

# Moldova:

## Policy Notes for the Government

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## EXECUTIVE SUMMARY

### PURPOSE

1. **This set of policy notes is intended to provide suggestions to the new Government on policy actions for addressing the various economic and social challenges that Moldova faces.** The notes have been prepared in the context of the current economic crisis, with short-term priorities and suggestions for immediate policy actions highlighted. This guidance for responding to the current crisis is followed by a medium-term agenda, which outlines possible policy measures for the longer term to promote and support sustainable development.
2. **Economic and social policy issues are the focus of this document.** However, it must be noted, that acting on these policy notes effectively will only be possible in a political climate of consensus in which the wounds left by the post-election conflict are allowed to heal. This will need reaffirmation of Moldova's citizens' basic human and civil rights. For specific suggestions in this area, a parallel note has been prepared by the donor community.

### COUNTRY CONTEXT

3. **The export of labor and resulting inflow of workers' remittances have come to dominate the economic and social life of Moldova's citizens.** Migrant workers' remittances have increased disposable income and fueled a rapid increase in final consumption and construction expenditures. In 2008, Moldovan workers sent home about US\$ 1.9 billion (31 percent of GDP). As a result, Moldova has weathered a number of economic shocks over the last few years. In spite of severe terms of trade shocks (in the form of substantially higher energy prices), export bans on its main export (wine), and a significant drought that devastated the agriculture sector, economic growth has still averaged more than 6 percent per year from 2000 to 2008.
4. **Between 2006 and 2008, there have been encouraging signs that the previous model of consumption-driven growth was broadening, with other drivers of growth increasingly playing a more prominent role.** For example, in 2007, investment began responding to improvements in the overall investment climate. Fixed capital formation increased from just over 15 percent of GDP in 2000, to an estimated 34 percent of GDP in 2008. Foreign direct investment (FDI) also increased sharply from 3 percent of GDP in 2003-2004 to 11 percent of GDP in 2008.
5. **However, the global economic crisis has significantly clouded Moldova's immediate outlook.** Moldova's economic partners are experiencing a substantial economic downturn, and there are signs that the recent growth in investment has been derailed. Exports and remittance flows are being severely affected by the regional recession, with a direct impact on the domestic economy. Poverty, which has declined sharply since 1999, will likely rise as remittances fall and economic growth slows down. The global crisis is also complicating fiscal policy by contributing

to lower fiscal revenue collection while increasing demands on social safety net expenditures. All of these factors underscore the need for consistent macroeconomic policy and a strategic approach to setting short-term and medium-term priorities for development.

6. **In addition, due to the global economic crisis, the economy of the Transnistria region has collapsed.** Russia is now paying the civil service wage bill and pensions. An important contribution to the reintegration of the region would be for the Government of Moldova to assist in mitigating the impact of the crisis on the poor in Transnistria. The IMF, World Bank, and UN stand ready to discuss options for support with the Government in Moldova and with the authorities in Transnistria.

## KEY CHALLENGES

7. **Despite devoting over 40 percent of GDP to public expenditures, Moldova still faces a host of unmet demands on the budget.** The road infrastructure remains in dreadful shape, higher energy costs have placed increased demand on social safety nets, and public sector wages and pensions are still low. The increasing share of GDP going to the Government, however, risks crowding out private sector activity and undermining growth prospects. Further, with a significant amount of the fiscal space gained during the recovery going towards increased public consumption—particularly public sector wages, transfers, and subsidies—critical infrastructure needs are largely unmet and state assets, such as roads, hospitals and schools, continue to deteriorate at an alarming rate.

8. **The global economic crisis has already begun to have an important impact on Moldova's fiscal accounts.** The slowdown in domestic economic activity as well as in imports has constrained the growth in fiscal revenues. Even with expenditures held steady, the slowdown or even outright decline in fiscal revenues will likely result in the emergence of a larger than expected fiscal gap. Given the fall in revenues and planned increase in spending contained in the 2009 budget, the fiscal deficit is projected to increase to close to 11 percent of GDP in 2009. This signals the need for expenditure reductions; however, the poor state of public investment planning and budgeting in Moldova makes it difficult to rank and cut less efficient investment projects. Moreover, given the significant public investment needs in the country, reduced capital spending could have a negative impact on long-term growth prospects. In addition, funding for basic social services will need to be preserved to minimize the impact of the crisis on the poor.

9. **Moldova's business climate has declined sharply in the past six months, with the private sector facing increased vulnerabilities.** There is a decreasing trend in export orders, and new orders include pressures to reduce prices and extend the payment terms. The lack of access to credit, especially for working capital finance—the capacity to accept longer payment terms—might trigger a loss of markets, resulting in bankruptcies with ripple effects in the economy.

10. **Despite regulatory reform efforts, Moldova's standing in the World Bank's Doing Business ratings remains low relative to its Central European neighbors (103<sup>rd</sup> in the 2008 report).** As a result of incomplete structural reforms, Moldova's industrial outputs and exports

continue to be dominated by traditional, low value-added products. The exports are not sufficiently diversified in terms of destination markets, increasing the risk of external shock. Enhancing the economy's competitiveness—the ability to participate in global trade and investment networks—is essential for achieving long-term growth.

**11. Continued reforms are needed in the social sectors to increase the efficiency and impact of public spending.** The education system is currently inefficient, with decreasing numbers of students but high numbers of poorly paid teachers and non-teaching staff. Health indicators remain well below EU averages. The social assistance system is fragmented, with most benefits not targeted to poor households. The pay-as-you-go pension scheme is socially unsustainable, with a distorted benefit formula, low replacement rates, and privileges granted to special categories.

**12. Substantial governance risks will exist during the post-election transition period.** Moldova faces long-standing developmental challenges such as the need to develop an effective national administration, public sector governance and controls, rule of law, policy formulation, good governance of key agencies, market regulation, and project management capacity. Sound internal and external audit institutions and compliance with international standards must be in place to engender public confidence in the way Moldova is being governed and accountable to its citizens. The need for an ambitious Government response to counter the economic downturn during a period of establishing post-electoral appointments and reshuffling personnel calls for heightened attention to the governance and anti-corruption agenda.

## RESPONDING TO THE CURRENT CRISIS

**13. The donor community has identified those policy actions that could be considered urgent short-term measures.** These suggestions focus in particular on public expenditure management, financial sector reform, and social protection. The full set of short-term policy actions by sector is presented in the table at the end of this summary.

**14. Fiscal rebalancing is an important early step for Moldova's development agenda under the new Government.** The relatively large size of Government is limiting growth prospects and needs to be reduced. Remuneration of public sector employees currently consumes close to a third of total government resources. Optimizing the structure of public sector employment through better organization of an institutional system of public service provision, enforcing merit principles in appointments and aligning remuneration system with skills and performance - are the key factors of rationalization of public expenditure. Moreover, better targeting of a significant portion of the budget transfers that have been found to be poorly targeted will lead to better expenditure effectiveness. The policy suggestions presented throughout this briefing book highlight opportunities for achieving a more efficient and equitable use of reduced fiscal revenues. Such improvements in public spending, over time, could increase the resources available to invest in the country's key infrastructure.

15. **In the short run, a significant fiscal gap signals the need for reductions in expenditures contained in the 2009 budget.** The recommended short-term fiscal adjustment measures (yielding fiscal savings of up to 6.8 percent of GDP) include the following:

- *Capital Spending* - Cut capital spending by around 2.5 percent of GDP, while preserving spending on road rehabilitation and maintenance.
- *Social Assistance and Pensions* – eliminate poorly targeted nominal compensation programs and redirect those resources (around 0.3% of GDP) to the new targeted social assistance scheme (effectively doubling it).
- *Public Sector Wages* – reduce the wage bill by around 1.8 percent of GDP by suspending scheduled wage increases.
- *Goods and Services* – eliminate excessive inflation adjustment in the 2009 budget; accelerate school network optimization; and eliminate non-growth enhancing agricultural subsidies, such as VAT input and output subsidies.
- *Taxes* - raise excise taxes on cigarettes, hard alcohol and luxury automobiles (0.2% of GDP).

16. **Ensuring the stability of Moldova’s financial sector will help the country withstand the current global economic and financial crisis.** To this end, the National Bank of Moldova (NBM) should immediately undertake a systematic assessment of the banking system on a bank-by-bank basis and be prepared to intervene in a timely and systematic manner. Interventions might include having the NBM extend temporary liquidity support to the banking system or prepare tools for problem banks, and having the authorities help banks to raise term funding at reasonable cost, particularly from international financial institutions.

17. **Actions will be needed to protect Moldova’s poor during the current crisis.** The Government should consider how the new targeted social assistance program can be used to offset the adverse impacts of the global economic crisis on poor Moldovans. The unemployment insurance system has significant gaps and does not cover the agricultural, urban informal sector, and returning migrant workers who would share in the suffering from an economic contraction. Public works programs could be an effective mechanism for employing skilled workers to work on planned investments in priority infrastructure. These and other options will need careful consideration to provide effective social protection for Moldovans during this time of reduced public revenues. Special attention may be needed to ensure that any adaptations ensure continued protection for the vulnerable Moldovans outside the labor market – children, people with disabilities, the elderly.

