water activities).



Source: PPA and author's calculations.

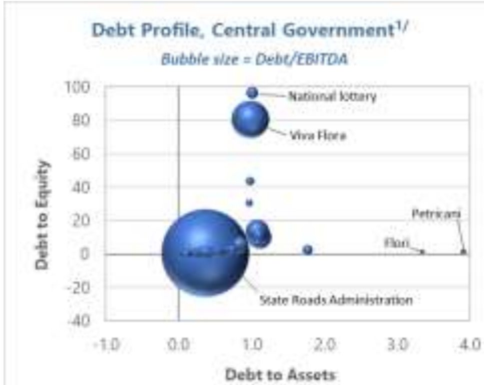


- ***However, debtor and creditor turnover were high,* suggesting liquidity constraints.** The number of days it takes to pay bills or collect claims is another useful indicator of companies' liquidity positions. While data is fragmented, *Debtor turnover*, which measures how fast a company is paid by its customers, was high at 2 months on average (for enterprises for which data are available), signaling that many companies possibly face increasing liquidity challenges. *Creditor turnover*, a measure of the speed with which companies pay their suppliers, came in worse at over 4 months, indicating slow repayment for company inputs; likely indicating underlying weak financial conditions. Many companies had extremely high ratios (outliers).[21]

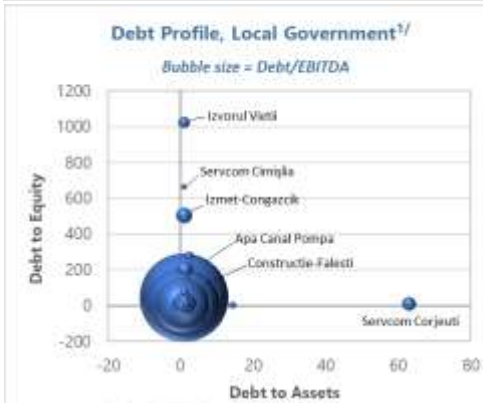
Solvency

The *solvency* of public enterprises in Moldova is a major weakness at all levels of government. The loss-making nature and negative equity positions in numerous public companies highly undermines their solvency prospects, i.e., heavy debt burdens that curtail their ability to pay off debt obligations under already constrained operations. The real solvency status may be worse than presented, given the quality and accuracy of company data for short and long-term debt.

- ***Debt-to-assets* were manageable overall yet hide severe divergences across companies.** A key indicator of solvency—the level of indebtedness relative to a company's asset size—was manageable for most sectors (less than 0.5; considered a moderate ratio), although it was higher in water services, agro-industry, electricity, and agriculture at the central government level, in addition to the construction and telecommunications at the sub-national level. The majority of companies had manageable ratios, with the exception of 9 companies whose debt exceeded their assets (among which two companies had debts three-to-four times the size of their assets).



Source: PPA and author's calculations
1/ Ratios are inverted (shown positive) for negative equity or EBITDA.



Source: PPA and author's calculations.
1/ Ratios are inverted (shown positive) for negative equity or EBITDA.

- ***Debt-to-equity* ratios were elevated and are more concerning, especially in companies with negative equity.** Many sectors suffered from excessive (double digit) ratios, such as agro-industries, water sector, retail, agriculture and construction, indicating the degree of their dependence (reliance) on external funding resources to finance ongoing operations. The picture was notably worse at the sub-national level and is unquestionably worse considering the level of indebtedness against the negative equity positions in many enterprises, which indicates overleveraging and/or undercapitalization. As expected, the ratio significantly differs across sectors depending on their capital intensiveness (where debt/equity ratios may be higher).
- ***Debt-to-profits (EBITDA)* were extremely high and particularly worrying in the case of loss-making enterprises.** Another important measure of enterprise solvency that assesses a company's debt burden and its ability to pay off debt in the future reveals worrying results for many companies, especially for those in the public works sector such as the state roads administrator (Box 4). The indebtedness in five other sectors was 20-to-50 times the size of their earnings, highlighting severe

[21] Forty-six enterprises recorded debtor or creditor turnover exceeding 1,000 days.

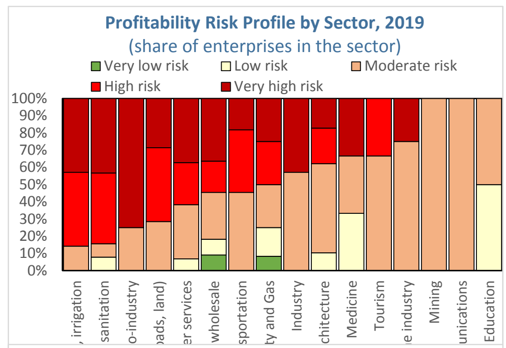
signs of financial instability and potential insolvency (the inability of a debtor to honor its payment obligations).

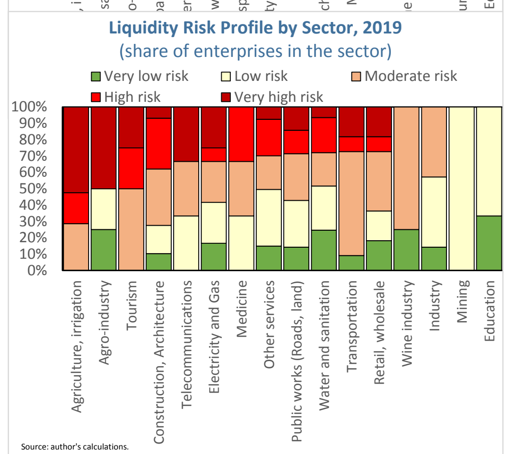
B. Assessing Financial Risks and Vulnerabilities

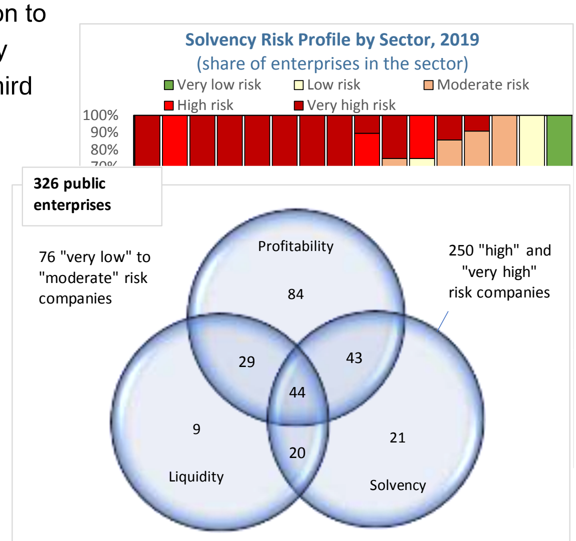
Overall, Moldova's 326 public enterprises under study face a "High" overall level of financial risk, both at the central and sub-national level of government.