18. **The Government could immediately set the tone for a coordinated and transparent approach to development.** The practice of convening semi-annual high-level donor forums, chaired by the Prime Minister, would send the right signal about country ownership and renewed donor cooperation and coordination. To facilitate that the role of the Strategic Planning Committee in prioritization and coordination of policies internally should be strengthened. It will also be important for the Government to signal its commitment to strategic governance issues by championing possible quick wins such as judicial reforms, medical standards, and preventing customs corruption. An important crosscutting priority is to build the capacity of country systems, which should be increasingly used and strengthened to reinforce country ownership and place the country in the driver’s seat.

## MEDIUM-TERM AGENDA

19. **Protecting Moldova's poor while fostering economic development will require a strategic combination of social assistance and job creation measures.** A structural agenda is needed to reform Moldova's safety net over the medium term. Once short-term measures have been achieved to implement and extend the new, targeted, social assistance program, ongoing efforts are needed to improve, modernize, and consolidate beneficiary registries for the many programs, improving cross-program coordination. Job creation should continue through government investments in public works projects and also through the development of the off-farm rural economy, especially agro-processing. Improving the business environment for agro-processors (e.g., reducing obstacles to licensing, obtaining permits, and border crossings) would likely do much to reduce emigration and to absorb returning migrants.

20. **Critical infrastructure needs should be addressed on a sustained basis to support long-term growth prospects.** The development agenda could harness Moldova's growing potential to become a service center for the EU. This is particularly true in terms of information and communication technologies (ICT), tourism, transport and logistics. In ICT, the Government should revise its information society strategy, partner with the private sector to build a national broadband infrastructure, and raise employability by strengthening ICT skills development. In the transport sector, the Government should implement the key policy measures to which it has already committed in the 2007 Land Transport Infrastructure Strategy. In addition, significant investments will be required to reduce Moldova's energy vulnerability, improving energy efficiency, reducing waste, and diversifying energy supply sources. Implementing the energy reform agenda will require focusing on the legal and regulatory framework.

21. **Promoting European integration will require modernizing the public sector.** Priority actions to reform the public financial management system, already underway, will bring planning, budgeting, accounting, and auditing practices in line with international standards. However, Moldova struggles with persistent weaknesses in public administration and should maintain public administration reform as a policy priority. Suggested medium-term measures include implementing civil service reform, continuing demand-driven training, introducing systems of internal controls for public administration, developing a legal basis for establishing a hierarchy within the public sector, reviewing the effectiveness and efficiency of service delivery systems, and introducing public consultations on policy issues.

22. **Further enhancements to donor coordination can maximize the impact of development efforts.** The Government should work with donors to renew partnership principles related to the regular exchange of information, strengthened country accounting, reporting and procurement systems, and improvements to monitoring and evaluation systems to track progress under the National Development Strategy, including towards national Millennium Development Goal targets.

## Suggested Short Term Policy Priorities for the Government of Moldova

Sector / Area	Short Term Policy Suggestions
Public Expenditure Management	<ul style="list-style-type: none"> <li>▪ Short –term fiscal adjustment measures could yield fiscal savings of up to 6.8 percent of GDP: Cutting capital spending while preserving road rehabilitation and maintenance; eliminating poorly targeted nominal compensation programs; reducing the public sector wage bill; eliminating the excessive inflation adjustment; and raising excise taxes.</li> </ul>
Financial Sector	<ul style="list-style-type: none"> <li>▪ The NBM should undertake an assessment of the banking system’s vulnerabilities, be prepared to extend temporary liquidity to the banking system, and prepare tools to intervene in problem banks if needed.</li> <li>▪ The authorities should try to help banks raise term funding at reasonable cost.</li> </ul>
Social Assistance, Social Care Services, and Unemployment Insurance	<ul style="list-style-type: none"> <li>▪ The Government should implement and extend the new targeted social assistance program and protect the poor from budget cuts.</li> <li>▪ The Program to develop an Integrated System of Social Services should be carried out.</li> <li>▪ To absorb skilled construction workers, the Government could accelerate planned government investment in infrastructure. A program that invests in youth education and skills training could mobilize youth for appropriate public works.</li> </ul>
The Pension System	<ul style="list-style-type: none"> <li>▪ The Government should prioritize fixing its first pillar: using the wage history to establish pension benefits, initiating measures to improve compliance and collection, increasing the retirement age, reintroducing the mandatory participation of individual farmers, and eliminating pension privileges.</li> </ul>
Good Governance and Anti-corruption	<ul style="list-style-type: none"> <li>▪ Possible quick wins include judicial reforms, monitoring medical standards, simplifying the procedures for public procurement in medical services, creating mobile monitoring teams to prevent corruption and smuggling, giving the Parliament oversight of the CCECC, and complete political-administrative consolidation.</li> </ul>
Migration	<ul style="list-style-type: none"> <li>▪ The Government should avoid cutting the targeted social assistance program, plan public works to absorb skilled construction workers, and launch a youth program to prepare them for the labor market.</li> </ul>
Public Financial Management	<ul style="list-style-type: none"> <li>▪ The revision of methodologies for budget preparation and budget execution will continue in 2009-2010.</li> </ul>
Public Administration and Civil Service Reform	<ul style="list-style-type: none"> <li>▪ A new civil service remuneration system should be developed and introduced during 2010.</li> <li>▪ The coordination capacity of the Government Office should be strengthened.</li> </ul>
Business Environment	<ul style="list-style-type: none"> <li>▪ Effective private sector development will require facilitating formal employment through simplifying business entry/ operations, facilitating the flow of credit, removing unnecessary barriers to trade, improving public-private dialogue, and accelerating the reform of the measurement, standards, testing, and quality assurance system.</li> </ul>

Sector / Area	Short Term Policy Suggestions
Education	<ul style="list-style-type: none"> <li>▪ Revising outdated norms and procedures in education is needed to improve quality and efficiency.</li> <li>▪ Cost-recovery measures should be promoted.</li> <li>▪ The Strategy for Reform of the Residential Care System needs to be fully implemented.</li> <li>▪ The work of Psycho-pedagogical Committees needs to be reviewed.</li> </ul>
Health	<ul style="list-style-type: none"> <li>▪ Key national public health programs should be protected from budget cuts in the event of a financial crisis.</li> <li>▪ Ongoing reforms should continue, including increasing insurance coverage and improving targeting of state contributions to the NHIC; strengthening the purchasing capacity of the NHIC; promoting efficiency, quality and user satisfaction in the provider network; and reducing out-of-pocket spending on pharmaceuticals.</li> </ul>
Road Subsector	<ul style="list-style-type: none"> <li>▪ The Government should resist cutting spending for the maintenance and rehabilitation of roads.</li> <li>▪ The key policy measures in the 2007 Land Transport Infrastructure Strategy should be implemented.</li> <li>▪ The procurement of road works must be handled in full accordance with applicable procurement guidelines.</li> <li>▪ The leadership role of the MCTD should be strengthened.</li> </ul>
Energy	<ul style="list-style-type: none"> <li>▪ The first step for energy reform should focus on the legal and regulatory framework.</li> <li>▪ There needs to be a resolution of the district heating and energy consumption issues in Chisinau.</li> </ul>
Water Supply and Sanitation	<ul style="list-style-type: none"> <li>▪ The path for recovery and sustainable development will include improving energy efficiency, restructuring tariff policies, and improving donor coordination.</li> </ul>
Information and Communication Technologies	<ul style="list-style-type: none"> <li>▪ The Government should accelerate the ongoing revision of its information society strategy.</li> <li>▪ Specific regulatory and investment actions are necessary to implement the national broadband program.</li> <li>▪ The Government should move to modernize its state-owned enterprises and the education system, while improving the autonomy of ANRCETI.</li> </ul>
Agriculture	<ul style="list-style-type: none"> <li>▪ Stable pro-market and pro-trade policies are urgently needed to ensure a favorable environment for business development along the agri-food chain.</li> <li>▪ A food security strategy with a short-, medium-, and long-term perspective is needed.</li> </ul>
Forestry	<ul style="list-style-type: none"> <li>▪ The recently prepared National Action Plan for Combating Illegal Logging and Improving Forest Governance identifies priority actions.</li> </ul>
Natural Resource Management	<ul style="list-style-type: none"> <li>▪ Preventing water resources pollution and their efficient usage should be a priority.</li> <li>▪ Special attention should also be given to waste management.</li> </ul>
Donor Coordination	<ul style="list-style-type: none"> <li>▪ Steps should be taken to further enhance donor coordination through the regular exchange of information, division of labor, strengthened country systems, and a focus on monitoring and evaluation.</li> </ul>

# I. LAYING THE FOUNDATIONS FOR SUSTAINABLE AND INCLUSIVE ECONOMIC GROWTH

## CONTEXT: MOLDOVA'S RECENT GROWTH EXPERIENCE

1.1 **The export of labor and resulting inflow of workers' remittances have come to dominate the economic and social life of Moldova's citizens.** Migrant workers' remittances, amounting to over 30 percent of Gross Domestic Product (GDP), have increased disposable income and fueled a rapid increase in final consumption and construction expenditures. In 2008, Moldovan workers sent home about US\$ 1.9 billion (31 percent of GDP). As a result, Moldova has weathered a number of economic shocks over the last few years. In spite of severe terms of trade shocks (in the form of substantially higher energy prices), export bans on its main export (wine), and a significant drought that devastated the agriculture sector, economic growth has still averaged more than 6 percent per year between 2000 and 2008.