- ***Profitability risk: "Moderate" overall, but "High" at the sub-national level.*** 200 enterprises faced "high" or "very high" risks to their profitability, three-quarters of whom operated at the sub-national government level, scoring "high" risks in ROA, ROE and in cost recovery. Sectorally, eight sectors had a significantly higher share of companies facing elevated risks, making them more vulnerable from an operational standpoint: a reflection of weak financial performance.
- ***Liquidity risk: "High" overall, but "Very high" at the sub-national level.*** 102 enterprises suffered from "high" or "very high" risks to their liquidity positions, among which two-thirds at the sub-national level who faced "very high" risks according to their current ratio and creditor turnover indicators (in addition to aggregate negative net liquidity positions). Sectorally, eight sectors had 30 percent or more of their companies exposed to elevated liquidity risks.
- ***Solvency risk: "High" overall and at all levels of government.*** 128 enterprises faced "high" or "very high" solvency risks, three-quarters of whom operated at the sub-national level, scoring "very high" risks in relation to the level of their indebtedness relative to their equity and to net earnings (income). Eight sectors had a third or more companies facing potential insolvency.

A large share of public enterprises face combined or multiple financial risks. In Moldova, that number is 250 companies, representing over three-quarters of the sample under study. Among these companies, 44 stand out as the most vulnerable "core" group who are confronted with "high" or "very high" risks in all financial indicators covering their profitability, liquidity, and solvency. This core group includes 14 companies at the central level of government, among which are three companies operating in the energy sector (production, supply, transmission, distribution, etc.) and who are also



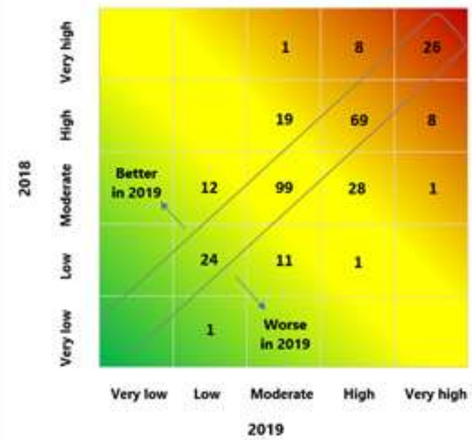




among the largest companies in terms of the size of their outstanding liabilities. At the sub-national level, the same core group includes 30 companies, among which one company operates in the water and sanitation sector and is also a large company by liability size. This core group's liabilities make up over 13 percent of the 326 public companies' liabilities, or 1 percent of GDP.

Another concern relates to the worsening risk profiles in over 15 percent of public enterprises in Moldova prior to the COVID-19 pandemic. While 40 companies managed to reduce their overall financial risk in 2019 relative to 2018 (such as the Cricova wine company), 50 companies saw their riskiness rise in the same year just before the pandemic hit (including two electricity companies). While data for 2020 was unavailable, the impact of the pandemic on public enterprise performance is likely to have been severe—heightening existing vulnerabilities while introducing new ones—potentially exposing the whole sector to deeper scarring effects and contributing to a further buildup of fiscal and macro-economic risks.

Overall Riskiness of Public Enterprises: 2018 versus 2019 (number of companies)



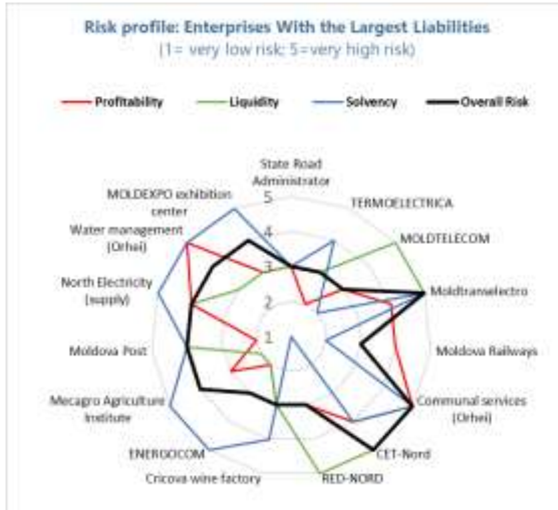
Source: author's calculations.

VI. Stress Testing Public Enterprises and the Links to Macroeconomy-wide Vulnerabilities: The Role of Contingent Fiscal Liabilities

Public corporate risks, fiscal costs, and macroeconomic vulnerabilities are intertwined. Public enterprises exhibiting poor performance are a direct burden on the state via their dependence on the state's treasury (budget) for survival. They pose higher fiscal costs in the event of their failure, particularly when they carry large contingent liabilities. Higher fiscal costs in turn fuel unsustainable public debt trajectories which can destabilize financial markets—including by squeezing out credit for the private sector and raising government borrowing costs to prohibitive levels when financing is available. And where financing is constrained or limited, the government will have no choice but to undertake severe cuts to other productive spending or to raise revenue abruptly; ultimately precipitating in a lack of confidence in the economy. The macroeconomy-wide repercussions from these scenarios are multifaceted, potentially resulting in both domestic and external imbalances. First, economic growth, employment and the general price level will all be affected. Second, other costs and externalities can be incurred by the state due to a sudden lack of the government's ability to deliver on its public policy objectives—namely, the provision of vital public goods and services to citizens through these enterprises (i.e., a severe supply shock). For instance, compensating for the commodity shock via more expensive imports may lead to large losses in foreign currency that culminate in exchange rate pressures. In addition, the social costs to the state from labor market dynamics and unemployment should not be understated (e.g., mitigating measures to cover costs of unemployment benefits or severance packages paid to the employees of these enterprises or their re-training). As such, a shock that starts at the company level and reverberates through the financial, commodity, household, and labor markets can morph into an economic crisis.

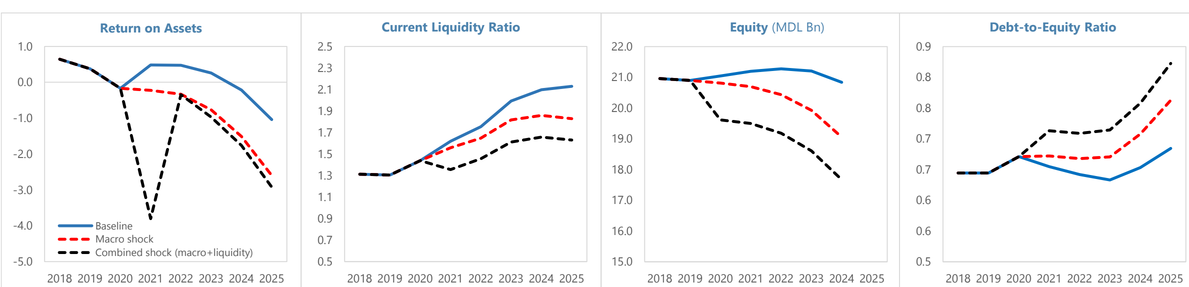
Stress Testing the Enterprises with the Largest Liabilities

Underlying financial vulnerabilities are acute in the largest companies having the biggest outstanding liabilities, a direct source of fiscal risk. Another way to analyze public corporate risks is to look at companies that have the largest liabilities across several sectors, as these tend to be the more vulnerable in the event of incurring sizeable losses, lack of liquidity, or insolvency because they often require the most substantial bailout (fiscal) costs via state intervention. Among the group of companies with the largest liabilities (15 in total, whose liabilities amount to over 6 percent of GDP or 88 percent of the liabilities of all enterprises covered), all had at least one "high" or "very high" risk, except for the largest company (the state road administration, with liabilities equivalent to 2.1 percent of GDP). Several other enterprises in this group also suffered multiple (combined) elevated risks, further accentuating their operational vulnerabilities.



Source: author's calculations.

With such risks and vulnerabilities in mind, a simple stress testing tool is employed to model the impacts of growth and liquidity shocks in 2021 on the baseline finances of these 15 companies.[22] The first shock—an economy-wide growth shock—assumes a 1.5 percentage points weaker economic growth recovery from the pandemic in 2021 (relative to the baseline) coupled with a weaker leu (10 percent). The second shock adds the impact of a liquidity shock on top of the growth shock by imposing a liquidity constraint defined as a 30 percent share of receivables potentially materializing; a risk that needs to be provisioned for and that negatively affects companies' financial statements. Results indicate an immediate deterioration in profitability indicators, coupled with weaker liquidity positions and debt indicators in the years ahead for this group of enterprises.



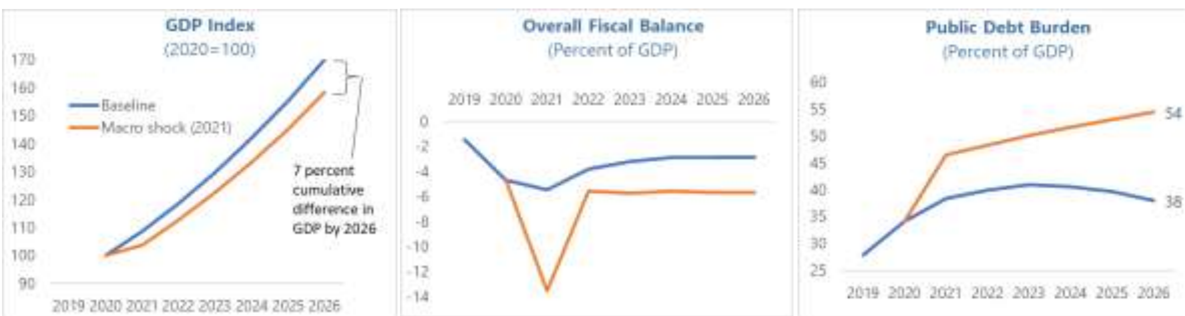
Source: PPA and author's calculations.

Macroeconomic Vulnerabilities from Contingent Public Liabilities

[22] Based on the IMF's Fiscal Affairs Department *SOE Fiscal Risks and Stress Test* tool.

A failure of these 15 enterprises carries significant fiscal costs to the state and poses severe macroeconomic repercussions. A worst-case scenario under a modeled shock that foresees the government assuming the liability burden of the 15 companies would add about 8 percentage points of GDP to public debt in the year of the shock (2021) and 16 percentage points of GDP to debt over the next 5 years. This includes the additional burden on the state of absorbing their economic losses that is estimated at a cost of 0.7 percent of GDP in 2021 and 1.4 percent of GDP cumulatively over the medium term.23 While these estimates remain conservative—by excluding other forgone financial flows to the state from these enterprises (e.g. tax and dividend transfers or tariff collections)—they are sizeable, and highlight the extent to which macroeconomic repercussions from fiscal risks driven by a materialization of enterprises' contingent liabilities in one year translates into permanent scarring of overall macroeconomic activity. Notwithstanding the range of other possible repercussions on the economy noted earlier, the results from such a scenario reiterate the urgency in carefully reforming these enterprises. In particular, the cases of the electricity companies and the National Railway Company merit further scrutiny (Box 5).

Possible Macroeconomic Repercussions from Fiscal Risks Driven by Contingent Public Liabilities [1]



Source: author's calculations and estimates based on financial statements for the 15 enterprises with the largest liabilities from the PPA.

[1] The modeled shock assumes higher interest payments on debt, as well as the impact of cuts in productive fiscal spending in 2021 on real economic activity, which—together with lower economic growth from squeezed private sector credit—feed back to lower tax revenues via a second-round effect.

[23] Costs due to economic losses are calculated relative to the baseline scenario.

Box 4. Too Big to Fail? Pulling the Plug on the Government's Direct Support Schemes for Public Enterprises: Moldova's State Roads Administration (Public Works)

The State Roads Administration company is by far Moldova's largest SOE, managing the biggest chunk of state assets worth almost 6 percent of GDP and employing about 170 staff. It is a recipient of sizable government subsidies amounting to 1.4 percent of GDP. The company's financial statements for 2019 reported a net income of MDL 0.8 million, inclusive of the state's direct subsidies to support its operations.