1.2 **Between 2006 and 2008, there have been encouraging signs that the previous model of consumption-driven growth was broadening, with other drivers of growth increasingly playing a more prominent role.** For example, in 2007, investment began responding to improvements in the overall investment climate. Fixed capital formation increased from just over 15 percent of GDP in 2000, to an estimated 34 percent of GDP in 2008. Similarly, foreign direct investment (FDI) also increased sharply to nearly 10 percent of GDP, much higher than other countries in the region (though cumulatively and in per capita terms, Moldova still lags well behind its neighbors).

## KEY CHALLENGES

### The Global Crisis

1.3 **The global economic crisis has significantly clouded Moldova's immediate economic outlook.** Although Moldova's economy has been resilient to previous shocks, they do not compare with the scope of the ongoing crisis, with Moldova's economic partners experiencing a substantial economic downturn. Already there are signs that the recent growth in investment is being derailed. Exports and remittance flows will be severely affected by the regional recession. Reduced demand for exports and a slowdown in remittances, in turn, will directly impact the domestic economy. With fewer migration opportunities and the evidence pointing to acceleration in the return of Moldova's migrant population, there will be pressures on the domestic labor market.

1.4 **Poverty will likely rise.** Between 1999 and 2004, Moldova's economic recovery moved 40 percent of the population out of poverty, the largest absolute decline in poverty in all of Europe. Poverty reduction appeared to stall between 2004 and 2005, but poverty has since continued to decline through 2007, according to the most recent data available. Such gains now risk being reversed, as remittances fall and economic growth slows down. Many of those who recently moved out of poverty are just above the poverty line and are vulnerable to an economic

downturn. The Bank's poverty team together with the UN and IOM are now working with the authorities to assess the likely social impact of the remittance slowdown.

**1.5 The global crisis will complicate fiscal policy in Moldova.** The weaker domestic demand (reflecting, in part, a reduction in remittance flows and construction activity) has resulted in reduced demand for imports and, hence, has contributed to lower fiscal revenue collection. On top of the expected decline in revenues, the crisis will likely contribute to increased demands on social safety net expenditures. The loss of fiscal revenue and additional pressures on expenditures will likely result in the emergence of a significant fiscal financing gap in the remainder of the year. While additional financing might help close some of this gap, it is likely that fiscal and monetary policy adjustment and an acceleration of structural reforms will be required.

**1.6 Macroeconomic policy consistency will be critical.** To date, the authorities have supported a tight monetary policy to contain inflation and foster exchange rate stability. In the new global economic environment, the authorities will need to assess the appropriate macroeconomic policy.

### **Quality of Growth over the Medium Term**

**1.7 In the longer term, as the world economy recovers, Moldova will need to take a hard look at key drivers of its economic growth.** One scenario would be the resumption of remittance-driven growth. This is a reasonable scenario given limited options in the short-run, persistent wage differentials between Moldova and host countries in the short-run, and the lack of employment opportunities in the local economy.

**1.8 The country needs a sustainable growth strategy, recognizing that it is unlikely that remittance flows will continue to grow very rapidly.** In fact, even at the same pace of growth driven by remittances just before the onset of the global crisis, it will take Moldova another 15 years to reach output levels commensurate with those that prevailed before independence. In addition, it is unlikely that the rapid growth in remittances experienced over the last few years can be sustained over the longer run: There is, first of all, an eventual limit to the number of workers that can migrate and a limit to wage increases in the host countries. As migrants are absorbed by the host countries and reunite abroad with their families, some of them will cease to remit income to Moldova. Although the majority of workers will likely continue to remit large sums of money, this will not translate into sustained growth in remittance inflows to Moldova, unless these remittances are ever-increasing proportions of migrant workers' earnings.

**1.9 If Moldova is to reduce poverty and improve the standard of living of its citizens, growth will need to accelerate and be sustained.** There are, however, a number of concerns about the quality of growth in Moldova in recent years. These include the following:

- *Lack of employment growth.* The economic recovery has been accompanied by continued economic transformation. The economy has increasingly reduced its dependence on the agricultural sector and the sector's share of the economic output has declined by over 10 percentage points of GDP while shedding its workers. The rest of the economy, however, has

been unable to absorb these former agricultural workers. Overall employment since 2000 has fallen by nearly 260,000 workers, and only 90,000 have been absorbed.

- *Labor shedding and the gains in labor productivity.* Average labor productivity has tripled since 2000, mostly due to labor shedding in agriculture and the reallocation of workers toward more productive sectors. With nearly a quarter of the labor force already working abroad, it becomes difficult to sustain growth in labor productivity as the opportunities provided by labor shedding and factor reallocation are also being exhausted. Future productivity will require sustained increases in investment and innovation. This, in turn, requires continued improvements in the investment climate, particularly removing barriers to firm entry and exit to ensure that emerging sectors and industries are able to flourish.
- *Limited export diversification.* The 2006 Russian wine ban had a strong negative impact on the real sector of the economy. It also highlighted the risks associated with Moldova's undiversified economy. Economic linkages with the rest of the world are still dominated by traditional Commonwealth of Independent States (CIS) markets. Given its proximity, Europe should account for the majority of Moldova's trade. However, trade with Europe and other non-traditional markets remains below its potential and the reorientation toward the European Union (EU) has been slower than those of other countries in the region. In addition to market concentration, there is also a commodity concentration in exports. Nearly 60 percent of Moldova's exports are in the form of agricultural products (including from the agro-processing industry) and predominantly from the wine and beverage sectors.

**1.10 As Moldova creates the conditions for private-sector led growth, there is an opportunity to learn from the strengths and weaknesses of more advanced economies, especially in the areas of financial sector regulation.** A major challenge will be to raise the level of financial intermediation while keeping potential systemic risks under control. The development of the non-bank financial sector could increase the relatively low level of savings in the economy and fuel the growth of the domestic capital market. To mitigate risks, Moldova needs to finalize the legal and regulatory framework for non-bank financial institutions.

## II. PUBLIC EXPENDITURE POLICY

### CONTEXT: DEMANDS ON FISCAL POLICY DURING THE RECOVERY

2.1 **Throughout Moldova's economic recovery, fiscal policy has supported efforts to contain inflation and has remained prudent with the overall cash balance of general government remaining close to zero.** The recovery has resulted in very buoyant fiscal revenues giving the Government considerable room to increase expenditures, particularly social spending. Both revenues and expenditures have grown by over ten percent of GDP since 2001. Further fiscal space has been gained by rapid reduction in public and publicly guaranteed debt as a share of GDP as a result of growth, exchange rate appreciation and better debt management.

2.2 **As the Government's National Development Strategy suggests, despite devoting over 40 percent of GDP to public expenditures, there are still a host of unmet demands on the budget.** Moldova's road infrastructure remains in dreadful shape, higher energy costs have placed increased demand on social safety nets, and public sector wages and pensions are still quite low. The increasing share of GDP going to the Government, however, risks crowding out private sector activity and undermining growth prospects. Further, with a significant amount of the fiscal space gained during the recovery going towards increased public consumption – particularly public sector wages, transfers and subsidies – critical infrastructure needs are largely unmet and state assets, such as roads, hospitals, kindergartens and schools, continue to deteriorate at an alarming rate.

### KEY CHALLENGES CONFRONTING PUBLIC EXPENDITURE POLICY

2.3 **In the short term, the global financial and economic crisis has already begun to have an important impact on Moldova's fiscal accounts.** The slowdown in domestic economic activity as well as imports has constrained the growth in fiscal revenues. Even with sequestration of expenditures, the slowdown or even outright decline in fiscal revenues will likely result in the emergence of a larger than expected fiscal gap. Given the fall in revenues and planned increase in spending contained in the 2009 budget, the fiscal deficit is projected to increase to close to 11 percent of GDP in 2009.

2.4 **Macroeconomic policy objectives aside, the ability of the Government to maintain its expenditures plans will be dependent on its ability to mobilize additional domestic and external financing.** An analysis of Moldova's debt situation suggests that, given the relatively low levels of public indebtedness (general government debt is estimated at around 25 percent of GDP, with external debt, at 18.5 percent of GDP, accounting for most of that), there is some headroom to increase public borrowing. One needs to recognize, however, that the global credit crunch may reduce the scope and appetite to lend to Moldova, even on the part of traditional donor partners. Increased borrowing from the domestic sector (i.e. the domestic banking sector) may be an alternative. The increased demand for borrowing by the public sector, however, would

increase the pressure on the domestic credit markets, already constrained by tight monetary policy, and crowd out the private sector.