Stress testing the company's financial performance by removing direct state support reveals clear underlying operational weaknesses that mask seemingly profitable, liquid and solvent positions and exposes severe hidden fiscal costs and risks that could materialize, both for the company and for the state. In the absence of such support, the company would have faced a huge loss hampering its cash flow operations and impacting its performance, potentially precluding it from meeting its existing and future obligations i.e., triggering possible defaults on its current and other payments (a situation in which imminent liquidity and solvency risks materialize). Alternatively, the company may have been forced to resort to either fire asset sales, borrow from the local market at a prohibitively high cost, or tap into its reserves (which would have depleted/wiped out 40 percent of the its equity), ultimately requiring a costly capital injection through state intervention.

While the company provides an important public service in a systemically important sector, it does so at a price, calling into question the costs/benefits and rationale for its operations. Experience in other countries points to large fiscal costs of resolving failing SOEs. As such, a deeper cost-benefit analysis and examination of the rationale behind the existence of this and similar public enterprises in Moldova could focus on addressing a few valid questions, including: (a) why the state needs to subsidize otherwise failing companies through a continuous lifeline of direct government support (i.e. rationale for state ownership), especially in the presence of alternate market structures; (b) the opportunity cost related to the provision of such large public funds (especially to one single company), and the mechanisms underlying its financing (including via external funding channels that may carry a high debt burden for the state); (c) the extent to which the state is efficiently and effectively managing a large share of its public assets; (d) market efficiency and level playing field considerations related to competitiveness of public enterprises; and (e) the degree and aptitude of managerial oversight over the company's operations. Overall, revisiting the role of governance frameworks within which this and similar companies operates deserves merit.

Source: PPA and author's calculations based on the IMF's Fiscal Affairs Department *SOE Fiscal Risks and Stress Test* tool.

Box 5. Stress Testing the Financial Performance of the National Railway Company

The financial performance of Moldova's Railway Company was mixed. It is the second largest in Moldova (by asset size), managing state assets worth 1.6 percent of GDP and employing around 7,600 staff, and a recipient of on-lent external financing from the state for its projects. In 2019, while sales revenues increased and cost of goods sold declined, the company still incurred a large cumulative net loss for a second year in a row, alongside a reduction in equity (net worth). Overall financial performance was mixed; on profitability, the positive rate of return on assets was met by a negative ROE, maintaining its high profitability risk. Its liquidity position fared better, scoring a moderate risk due to strong current and quick ratios and a positive net liquid asset position. Last, risks of insolvency

Box 5. Stress Testing the Financial Performance of the National Railway Company (concluded)

remained very low, as debt remained subdued relative to assets and to equity (the company reduced long-term debt in 2019 relative to other companies after sharply increasing in 2018 and reigned in long-term debt in 2019 relative to other companies after sharply increasing in 2018 and reigned in its short-term liabilities). In March 2021, salary arrears were reported, and the company's staff were advised to take voluntary leave with less than full remuneration, partly reflecting the impact of COVID restrictions on consumer travel demand. Noteworthy here are the historic challenges faced by the company—including reported poor investments and mismanagement—which have affected the quality of the rail service through slower speed capacity and inadequate tariff setting, besides other freight-related obstacles.

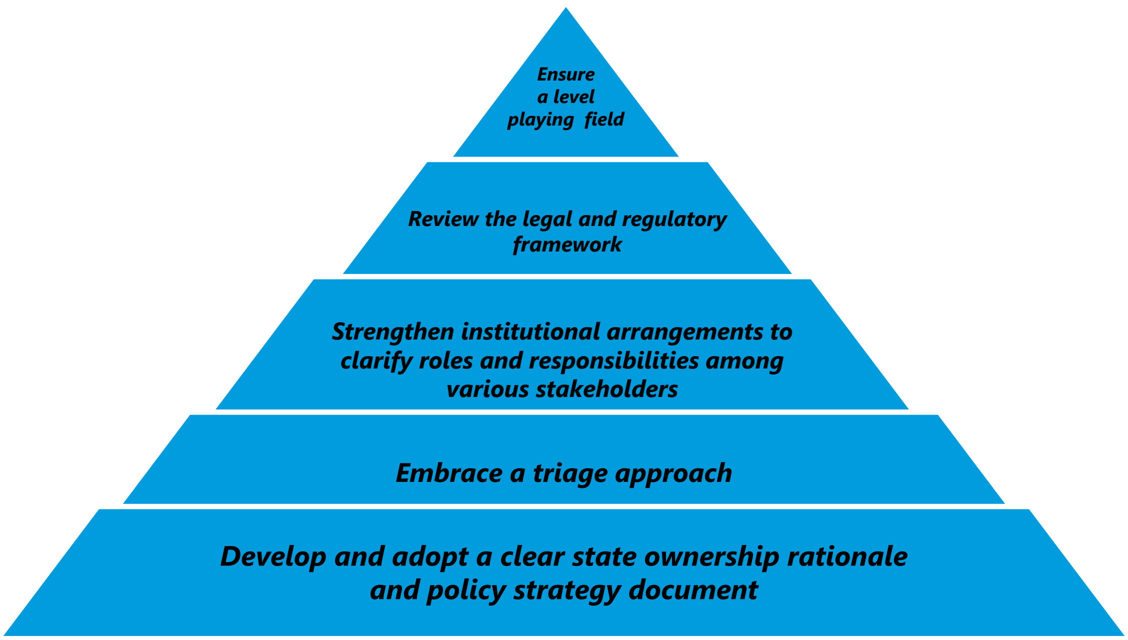
Results of similar stress tests that expose the company to potential macroeconomic and liquidity shocks point to underlying vulnerabilities. Results indicate moderate vulnerabilities to the company's performance under the growth shock, especially on key profitability and liquidity indicators. However, the combined liquidity-macro shock yields more pronounced results, as expected, highlighting stronger risks to the company's performance. Both shocks underscore the permanent nature of losses that could affect company operations beyond the immediate year. This reiterates the importance of strengthening the company's governance framework, including through improved oversight of—and a stronger role played by—its executive board, mitigating operational risk by setting clear forward looking financial targets and ensuring implementation of prudent risk management practices, and enhancing managerial accountability over the use of public funds (including those on-lent) to improve the management of state assets and reduce vulnerabilities in such a vibrant sector.