**2.5 If the global financial crisis imposes limits on the ability of the Government to mobilize additional financing to close the fiscal gap, then it is unavoidable that some fiscal policy adjustment will be needed.** Since the tax burden (as a share of GDP) in Moldova is already quite high, mobilizing a significant amount of additional resources through higher taxation may not be optimal. Indeed, since the domestic economy may suffer from the regional slowdown, significantly raising taxes at this time may not in the best interest of any efforts to support economic recovery.

**2.6 Over the medium term, the Government needs to recognize that the rapid growth in the level of expenditures and revenues in Moldova has resulted in a fiscal footprint that is now too high given Moldova's income level and institutional development.** The relatively large size of Government is limiting growth prospects and needs to be reduced. Constraining expenditure growth below the increase in nominal GDP and increasing the efficiency of public spending will enable the Government to gradually reduce the size of Government.

## POLICY SUGGESTIONS

### Short-Term Measures

**2.7 In the short-run, a significant fiscal gap implies that there must be some reductions in expenditures contained in the 2009 budget.** Which expenditure items to cut will be the key challenge confronting policymakers. International experience suggests that most country choose to cut capital expenditures in the time of fiscal crisis. Leaving aside problems with measurement (the capital budget includes many current expenditure items), with capital expenditures amounting to some 7 percent of GDP, there is probably some scope to cut these expenditures in Moldova. However, the poor state of public investment planning and budgeting in Moldova makes it very difficult to rank and cut less efficient investment projects. One also has to realize that given the significant public investment needs in the country, excessively reducing capital spending could have a negative impact on long-term growth prospects.

**2.8 A significant portion of the budget is devoted to transfers that have been found to be poorly targeted.** Since a domestic slowdown will likely result in an increased demand for transfers, the Government may need to accelerate its planned reallocation and phasing out of non-targeted social assistance spending earlier than anticipated to create the fiscal space for additional spending directed towards vulnerable groups. Similarly, long delayed pension reforms may need to be finally completed in order maintain the financial sustainability of the pension system.

**2.9 Remuneration of public sector employees consumes close to a third of total government resources.** Since low public sector wages inhibits the ability of the Government to attract and retain skill staff, the Government efforts to reform the public pay system are critical. However, planned increases in public sector wages will likely result in even greater demands on the budget. If the Government wishes to pay its public sector employees higher wages and not

compromise the overall stance of fiscal policy, then some further downsizing in public sector employment will be needed, accompanied with by an increase in the efficiency of the public administration.

#### 2.10 **Summary of short-term fiscal adjustment measures (which could yield fiscal savings of up to 6.8 percent of GDP):**

- *Capital Spending* - Cut capital spending by around 2.5 percent of GDP, while preserving spending on road rehabilitation and maintenance.
- *Social Assistance and Pensions* – Eliminate poorly targeted nominal compensation programs and redirect those resources (around 0.3% of GDP) to the new targeted social assistance scheme (effectively doubling it). Falling pension contributions may necessitate measures to limit automatic indexation of pension benefits (see IV. Social Protection for additional recommendations related to pensions).
- *Public Sector Wages* – Reduce wage bill by around 1.8 percent of GDP by suspending scheduled wage increases. Accelerating rationalization of public employment, including eliminating current vacant position (see VII. Public Sector Reform).
- *Goods and Services* – Eliminate excessive inflation adjustment in 2009 budget, which could reduce expenditures by 1.0 percent of GDP. Accelerate school net work optimization which, as estimated in the World Bank’s Public Expenditure Review, could reduce education spending by nearly 1 percent of GDP (see section V on education sector reforms). Eliminate non-growth enhancing agricultural subsidies, such as VAT input and output subsidies (roughly 0.3 percent of GDP).
- *Taxes* - Raise excise taxes on cigarettes, hard alcohol and luxury automobiles (0.2% of GDP).

#### **Medium-Term Measures**

2.11 **Within the context of the effort to reduce the size of government, there is the need to reduce public consumption spending and increase the allocation towards growth-enhancing public investment in human capital and infrastructure.** Considerable effort is still required, however, to introduce evidence-based strategic priorities in the investment budget with project screening, selection and appraisal drawn from appropriate cost-benefit analyses. Existing public infrastructure, particularly the road network, is in urgent need of higher levels of maintenance spending so as to prevent the further deteriorations (see X. Infrastructure).

2.12 **Increasing the efficiency of public spending will be instrumental to efforts to reduce the size of Governmental structures, particularly those subordinated to the line ministries.** While health outcomes have improved considerably over the last ten years, the hospital sector continues to be overburdened by excess capacity. Poor performance is observed in a number of key indicators. Efficiency gains can be achieved by improvements utility management, outsourcing of services and further hospital consolidation. In the education sector, the need to

attract better skilled teachers with higher wages dictates the need to increase the efficiency of education spending. Efficiency can be increased by closing schools with too few students, small class sizes or low student/teacher ratios. Along with school network optimization, decentralization of authority to autonomous schools needs to be explored (See Health and Education in IX. Social Sectors).

**2.13 Expenditure efficiency can also be achieved by reforming the system of transfers from upper to lower tier governments.** Local governments still lack sufficient fiscal autonomy— they should be more reliant on local taxes where it is possible, rather than transfers, and have more control over the rates of local taxes. Allowing greater local government control over tax rates also provides a safety valve—a means through which local governments can respond to demands for higher spending or adjust to sudden downturns in revenues without having to go hat in hand to the central government. Current proposals to permit local governments to contract loans or issue guarantees give more responsibilities and opportunities to the local authorities but carry a number of important risks. To restrain reckless borrowing, the Government might want to consider several restrictions, such as prohibiting borrowing in foreign currency, prohibiting any credit operation with a financial institution not registered in Moldova, and other measures.

### III. FINANCIAL SECTOR DEVELOPMENT

#### CONTEXT

3.1 **The financial sector in Moldova remains relatively small, dominated by banks, and sensitive to external shocks.** Despite the high growth rates in the last ten years, the banking sector is still small by European standards, with total assets equivalent to slightly more than 60 percent of GDP at the end of 2008 (42 percent at the end of 2004). The dependence on remittances, foreign trade and foreign direct investment makes Moldova, and its banking sector, sensitive to external shocks.

#### KEY CHALLENGES

3.2 **Despite its relatively weak integration in global financial markets, Moldova's banking system has come under severe strain in recent months as the effects of the regional economic downturn gradually spread to the local economy.** Deposit withdrawals started in September/October 2008 due to negative rumors from abroad. With liquidity of most banks at around 30 percent of total assets, banks were able to withstand the immediate run. However, although deposit rates were increased by all banks, the steady outflow of deposits continued in early 2009. The total reduction of the deposits balance since the beginning of the crisis in September 2008 amounted to more than 7 percent as of March 2009, with the deposit base in local currency being hit especially hard. At the same time, the level of term deposits has fallen rather dramatically as the clients, even if they kept their deposits in a bank, chose to switch to shorter maturities deposits. With remittance inflows declining dramatically and the corporate sector under pressure, it is very likely that the deposit drain will continue.

3.3 **Access to credit has become very problematic in recent months, even for profitable real sector firms.** As banks' domestic (deposits) and foreign (e.g., credit from parent banks) sources of funding declined, even short-term loans for working capital have become prohibitively expensive, not to mention term credit (over 12 months) for investment purposes. In 2007, credit was already rather expensive, with average rates of 18-19 percent – in an environment with inflation in the range of 10.5-14 percent. Since August 2008, interest rates for loans in MDL fluctuated from 22.5 to 23 percent, although the inflation rate was steadily falling. Therefore, the spread increased from between 4 and 6 percent in 2007, to over 10 percent in September 2008, to about 16 percent at end 2008 and 20 percent in early 2009. The growing credit crunch may lead to loss of markets for Moldovan enterprises, triggering bankruptcies with a ripple effect in the economy and on the banking system in particular.

3.4 **The economic crisis has led to the deterioration of credit quality.** Credit portfolio quality in Moldova has traditionally been high. As of the end of 2007, loans classified as substandard, doubtful and loss accounted for 3.7 percent of the total loan portfolio. Past due and loans in the non-accrual of interest status were 2.4 percent of the total loan portfolio. By the end of 2008, these ratios deteriorated to 5.2 and 5.5 percent. Most alarmingly, the trend seems to

accelerate in early 2009, with classified loans reaching 8 percent of the loan portfolio. While Moldovan banks are still able to carry this level of problem loans due to an accumulated safety cushion, it is a matter of time before the worst hit institutions begin experiencing liquidity and solvency problems<sup>1</sup>. This is particularly true for banks with significant exposures to construction sector, which was hard hit by the crisis.

**3.5 A number of factors are likely to lead to the further deterioration of credit portfolio quality and threaten the solvency of the system.** The impact could be significant and will differ from bank to bank. Such factors include:

- *Dollarization of the banking sector's balance sheet.* The high degree of foreign currency lending (about 40 percent of the total loans) is a risk, particularly due to the flexible exchange rate, meaning that un-hedged borrowers are highly exposed to currency swings that can result in degradation of loan quality.
- *Sensitivity to remittances-related lending and remittances-based fee income,* which is significant and confirmed in stress tests. While the remittances are unlikely to totally dry up, adverse economic conditions abroad are already resulting in reduced inflows. This, in turn, may have a significant impact on banks' remittances fee income and credit quality, as the repayments of consumer and to some extent mortgage loans are, at least partially, financed by remittances.
- *The slowdown in Moldova's key export markets and incapacity of banks to provide the needed funding for exporters.* As a relatively open economy, Moldova has been exposed to the spill-over effect from the economic slowdown in Russia, Ukraine and the Eurozone. There is a decreasing trend in export orders, and new export orders include pressures to reduce prices and extend the payment terms. Thus the exporters now need a higher level of working capital in order to remain competitive, and/or they need bridge loans, which the banks are not able to provide on acceptable terms. The problems in the export sector are likely to spill-over to their suppliers and then to the rest of the economy. The vicious cycle is likely to continue with the number of NPLs growing across the economy, thus leading to more problems in the banking system.

## POLICY SUGGESTIONS

**3.6 In the short term (up to six months), it is recommended that the authorities undertake the following steps, in the approximate order of priority, aimed at mitigating the negative impact of the regional financial crisis on the Moldovan banking sector:**

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<sup>1</sup> Moldovan banks have traditionally kept CAR that is significantly higher than the statutory minimum of 12 percent. At the end of March 2009, the average CAR for the banking system was 32.83 percent as of end March 2009 (32.23 end 2008). Similarly, most banks continue to maintain the liquidity ratios that are significantly higher than the minimum level set by NBM regulations (20 percent).

- *The NBM should undertake a systematic assessment of the banking system’s vulnerabilities in order to forecast negative developments on a bank-by-bank basis.* At the core of the assessment should be the diagnostic stress-testing to be conducted in accordance with the standard NBM-approved methodology. The key objective of this exercise would be to establish potential capital shortfall in case the worsening economic situation (lower growth and exports, exchange rate fluctuations, decline in remittances) leads to substantial deterioration of banks’ balance sheets. Following the completion of the diagnostic, the bank owners should be required to conduct the necessary recapitalization, or face NBM intervention.
- *NBM should stand ready to extend temporary liquidity support to the banking system.* NBM needs to have the full range of instruments for providing urgent liquidity support in order to maintain the stability of the system. It is crucial that the support is awarded to banks in a transparent fashion, on a temporary basis, and with a clear understanding how NBM resources will be used towards more permanent improvement in a bank’s financial position.
- *In parallel, the NBM should prepare tools to intervene in the problem banks if needed.* Institutional capacity for the bank resolution unit at the NBM needs to be strengthened. Financial and institutional ability of the deposit insurance scheme to cope with the increased volume of work needs to be reassessed. NBM would do well to study the recent regional (e.g., Ukraine) and global experiences related to the resolution of failed banks. The World Bank and the IMF stand ready to provide technical assistance if necessary.
- *The authorities should try to help banks to raise term funding at reasonable cost, particularly from the international financial organizations (World Bank, EBRD, EIB) and bilateral donors, to be able to maintain the flow of credit to real sector.* The lack of access of the real sector to term credits and credit cost has to be addressed, especially for exporters. Given the drying up of private sources of funding, Moldova could follow the example of many transition countries in seeking the help of multilateral and bilateral donors in order to keep the flow of credit to the vital sections of the economy. Donor resources typically come with specific eligibility criteria which would help ensure that the banks direct the scarce resources to viable and creditworthy enterprises.

3.7 In the medium to long term, the following policy priorities could be considered to increase the level and quality of financial intermediation while minimizing the risks.

- *Reassessing the cost of compliance and trying to reduce it, where possible.* Traditionally, the NBM imposed a relatively high cost of compliance on the financial system, and a leaner, risk-based system is recommended after the current crisis subsides.
- *Developing NBFIs and securities markets.* The quality of savings in the economy could be improved through the development of the insurance sector and further pension reform, which in turn would fuel the growth of the domestic capital market. The supervisory and regulatory capacity of the recently established “megaregulator” for NBFIs sector needs to be steadily increased with the help of available TA.

- *Enhancing the financial infrastructure.* The cost of intermediation can be substantially lowered by filling in a few remaining gaps in financial infrastructure. In practical terms, a national settlements system for banking cards and emerging types of retail payments, such as mobile payments, needs to be established. At the moment the retail sector relies on expensive off-shore settlements for local transactions. Similarly, the development of domestic credit information bureau with universal coverage should be encouraged.
- *Improving financial literacy.* The Government should place a strong emphasis on developing financial literacy among the general population, which should both enable faster financial inclusion and help prevent building up systemic risk by helping people choose the financial services they really need and comprehend.

3.8 In the *long term*, the central challenge for the authorities will be to manage the integration of Moldova in the single EU market for financial services as part of the proposed Free Trade Agreement (FTA) with the European Union under the Europe Neighborhood Policy. The European Commission is currently undertaking a feasibility study of the proposed FTA, which will cover the four freedoms, i.e., goods, services, capital and labor. Following the conclusion of the feasibility study in the middle of 2009, negotiations of the FTA will start between the European Union and the Government of Moldova. The integration of the Moldovan financial sector within the EU single market in financial services will raise three fundamental challenges: (i) approximation of Moldovan financial sector laws and regulations with EU financial sector Directives; (ii) mutual recognition between Moldovan financial sector regulators and their counterparts in EU Member States; and (iii) adaptation of market participants to competition in the single market.

## IV. SOCIAL PROTECTION

### SOCIAL ASSISTANCE, SOCIAL CARE SERVICES, AND UNEMPLOYMENT INSURANCE

#### Context

4.1 **Moldovans benefit from an elaborate system of social protection, including a social assistance system inherited from the Soviet Union.** The social care service system for vulnerable people is fragmented and relies excessively on residential institutions. Moldova's unemployment insurance program covers workers in the formal non-agricultural sector. In recent years, Moldova has not operated public works to absorb unemployed labor. But the Social Investment Fund boosts employment by rehabilitating small-scale infrastructure in villages and small towns. A separate Policy Note addresses issues facing the relatively large pension system.

#### Key Challenges

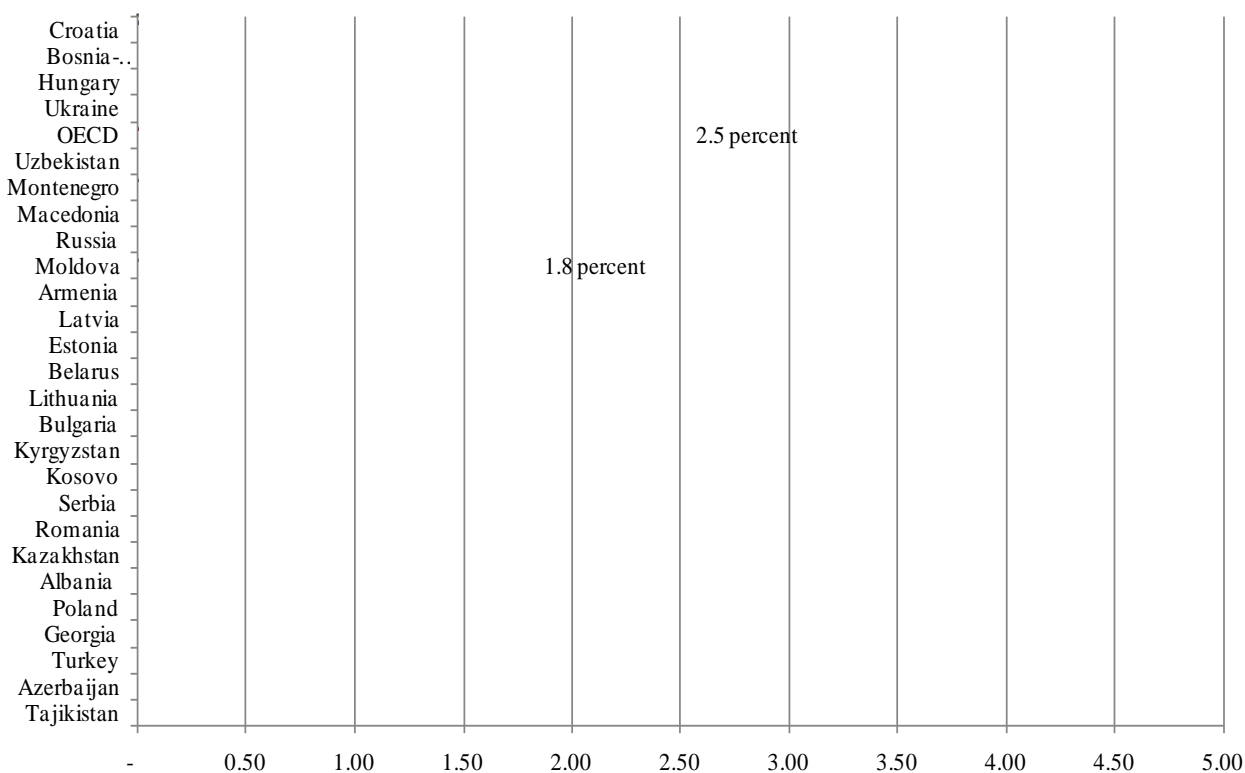
##### *Social assistance*

4.2 **Moldova allocated 1.8 percent of GDP in 2007 to spending on social assistance programs.** This is slightly higher than the regional average for countries in the Eastern Europe and Central Asia region –between Russia and Armenia. Moreover this is higher than for most lower-income countries (Figure 1).