Profits ***Liquidity*** ***Solvency***

Source: PPA and author's calculations based on the IMF's Fiscal Affairs Department *SOE Fiscal Risks and Stress Test* tool.

VII. Reforming Moldova's Public Enterprises: A Roadmap to Strengthen Governance

Establishing a clear roadmap will serve to anchor reforms. Five interrelated areas in line with international best practices can be identified in Moldova's case. Strengthening public enterprise governance practices at all levels of government calls for concerted reform efforts in each of these areas:



Source: author's representation, based on various reports and studies by the OECD, the World Bank, and the International Monetary Fund.

i. **Develop and adopt a clear state ownership rationale and policy strategy document** that supports clear stated public policy objectives for these companies (including rationale and criteria establishing their existence/termination, criteria for classifying companies as public enterprises, their legal form, defining commercial versus non-commercial mandates, financial or non-financial functions, choice of sectors, etc).[24] The ownership policy and rationale should be reviewed and updated thereafter (e.g. see experiences from Sweden, Finland, Germany, Netherlands, Norway, and Switzerland).[25]

[24] According to an IMF TA report on GFS (August 2020), "*…the classification of entities may not be in full alignment with international standards. The lists of JSCs and SOEs contain at least some institutions, such as the State Road Administrator, which may be wrongly classified as public nonfinancial corporations in Moldova's statistics, rather than general government units*".

[25] See OECD 2015 (b).

ii. **Embrace a triage approach** to assess the health and viability of enterprises by dividing them into (i) viable and healthy; (ii) viable but unhealthy, and (iii) non-viable entities, and focusing on the justification of state ownership. The triage approach will thus aim to identify enterprises to undergo restructuring by means of reorganization (mergers and acquisitions, or recapitalization), privatization or liquidation, as well as plans to strengthen their governance structures.

iii. **Strengthen institutional arrangements to clarify roles and responsibilities among various stakeholders, enhance management, performance, and transparency.** Undertake a comprehensive review of existing institutional arrangements to:

- *Reduce fragmentation in the respective roles and responsibilities of MoF, all line ministries, the legislature, and other relevant bodies* in their management and interactions with state-owned enterprises. This includes clarifying lines of authority and subordination, managerial responsibility and accountability, and the split between oversight responsibilities.
- *Strengthen MoF's roles with respect to fiscal risk oversight and fiscal cost and risk management functions,* including by expanding the Fiscal Risk Statement (FRS) to include a more detailed assessment and bigger share of public enterprises subject to high and very high risks (at least the 44 "core" companies identified herein, besides other systemically important enterprises in strategic sectors and those having large liabilities), and improving the coverage, monitoring, inter-agency coordination, and reporting of contingent liabilities.
- *Strengthen managerial (policy making) functions and separate them from ownership, and clearly identify enterprise management structures* (including private and controlling ownership), address opaqueness in institutional set-ups, and establish and ensure clear codes of conduct for management to hold them accountable for actions and performance.
- *Strengthen oversight over the PPA's role and function*; hold its management accountable; and upgrade its institutional capacity with necessary resources (human and financial) for it to be able to execute its mandate effectively. This also includes adopting a strategy to strengthen accountability over the use and management of public funds, and undertaking a cost/benefit analysis of the use of state resources to determine the efficiency of the use of the state's assets to improve its management.
- *Create incentives to improve public enterprise performance.* Critical areas of reform in this context are to *strengthen operational efficiency and incentives to improve company performance*; *strengthen risk management practices* at the company level by requiring companies to set clear forward-looking performance targets (KPIs) and limits on liabilities to allow for scenario analysis, stress testing, and adequate continencies in their budgets; *enforce accounting standards and sound data and record keeping*; *hire and retain* members of BoDs and BoAs through *transparent processes* upholding the highest levels of merit-based competencies; and ensure that *remuneration* is commensurate with expertise.
- *Enhance and enforce best practice transparency and disclosure principles*, starting with *strengthening the PPA's annual consolidated report*: expand the analysis of companies to include information on employment; key changes to company ownership policy (state shares in capital); a synopsis on intended reforms to be implemented in selected enterprises (in line with ownership policy and sectoral reform priorities); strengthen the breakdown of analysis between commercial and non-commercial enterprises; disclose website links to all companies

analyzed in the report, and report instances of mismanagement in any company during the year alongside proposed remedies to address it (e.g. conflicts of interests, political interference in decision making, etc.)

iv. **Undertake a comprehensive review of existing legal and regulatory frameworks** governing public enterprises operating at all levels of government, with a view to:

- *Root out corruption and conflicts of interest* by closing loopholes that aid corrupt practices and enforcing stringent penalties to make it more difficult and costly to be corrupt through the use of public office for private gain*.*
- *Review and clarify rules for remuneration policy of company boards* and for *dividend payout policies.*
- *Strengthen rules and regulations to safeguard policy independence and integrity in public companies.* Review the heavy presence of state representatives on company boards and management and report to MoF with proposals for reform.
- *Clarify state aid rules and intervention criteria.* This includes guidelines for what constitutes fiscal or quasi-fiscal activities, linkages between the state and public enterprises and identification of net-financial flows, when state intervention is allowed/prohibited, and rules on bail-out clauses to mitigate state exposure due to extending various kinds of fiscal support (subsidies, other transfers, grants, loans and on-lending schemes, government guarantees and loan criteria, and other debts).

v. **Enable a level playing field** between public enterprises and private corporations to raise market efficiency, boost competition and nurture a vibrant private business sector as the main engine of growth, via concerted efforts to:

- *Review and amend relevant legislation to address the extent of over or under-regulation* that governs privileged access to government resources by public companies. This includes access to land, utilities, infrastructure, other irregularities related to lack of transparency and complicated procedures in public procurement contracts and project selection—including weak follow-up and inspections—and in the extension of loans, credit, grants and other forms of support.
- *Review and amend relevant laws to enhance domestic and foreign private investments*.
- *Review relevant anti-monopoly legislation* to cut down on harmful and inefficient practices of monopolistic (and oligopolistic) activity.
- *Balance the merits of economic vs. social returns* in public companies vis-à-vis their private counterparts.