4.3 **The fragmentation of the social assistance system limits the programs' impact on beneficiary well-being.** There are more than 13 social assistance programs, and in 2007, the average per capita transfer to beneficiaries of social assistance was only about 40 MDL, which amounts to only 3.2 percent of beneficiaries' expenditures.

4.4 **The challenge is to deliver the assistance efficiently to the poorest households.** In terms of coverage, fewer than half of people in the lowest two quintiles (40 percent) of the distribution of consumption expenditure received any social assistance in 2007. Moreover, people in the lowest two quintiles received less than 40 percent of the total value of social assistance. This means that more than 60 percent of social assistance payments leaked to the middle and upper expenditure quintiles so that these payments are regressive.

**Figure 1. Public Spending on Social Assistance: Shares in GDP**  
(In percentage points)



*Social care services*

4.5 **Moldova offers services to vulnerable groups such as people with disabilities, orphans, children left behind, and the elderly.** Residential institutions sometimes deliver poor quality care and house residents that could have been placed in their community. This implies inefficient expenditure of the scarce funds allocated for social care services. Furthermore, low salaries and lack of repeated training make it difficult to recruit, motivate, and retain good quality staff. The challenge is to use scarce funds efficiently on services that improve outcomes for vulnerable people, by keeping them in their homes, or at least in their communities, whenever possible.

*Unemployment insurance*

4.6 **Formal sector workers who received salaries for 12 out of the past 24 months of unemployment and who lost their jobs for economic reasons are eligible for unemployment insurance.** To receive benefits, these unemployed people must have no income, must register at an employment office and stand willing to work. Many unemployed people must fulfill a waiting requirement before receiving benefits. If employed previously for up to 5 years, the benefit is 50 percent of the national average wage and is paid for a maximum of 6 months; the benefit rises with job tenure to a maximum of 60 percent of the average wage for 12 months.

### *Public works*

**4.7 Moldova can regain some benefit from the economic and financial crisis by mobilizing its unemployed and inactive population to participate in public works.** The challenge is to identify public works with a high return in long-term development and that would also engage disparate groups. The cutback in credit for both domestic and foreign construction is likely to increase the pool of skilled construction workers in Moldova. At the same time, youth will face greater difficulty in finding employment within or outside of Moldova.

## **Policy Recommendations**

### *Social assistance*

**4.8 A balance is needed between actions to protect the poor during the crisis, and a more structural agenda to strengthen Moldova's safety net over the medium-term.** With that in mind, four areas of priority actions should be the focus of social assistance reform strategies in Moldova:

- *Implement and extend the new, targeted, social assistance program.* As noted above, a small share of existing benefits actually reach the poor and lower-income groups. To improve targeting, the Government of Moldova adopted, in 2008, a Law establishing a targeted safety net program. The Government has identified many beneficiaries and started to make transfers. As the targeting mechanism is reinforced, the Government should also consider the possibility of adapting the tool for the targeting of other existing benefits based on need.
- *Consolidating or eliminating existing programs.* Because of the fragmentation of social assistance programs, the available budget allows this new program to pay a guaranteed minimum income (GMI) benefit of MDL 430 per month. Additional resources could be made available if existing untargeted programs were consolidated, eliminated, or merged into the new targeted scheme. One candidate for consolidation would be the existing Nominal Compensation Program, which is poorly targeted and inefficient.
- *Improving cross-program coordination and benefits administration.* Further efforts are needed to improve, modernize, and consolidate beneficiary registries for the plethora of safety net programs, and to strengthen oversight and controls mechanisms. A unified, automated registry can go a long way towards reducing duplications, errors, and inefficiencies associated with administering multiple programs. Additional tools are needed to strengthen oversight and controls (such as internal and external cross-checks, random spot checks, operational and financial audits) to help detect, remedy and minimize fraud and errors. Some improvements in benefits administration are being supported via the World Bank's health and social assistance project, and such efforts should continue.
- *Protecting the poor from budget cuts in times of crisis.* The newly introduced targeted social assistance program could provide the Government with a powerful tool for offsetting adverse impacts of the world financial and economic crisis on poor Moldovans. Newly poor households could apply to the Ministry of Social Protection for benefits. If enough resources

are available, the Government could increase the standard targeted transfer to all poor beneficiaries for a period of one or two years –until the crisis has passed.

#### *Social care services*

**4.9 The Government should carry out its Program to Develop an Integrated System of Social Services of 2008.** The Program would deliver care on an out-patient basis to people living at home, or in small-scale community group homes. The Program emphasizes the integration of fragmented services, a referral system to regional and central care, and elimination of gaps in coverage. The concept is to deliver preventive and early intervention services so that conditions do not worsen and become more expensive to address.

#### *Unemployment Insurance*

**4.10 This system does not cover the agricultural, urban informal sector, and returning migrant workers who would share in the suffering from an economic contraction.** Therefore, the unemployment insurance system would be an ineffective instrument for responding to the crisis.

#### *Public Works*

**4.11 To absorb skilled construction workers, the Government could accelerate planned government investment in hospitals, schools, roads, water supply, natural disaster management, and other priority infrastructure.** This would require careful planning to assure that, for example, that under-utilized schools and hospitals are not rehabilitated, and also to set fast but fair procurement procedures. The Social Investment Fund has demonstrated its capacity to absorb skilled construction labor in small-scale civil works in villages and small towns. Furthermore, the Social Investment Fund has had a good record in rapid and fair procurement.

**4.12 To absorb youth, the Government could support a program that invests in youth education and skills training and mobilizes them for sports and for suitable public works.** For instance, youth employment could be created through “green projects,” such as planting tree belts, working on erosion control, and participating in natural disaster management projects. The skills training could be provided to help youth receive information about the labor market, on risks facing migrants, and in even in areas such as sexually transmitted diseases, alcoholism and drug abuse, and conflict resolution. The education component could consist of reinforcement of the secondary curriculum.

## THE PENSION SYSTEM<sup>2</sup>

### Context

4.13 **Moldova's pension system consists of a pay-as-you-go (PAYG) scheme that currently absorbs 7.2 percent of GDP.** The system covers just over 40 percent of the working-age population, though the number of insured persons (contributors) has been decreasing over the past five years due to emigration, unemployment, and a large informal economy. On the other hand, the number of pensioners has been stable, thus yielding a system-dependency ratio of 59 pensioners per 100 insured persons (contributors), which is quite high by comparable international standards. Pensioner coverage is almost universal due to high labor force participation and full contribution coverage in the past planned economy times.

### Key Challenges

4.14 **The current PAYG pension system in Moldova faces several challenges.** It underperforms on pension benefit adequacy, struggles with compliance and collection, and weakens the incentive to participate and contribute to the system. Specifically:

- *While the retirement age for men (62) is similar to EU10 countries, retirement age for women is the lowest among the same comparators (57).*
- *Compliance and incentives to contribute to the system are low.* It yields a net replacement rate of 27 percent, compresses the pension benefits, and weakens the interdependency between the paid contributions and pension benefits. Second, the system is highly redistributive. With the current amount of the minimum pension, farmers acquire pension benefits that are 2.5 times higher than the pension benefits they are entitled to on the basis of their contributions. Third, the overall pension contribution rate of 25 percent is high, but stands at an effective 10.2 percent for self-employed and 2.5 percent for farmers. Fourth, there is significant wage underreporting, as indicated by the fact that covered wages represent about 75 percent of average wages according to official statistics. Fifth, the link between benefits and contributions has been diluted by frequent contribution amnesty.
- *The pension benefit formula is distorted.* For wages earned after 1999, there is no valorization of wage histories for the calculation of the pension base. Zero valorization dampens new initial replacement rates and creates large discrepancies in the benefits levels between new and old pensioners. To close the gap between old and new pensions, the accrual rate was increased to 1.4 percent per year of service, which further complicated the benefits formula.
- *The Moldovan pension system pays the lowest replacement rates in the region.* The general level of pension benefits compared to wages is low: average old-age pension is 27.4 percent

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<sup>2</sup> This note is drafted on the basis of “Policy Options for Further Reform of Pension System in the Republic of Moldova”, prepared by Zoran Anusic, Senior Economist, ECSHD and Ljiljana Marusic, Consultant.

of gross wage (35.1 percent net). Nevertheless, the costs of the pension system increased from 4.4 percent of GDP in 1999 to 7.2 percent in 2007. The growth of the pension costs in GDP is the consequence of 50-50 wage-price indexation pattern exceeding the GDP deflator growth.