Proper sequencing of reform objectives and priorities, in addition to political will and stability, and ownership of the reform process, will be key to its success. A comprehensive assessment of the financial position of all public enterprises operating at all levels of government is a key first step to identify public corporations at risk of generating fiscal costs.[26] Results should feed into and inform the development and adoption of a time-bound and explicit state-ownership strategy. This document will identify enterprises chosen to undergo restructuring by means of reorganization (mergers and acquisitions, or recapitalization), privatization[27] or liquidation, as well as plans to strengthen their governance structures. Given the long tenure often associated with reforming public enterprises and the scope of reforms likely to be needed in Moldova (Annex II), a stable political environment and a government that owns the reform process and oversees its completion is vital.

Moldova stands to gain from leveraging international best practices and learning from reform experiences in other countries, including on mitigating measures (Annex III). Experience elsewhere indicates gains to productivity of between 6-14 percent in strategic sectors and labor cost savings of up to 2.5 percent as a result of public corporate governance reforms.[28] Reform policies that may have socio-economic implications on labor or commodity markets (e.g. relocating furloughed or overstaffed workers, redesigning tariffs or abolishing administered or below-market prices) are often based on an upfront detailed assessment and review of the potential effects of restructuring public companies. This helps to mitigate costs and ensures that adequate safety nets are in place. In all cases, Moldova will not need to reinvent the wheel, and should rely on the existing abundance of international expertise.

[26] Imperative to such an assessment will be efforts aimed at (i) strengthening disclosure of critical missing data and narrowing key data gaps in public enterprises identified a survey used in a cross-country study of SOEs (such as on employment and remuneration—see IMF, November 2019); (ii) deepening the analysis of net financial flows between the government and all public enterprises in Moldova, for all enterprises at all levels of government, which is vital to help identify the degree of dependence of such enterprises on government funding, the role of the government in their financial management, and the best approach to reform; and (iii) strengthening the understanding on intra-company debts, which could pose serious financial risks across sectors (such as between companies providing a service and others providing a commodity as input to such a service, e.g. the telecommunications sector). In the future, it will be important to undertake a comprehensive *Public Sector Balance Sheet (PSBS) approach* to provide a complete assessment of the financial performance and net worth of all public enterprises operating at various levels of government in Moldova, in addition to all other entities that the government controls (e.g., pension funds) to give a fuller picture of total public wealth (or fiscal solvency). See IMF, Georgia TA report (July 2020).

[27] Moldova's existing regulations allow for privatization via sales through commercial or investment competition, auction, or via the stock exchange. Natural and legal persons in Moldova; private foreign natural and legal persons; stateless persons; and certain associations are allowed to participate in the privatization process as buyers.

[28] IMF Fiscal Monitor (April 2020).

Annex I. Benchmarking Methodology

To determine the profitability, liquidity and solvency risks of public enterprises, the following risk thresholds have been assumed in the analysis. The thresholds were provided by an expert in the IMF's Fiscal Affairs Department (FAD) as part of an FAD-led Technical Assistance (TA) workshop delivered to the Moldovan authorities in November 2020.

Thresholds

Profitability	**Very Low Risk**	**Low Risk**	**Moderate Risk**	**High Risk**	**Very High Risk**
Return on Assets	greater than	8.00	4.00	0.00	-5.00
Return on Equity	greater than	15.00	8.00	0.00	-10.00
Cost Recovery	greater than	1.50	1.25	1.00	0.75
Liqudity					
Current Ratio	greater than	2.00	1.50	1.25	1.00
Quick Ratio	greater than	1.20	1.00	0.80	0.70
Debtor Turnover Days	less than	30.00	40.00	50.00	75.00
Creditor Turnover Days	less than	30.00	60.00	90.00	120.00
Solvency					
Debt to Assets	less than	0.25	0.50	0.75	1.00
Debt to Equity	less than	0.50	1.00	1.50	2.00
Debt to EBITDA	less than	1.50	2.00	3.00	5.00
Interest Coverage	greater than	2.00	1.50	1.20	1.00
Cash Interest Coverage	greater than	3.00	2.00	1.50	1.00
Debt Coverage	greater than	0.50	0.30	0.20	0.10

Definitions

- Return on assets = earnings before interest, tax, depreciation, amortization (EBITDA) / assets
- Return on equity = net profit (loss) after tax / equity
- Cost recovery = total revenue / (cost of goods sold + other expenses)
- Current ratio = current assets / current liabilities
- Quick ratio = (current assets - inventory) / current liabilities
- Debtor turnover (days) = trade receivables*365 / total revenue
- Creditor turnover (days) = trade payables*365 / cost of goods sold
- Debt to assets = liabilities / assets
- Debt to equity = liabilities / equity
- Debt to EBITDA = liabilities / EBITDA

Annex II. How Does Moldova's Existing Governance Framework Compare to International Best Practices?