- *Numerous special and privileged pension schemes have emerged on top of the general pension system in Moldova.* For example, average civil servant pension is currently twice higher than the average old-age pension.

**4.15 In 1998, the Government introduced parametric measures to address these system flaws.** Specifically, the 1998 reforms aimed at increasing contributions compliance, improving system transparency and equity, increasing the retirement age, and changing the benefit formula to establish a stronger link between contributions and benefits. Although some measures were undertaken, the reforms were suspended in 2003 and none of the objectives has been fully achieved. Increases in the retirement age were suspended in 2002. The change in the benefits formula was overwhelmed by non-valorizing of past incomes for new retirees. Finally, the determination of benefits is still largely based on declared wages rather than on the basis of paid contributions.

**4.16 Continuation of the status quo will result in a fiscally sustainable system – but one that is socially unsustainable.** Under a “no-reform” scenario, assuming zero growth in 2009 (due to the global crisis) and gradual economic recovery from 2010, revenues from pension insurance contributions would be sufficient to cover pension expenditures. With recovery and return to “normal” growth rates, a positive balance in the pension system would emerge. Despite such fiscal sustainability, the system without reforms is projected to generate a significant decrease in the average replacement rate – to a low of 12 percent – over the next 40 years. This projected low average replacement rate is unlikely to be socially sustainable.

**4.17 In 2008, the Government drafted a set of strategy documents on further pension system reforms.** These documents set forth the Government’s objective of completing the unfinished 1998 pension reform agenda by strengthening the link between benefits and contributions paid, including for the civil servants, military, policemen, deputies etc, unifying the contribution rates, reducing the privileges to the most needed members of the society changing the formula, and tightening the disability pension rules.

**4.18 Along with these strategic directions, the Government expressed an interest in partially supplementing the PAYG pillar with a mandatory fully-funded second pillar pension scheme.** However, Moldova’s readiness for the second pillar is lower than in other countries at second pillar inception (see Figure 2). Moldova scores well on administrative readiness (with individual and personified reporting already introduced), ability to collect contributions, and a fairly robust banking sector. Remaining areas, such as market regulation and supervision, market instruments, liquidity, licensed market participants governance and disclosure, need to be substantially improved before launching a mandatory second pillar.

## Figure 2. Second pillar readiness indicators

### Policy Suggestions

4.19 **In its pension policy efforts, the Government should prioritize fixing its first pillar.** Despite the economic downturn, Moldova's pension system is not expected to generate significant deficits in the short run. Recommended first pillar measures include:

- *Introducing 50-50 wage-price valorization of past wages* (wage history) to establish the pension base for calculating the pension benefits formula, accompanied by a reduction in the accrual rate by some 20 percent.
- *Initiating measures to improve compliance and collection* including (i) establishing a tighter link between pension benefit and contributions paid, (ii) introducing a more appropriate relation between the average old-age and minimum pension benefits by price indexing the minimum pension, and (iii) replacing the flat contribution for self-employed and farmers with a unified contribution rate and adequately established contribution bases.
- *Increasing the retirement age*, according to EU norms;
- *Re-introducing the mandatory participation of individual farmers* in the pension system.
- *Reducing the difference between the special-privilege pension benefits and pension benefits from the general system.*

4.20 **Moldova is not ready for the second pillar for pension reform.** However, the Government should continue with analysis and simulations of all pension reform options, including the introduction of the second pillar in the future. The second pillar might be introduced for Moldovans working abroad and those who returned and did not contribute to the state pension system. The experiences related to policy actions legislated or considered by other countries in the region should also be considered (Box 1).

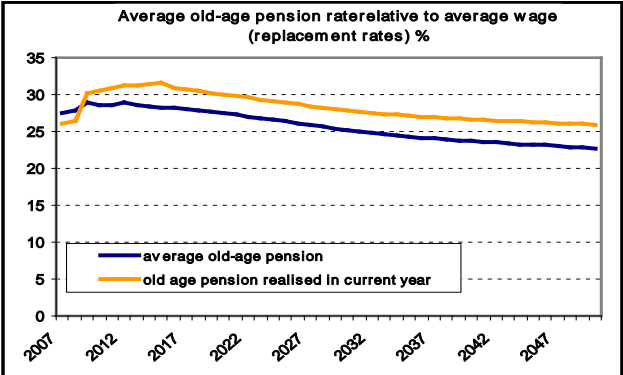
**Table 1. Policy Actions In ECA Countries – Legislated and Considered**

<b>Policy Action</b>	<b>Legislated</b>	<b>Considered</b>
Increase in Overall Contribution Rate	<p><b>-Romania:</b> From 27.5% in 2008 to 31.3%.</p> <p><b>- Russia:</b> From 20% to 26%, and moving contributions from basic pension to NDC pension.</p>	
Adjustment to Second Pillar Contribution Rate	<p><b>-Romania:</b> Contribution rates to the second pillar frozen at 2% (instead of legislated increase to 2.5%)</p> <p><b>-Lithuania:</b> Second pillar contribution rates reduced from 5.5% to 3% 2009 and 2010, to go back to 5.5% in 2011.</p>	<p><b>-Latvia:</b> Diverting part of contributions from second to first pillar.</p> <p><b>-Estonia:</b> Diverting 4% of 2<sup>nd</sup> pillar contributions to 1<sup>st</sup> pillar</p>
Allowing Opting in/out of Second Pillar	<p><b>- Slovak Republic:</b> First option (Jan –June 2008) and second option (Jan – June 2009) to switch in/out of the second pillar.</p>	<p><b>-Croatia:</b> Allowing second pillar participants (age between 40-50 ) to switch back to the first pillar, with the individual saving accounts transferred to treasury in exchange for the full first-pillar guaranteed pension benefit.</p>
Making Second Pillar Voluntary to New Entrants	<p><b>-Slovak Republic:</b> Second pillar participation for new participants voluntary as of January 2008.</p>	
Changing Indexation/ Minimum & Basic Pension	<p><b>-Serbia :</b> Suspension of indexation for 2009 per GoS agreement with the IMF</p>	<p><b>-Latvia:</b> Elimination of wage indexing of contributory pensions.</p> <p><b>-Hungary:</b> Switch to Swiss or pure inflation indexation depending on the GDP growth.</p>
Increase in Retirement Age		<p><b>-Ukraine:</b> Increase in retirement age to 62 for both men and women</p> <p><b>-Hungary:</b> Increase in retirement age from 62 to 65 by 2016.</p>
Measures to Address Early Retirement	<p><b>-Poland:</b> Elimination of numerous early retirement schemes (previously available to some 1 million people) .</p> <p><b>-Hungary:</b> Increase in penalties for early retirement and introduction of bonuses for delayed retirement.</p>	<p><b>-Ukraine:</b> Gradual elimination of special and early pension regimes</p>

Source: World Bank Staff based on country information

**4.21 Reforms are needed before the second potential pillar can be introduced.** These actions include developing and deepening capital markets and strengthening pension administration, individual recordkeeping and collection, measures that are needed regardless of the development of a second pillar and should commence without delays. These measures would significantly improve Moldova’s PAYG pillar’s fiscal and social sustainability and open fiscal space for the eventual introduction of the second pillar when the time is right (Figure 3).

**Figure 3. Simulation of Restored 50-50 Wage-Price Valorization, Reduced Accrual Rate, Increased Retirement Age, Higher Collection Rate and Price-Indexed Minimum Pension**



## V. GOOD GOVERNANCE AND ANTI-CORRUPTION

### COUNTRY CONTEXT

5.1 **Between the 2005 and 2009 Parliamentary elections, the majority and the opposition undertook important governance initiatives aimed at furthering democratic reforms and integration with EU.** Despite impressive growth and poverty achievements during this period, the current global financial crisis and the deepening recession in Europe threaten to roll back governance gains after a decade of gradual but unconsolidated transition. Repetition

5.2 **Moldova's objective to develop sustainable rule-based governance, which will support the pro-EU choice, is still relevant.** Under this goal, Moldova shall continue over the longer term to address long-standing developmental challenges such as developing an effective national administration, public sector governance and controls, rule of law, policy formulation, good governance of key agencies (customs, tax administration and CCECC), market regulation and project management capacity. This also includes the need for sound internal and external audit institutions and compliance with international standards that would engender public confidence in the way Moldova is being governed and accountable to its citizens.