Governance Area and Best Practice Principle	Moldova's status relative to best practices			Comments
	Aligned	Partially aligned	Not aligned	
State ownership				
Adopt an explicit ownership policy (define objective of state ownership)			●	The authorities have been developing a strategy document to look into ownership policy, which is under discussion. Its alignment to best practices is yet to be fully determined (see IMF, March 2021 report).
Rationale for establishing and terminating SOEs		●		The legal framework is clear on steps and regulations to terminate public enterprises but is less clear on the rationale for establishing companies. Reorganization or dissolution of SOEs and JSCs is governed by (Articles 12-15 of Law 246 and chapters 19 and 20 for JSCs) (voluntarily or forced dissolution) as well as distribution of company assets at the liquidation stage. For SOEs, Liquidations require a liquidator (liquidation commission of minimum 3 people appointed by the PPA. The decision to liquidate by the commission is adopted by majority vote. Reorganization or dissolution is by government decision… Based on the PPA's request, in some instances an enterprise can be subject to forced dissolution by a court decision (e.g. an enterprise has no assets or has not operated or reported financial statements for three years). For JSCs, their law stipulates reorganization according to mergers, split up of enterprises, transforming their legal form (e.g. from non-commercial to commercial), and dissolution/liquidation. The decision following general meeting of shareholders on the reorganization or dissolution of the enterprise is grounded in the Charter. Special provisions apply in case of privatization (Article 100 of JSC law). In line with the Laws for SOEs and JSCs, Dissolution is possible if "the entity's equity reported in the yearly balance sheet, for three years in a row, is lower than its share capital, in which case the PPA shall take action under the law (cut the share capital, contribute funds to share capital, close down the company, etc.)." Circumstances under which a JSC can be dissolved (Article 53 of the law): "The non-convening by the company for 2 consecutive years of the general meeting of shareholders constitutes a ground for dissolution of the company based on the decision of the court…". Also, "Any shareholder has the right to apply to the court for the dissolution of the company".
Aggregate reporting, including audits (facilitate transparency, disclosure)		●		The Law on SOEs mandates disclosure of annual financial reports of enterprises, as well as the audit report to be published both on the enterprises' webpage and on the website of the PPA (chapter VI, and Article 18). However, it is unclear if all companies abide by such mandates or if such legal requirements on financial and non-financial disclosures are met in practice (according to a media article many companies do not. See also IMF, March 2021 report). On financial audits: (Article 7) of the law notes that the BoD selects the audit entity, which may be strengthened by delegating such a responsibility to the PPA as the oversight body. Article 8 (5) notes that "the member of the board of directors shall be exempt from compensation for damage caused during the performance of his duties if he has acted in accordance with the written instructions of the founder", which needs to be reviewed in light of mitigating any likelihood of top down corruption. While (Article 10) notes that the Audit report includes an evaluation/assessment of activity/performance relative to the preceding year, it would be prudent for the assessment to be conducted relative to pre-set targets/objectives. (Article 11) states: "The annual financial statements of the state / municipal enterprises that have been subject to the audit of the Court of Accounts of the Republic of Moldova shall not be subject to the mandatory audit provided in paragraph (1) for the audited year", which weakens the objective of the audits. For the Law on JSCs—on accounting, reporting, audits and disclosure of information—the law explicitly ascribes responsibility to the company and its officers for negligence in keeping accounting records and/or preparation and submission of financial and other reports, inclusive of any unauthentic or erroneous data, as well as the publication (or the lack thereof) of untrue information about the enterprise's activities (Chapters 16 to 18; Article 87). However, the JSC law does not specify regular intervals for performing the audits. Also, in the case of JSCs, the audits are only obligatory to be undertaken in companies where the share of the state exceeds 50 percent of its capital, instead of being mandatory for all other companies as well regardless of the share of the state.

Governance Area and Best Practice Principle	Moldova's status relative to best practices			Comments
	Aligned	Partially aligned	Not aligned	
Competitive Neutrality: Ensuring a Level-playing Field and Fair Competition				
Separate responsibilities for ownership and regulation		●		The involvement of—and role playing among—the PPA, the MoF, and line ministries blurs lines of responsibility between ownership and regulation, fragmenting the overall institutional arrangement (see IMF, March 2021 report).
Separate competitive from non-competitive activity			●	Unknown / unclear from relevant legislation.
Fiscal (tax) and regulatory treatment akin to private companies			●	Unknown / unclear from relevant legislation.
Clear basis for financing decisions			●	Unknown / unclear from relevant legislation.
Access to debt financing from the market is non-preferential			●	Unknown / unclear from relevant legislation.
Set clear financial performance targets (e.g. establish or align required rates of return close to those in the private sector)		●		While the law on SOEs mandates the BoDs to establish performance indicators for the enterprise (Article 8, sub-bullet 7b) and regulates procedures related to post-operational management of bottom line results (e.g. distribution and use of the net profit and the manner of covering losses—Article 2, sub bullet 4j:), the Law on JSCs is less clear on the setting of performance targets. Both laws are vague on the extent of alignment of expected rates of returns in public corporations with those in the private sector.
Direct state support calibrated to the cost of fulfilling public policy objectives			●	Unknown / unclear from relevant legislation
Separate accounts of commercial and non-commercial activities			●	Unknown / unclear from relevant legislation
Dividend payout: align levels with private sector			●	Not mentioned in the Law on SOEs. The Law on JSCs has several articles outlining in detail dividend payouts depending on asset classes (e.g. Articles 15, 25, 35, 48, 49), but does not have provisions in relation to aligning dividend payments with the private sector.
Dividend payout: set in guidelines vs. negotiated annually	●			Negotiated.

Governance Area and Best Practice Principle	Moldova's status relative to best practices			Comments
	Aligned	Partially aligned	Not aligned	
Professionalizing the Board of Directors				
Set clear (minimum) qualifications for board members			●	The Law on SOEs sets minimum qualifications for member of BoAs (audit committee—Article 10), but not for members companies' BoDs. The Law on JSCs provides for minimum qualifications for members of companies' audit committees (article 71), but not for members of BoDs.
Rules governing board representation and composition (including diversity)	●			
Establish criteria for executive remuneration (mark-to-market, limits, etc)			●	Unknown / unclear from relevant legislation
Regular board evaluations	●			
Adopt and apply prudent financial and operational risk management systems (tools) and internal controls			●	The Law on SOEs and the Law on JSCs do not explicitly provide clarity on application of relevant financial and operational risk management tools or systems in public enterprises.
Other				
Asset management		●		While the Law on SOEs provides a number of articles dealing with management of state assets, it leaves operational aspects to be established by other undefined legislation (e.g. Chapter Two, Article 3 (3) : "possession, use and disposition over the assets of the state / municipal enterprise shall be established by the legislation" ; and Article 3 (5) : "transmission, commercialization, leasing / leasing or loaning and scrapping of the state / municipal enterprise assets shall be carried out in the manner established by the Government".) The law on JSCs has several references to assets in the context of definitions of operational nature (e.g. types of asset classes for the purposes of dividend pay-outs) but lacks specificities as far as prudent management of state assets are concerned.
Combating corruption and resolving conflicts of interest	●			The Law on SOEs has a number of articles dealing with resolving conflict of interests (Chapter One, Article 2 sub-bullet 4k; Chapter Five, Articles 16-17). The Law on JSCs (Article 74) covers conflict of interest from the lens of personal liability, i.e. damage to the company e.g. due to premeditated actions that led to bankruptcy, willfully distorting or concealing or furnishing misleading information, contravention of regulations (e.g. payment or failure to pay dividends/interest), over-pricing of securities purchased, (mis)abuse of company assets, allowing or willfully violating other procedures (e.g. concluding large transactions that exceed 25 percent of company assets in value (Article 83 and Chapters 15 and 18). The law provides some safeguards such as protection of whistleblowers who vote against violation of procedures, the prevalence of joint liability of persons in the event of adoption of joint decisions in violation of company charters, and the non-release of liability in the event of a delegation of decision making power. On disclosure, the Law mandates financial reports to include information on large transactions and others where there is a conflict of interest (Article 91)

Source: OECD (2018).

Annex III. Cross Country Experiences in Public Enterprise Reforms

Cross-country experiences in reforming public enterprises focused on targeted policies to strengthen governance and financial performance, deepen private sector participation, and mitigate externalities from reforms (annex table). A number of countries targeted to achieve clarity on their ownership policy (rationale) following a comprehensive review of all enterprises. Countries such as Morocco, Barbados, and Uzbekistan revamped governance through strengthening their legal frameworks and management and separating management from supervision, while enhancing oversight and audit functions, financial reporting and oversight, and continuous monitoring. Others reduced state interference and strengthened independence of company boards to uproot corruption, and improved internal controls and transparency (disclosure) requirements. Countries such as North Macedonia, Serbia, Belarus and Georgia tackled the viability of corporate financial performance ("commercial viability") through both operational revenue enhancements[1] and cost-effectiveness (e.g., structural reduction in expenditure financed through central government funding or support, in addition to risk mitigation measures like better monitoring and management of fiscal risks and liabilities). Poland included in its reforms improvements in asset management; putting state assets to the better productive use to earn higher returns. To strengthen the level playing field, some countries introduced a stronger role for competition councils, and decisive reforms often involved restructuring enterprises via mergers and divestments, selling state assets, and increasing private sector participation.

Experiences have shown that improvements in corporate governance can enhance SOE performance, both operationally and institutionally. Lithuania's experience during its phase of corporate governance reform of SOEs during 2012-13 is one example. Other studies have also asserted the degree to which strengthened governance is instrumental to overall improvements in public corporate efficiency and performance.[2] Strengthening the governance of public enterprises in Moldova is particularly relevant given the systemic underperformance of the majority of enterprises, their elevated financial risk profiles, dominance across all levels of government and sectors, and the magnitude of assets invested in these companies and managed by the state.

[1] For example, in Barbados, a comprehensive review of all tariffs and fees charged by SOEs was conducted.
[2] See IMF study (November 2019).

Country	Reform Priority Area(s)
Morocco	• Restructure SOEs through two draft laws, aiming at eliminating enterprises "deemed no longer essential" and merging others operating within their sector to exploit synergies. • Introducing a "National Agency responsible for the valorization and strategic management of SOEs, as well as the continuous monitoring of their performance". • Efforts to strengthen the national anti-corruption strategy and to reform public administration. • A stronger role for the Competition Council to address anti-competitive behavior.[1]
Uzbekistan	• Improve governance through restructuring of non-financial SOEs. • Strengthen and clearly separate management and supervision. • Potential set-up of an Agency to "monitor and provide financial oversight of all SOEs".[2]
Barbados	• Improve commercial viability and strengthen monitoring and oversight. • Mergers and divestment • SOE reforms already implemented include staff layoffs at SOEs, renegotiation of supplier contracts, an increase in some tariffs (bus fares, water rates), and new levies on sanitation, health services, and tourism. [3]
Poland	• Introduced several governance reforms such as a *Management by objective* framework in railway sector to enhance supervision and strengthen and centralize internal audit functions. • Sold real estate assets and created a company tasked with property development. • Eventually restructured failing railways through cost-cutting measures (labor shedding), followed by legal reforms to (a) establish a holding company, and (b) allow private sector participation in provision of selected rail services. [4]
Slovak republic	• Corporate governance reform that focused on strengthened management practices via a private investment in a large state-owned monopoly (aluminum). [5]
North Macedonia	• Reform of institutional and regulatory frameworks governing the operations of a state owned electricity company, including via improved internal management systems, reporting and monitoring, restructuring the tariff system and strengthening collection rates, investments, privatization of assets, and enhanced competition by acceding to best practice EU directives on energy.
Serbia	Reform areas were advised in areas related to: • Adopting an ownership policy document. • Appointing permanent professional management. • Publishing a comprehensive list of SOEs. • Expanding capacity to analyze fiscal risks from SOEs. [6]
Belarus	Reforms covering the following were advised: • A systematic, risk-based assessment of SOEs' viability, followed by an actionable plan to guide restructuring, including through strengthened corporate governance, reduced transfers, and better monitoring of contingent fiscal risks. • Enhanced social safety nets to cushion the impact of restructuring on vulnerable groups. • Improving the business environment to ensure a level playing field between public and private companies and facilitate private sector activity were also deemed important. [7]
Georgia	• Finalize an SOE Governance Law. • Strengthen the fiscal risk statement to better cover SOE risks, including by reviewing the sectoral classification of SOEs and including a risk analysis of the top 10 SOEs. • Determine the extent to which restructuring of SOEs (including recapitalizations) are reflected in the fiscal envelope. [8]
South Africa	• Address SOE weaknesses (e.g. indebtedness, structural inefficiencies and governance-related) via an improved governance framework and promoting competition and private sector participation. • A case in point is reforms to the macro-critical national electricity company, which underwent clean up efforts, including for the company's Board and Management. [9]

[1] Morocco, Staff Report for the 2020 Article IV Consultation. IMF, January 2021.

[2] Uzbekistan, Staff Concluding Statement of an IMF Staff Visit, July 31, 2018.

[3] Barbados, Staff Report for the Fourth Review under the Extended Arrangement. IMF, November 2020. As part of the IMF program with Barbados, a structural benchmark was proposed to prepare a dashboard to analyze financial performance of the government's 19 priority oversight SOEs as input to quarterly progress updates to Cabinet.

[4] IMF (November 2019).

[5] IMF (November 2019).

[6] Serbia: Concluding Statement of the Mission for the 2019 Article IV Consultation and the Second Review under the Policy Coordination Instrument (PCI). IMF, May 2019.

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