### KEY CHALLENGES TO GOVERNANCE AND ANTI-CORRUPTION

5.3 **The picture that emerges from the extensive governance and anti-corruption monitoring and analysis conducted by the Bank and the other donors reveals several key persisting governance impediments.** The following challenges could be exacerbated during the current economic downturn: (i) institutional set-up lacking traditional checks and balances conducive to concentration of power and capture by special interests; (ii) heavy-handed Government regulations and bureaucratic discretion create incentives for corruption contributing to the widespread culture of cynicism; (iii) disenfranchised civil society which now together with returning migrants demands more remedial actions from the Government in the areas of social protection and service provision.

5.4 **According to the most recent polls, poverty, unemployment, and corruption are the three top concerns which households face.** More than half of the recently surveyed population<sup>3</sup> believes that “we are poor, because we are corrupt.” The respondents see the public provision of health and education services as some of the most corrupt systems together with police and public prosecution. Besides the low compensation and salaries, other main causes for corruption are the impunity of the corrupt officials, lack of Government will to fight corruption and assure

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<sup>3</sup> Perceptions and experience of household representatives and businessmen regarding corruption in the Republic of Moldova, TI, USAID, GOM, Chisinau, 2009TI

more transparency in public administration, and an ineffective system of income and assets declaration by public officials, which currently does not track the discrepancies between incomes and assets.

**5.5 Enforcing ethical standards for public officials and putting in place mechanisms for avoiding and treating conflict of interest is missing.** The majority of the staff in the key public institutions (Customs Service, Ministry of Internal Affairs, Main State Fiscal Inspectorate, Ministry of Local Public Administration, Ministry of Health, Ministry of Youth and Education) does not understand the notion, procedures and mechanisms of conflict of interests as stipulated in the Law on Conflict of Interests (2008).

**5.6 Recruitment procedures of public officials are often violated.** In addition, the legal framework for recruitment procedures is contradictory; staff responsible for the public institutions' hot-lines are not properly trained and procedures on registering a corruption case are not adopted; responsibility for failure to take measures is not established; income and assets declaration by public officials system does not allow tracking down the discrepancies between incomes and assets.

**5.7 The previous Government recognized the lack of good governance and corruption as an endemic problem.** Since the beginning of anti-corruption reform in 2000, Moldova has launched a broad range of legislative initiatives and institutional reforms, some of which have been quite ambitious. However, the donors' view is that the commitment of the previous Government to implement governance and anti-corruption reforms has been mostly on paper; the track record of implementation has been insufficient and sporadic. The specialized agency, the Center for Combating Economic Crimes and Corruption (CCECC), has been perceived as politicized and targeting primarily low-level corruption and crime.

## POLICY SUGGESTIONS

**5.8 Some of the main governance risks during the post-election transition period will be:** (i) an ambitious Government agenda countering the economic downturn, which may require further increase of Government discretion at the expense of more rule-based policies; (ii) post-electoral new appointments, personnel rotation, reshuffling and loss of organizational capital slowing down implementation and effectiveness of the anti-crisis response; (iii) a much needed cross-sectoral approach may fragment if left without heightened attention to strategic coordination.

**5.9 The next Government will have a fresh opportunity for addressing the unfinished and pending governance agenda.** The next Government should put good governance and combating corruption on the top of its agenda together with its macro-stabilization program. This presents a window of opportunity to focus on issues, which would signal to the public and the stakeholders a fresh start and renewed commitment to strategic governance issues. It would require identifying quick wins, longer-term priorities and tradeoffs.

**5.10 The consolidated and specific recommendations of the lead donors to the newly formed Cabinet on priority governance and ant-corruption actions are the following:**

- **Focus on possible quick wins, and relatively low costs.**
  - *Judicial Reforms.* Approve concept of ensuring the financial independence of the judiciary and adopt internet publishing of court decisions.
  - *Health.* Put in place mechanisms for monitoring the implementation of medical standards; and simplify the procedures of public procurements in medical services.
  - *Customs.* Create mobile monitoring teams for prevention of corruption and smuggling, and establish transparent criteria for identifying customs goods and determining their value.
  - *The Center for Combating Economic Crimes and Corruption.* Make the Parliament assume the oversight of CCECC's and redirect its reporting line.
  - *Complete political-administrative consolidation* to combat corruption through the maximum application of legal means and enforcement of the legislation on corruption prevention.
- **Recommit to ongoing or previously planned priority actions over the medium to longer term.**
  - *Continue the implementation of Moldova's anti-corruption strategy* on the basis of annual action plans.
  - *Continue to strengthen the anti-money laundering/counter-terrorist financing (AML/CTF) system* of Moldova in accordance with international standards.
  - *Further reform the judiciary* in order to guarantee its independence and increase the effectiveness and professionalism of the courts.
  - *Ensure higher transparency in the selection of the private companies, that implement public investment projects, particular attention being given to possible conflict of interests and promotion of civil servant's family related business;*
  - *Reform taxation and fiscal administration:* including the e-declaration system, hotline and petition system, and security of confidentiality of information.
  - *Strengthen the investment planning capacity for the allocation of public funds* for appropriation of infrastructure projects, improving prioritization, diminishing the loss of efficiency and the waste of public monies.
  - *Improve the financial reporting, predictability, and accountability of the private sector* to counter corrupt practices and predatory short-term investments.
  - *Improve country systems and increase their use in operations* financed by the World Bank and other donors. Moldova still poses high systemic risks and lacks adequate system capacity. Supervision of procurement is particularly vulnerable.
  - *Adopt the following general measures for all public officials:* (i) Enforcing Ethics. Prepare missing and update existing Codes of Ethics (Codes of Conduct) for public institutions to include stipulations of the international standards in each public office field (OECD Guide on Treating Conflict of Interests, The Model Code of Conduct for Public Agents of the Council of Europe); develop implementation mechanisms for the Code of

Ethics in each field and include the obligation to respect the Code in the work contract; provide training and make the reports on implementation and report on investigations pertaining to the Code of Ethics publicly available. (ii) Conflict of Interests Policy. Public officials to study the Law on Conflict of Interests (COI) , and other normative acts for prevention of corruption in public institutions (Penal Code and Code on Administrative Contravention); initiate concrete procedures for settlement of COI; introduce post-engagement restrictions for vulnerable public positions; enforce the declaration on conflict of interests among fiscal inspectors and institute punishment for breaking the rules and regulations; prohibit fiscal controls of enterprises by affiliated persons/relatives/friends.

- *Devise an effective framework for public information disclosure* to support better transparency and accountability. Develop Regulation on the rights and obligations of officers in the provision of documents and official information; delimitate clearly between official public information and information with limited/sensitive character.
- *Ensure access to information and improve the quality of the web resources available to the public*. Assign staff in charge of correspondence with the public via e-mail, control the answers and appeals by e-mail; publish on-line mapping their structure and management organization; who plans and executes the budget; managers assignment procedures, audit reports by the Chamber of Accounts; petition procedures, audience itineraries; list of vacancies; recruitment procedures, organization of contests for public positions; technical assistance and beneficiaries or executor among the public institution; planned and current bids for public procurements, the composition of the procurements commissions, bidders and their proposals, bid winners and the conditions of their contracts; plans of anti-corruption measures and results of their implementation; hot-line and reports on petitions.
- *Install a hotline and petition system*. Include a separate article for administration of the hot-line and its publicity in the budget of the institution;
- *Integrate e-services into government and public systems* as a cross-cutting mechanism to improve monitoring of resources and programs, and to reduce opportunities for corruption,
- *Make available for the large audience the report of the Court of Accounts*.

## VI. MIGRATION

### CONTEXT

**6.1 Moldovan workers migrated abroad in large numbers following the Russian Financial Crisis of 1998-99.** The number rose from about 56,000 in 1999 to 318,000 in mid-2008—out of a resident population of less than 3.6 million.<sup>4</sup> Exact measurement of migration is complicated by seasonal migration: about 60 percent of migrants were abroad for less than six months in 2007.<sup>5</sup> About 61 percent of all migrants worked in Russia in 2008, many for seasonal work in construction; about 14 percent went to Italy, with the rest distributed through the European Community, Turkey, and Israel.<sup>6</sup> The average age of migrants was about 34 in 2007; almost 69 percent had received a secondary or vocational degree (but not one in higher education); the large majority, about 71 percent, came from villages.<sup>7</sup>

**6.2 Moldovan workers sent home about US\$ 1.9 billion in 2008: this amounted to almost 31 percent of GDP in 2008, the second highest ratio in the world, following Tajikistan** (Figure 4).<sup>8</sup> These remittances were the driving force behind the economic expansion that followed the crisis of 1998-99: they helped finance a boom in the rehabilitation and construction of housing, spurred household consumption, and paid school and university fees. As a result, the poverty rate fell by 44 percentage points over 1999-2005, and the rate, (computed from a survey with a revised framework) fell further in 2006 and 2007.<sup>9</sup>

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<sup>4</sup> National Bureau of Statistics. *Labor Force Migration in the Republic of Moldova*. (Based on data collected as a module of the second quarter 2008 Labor Force Survey, April 2009.

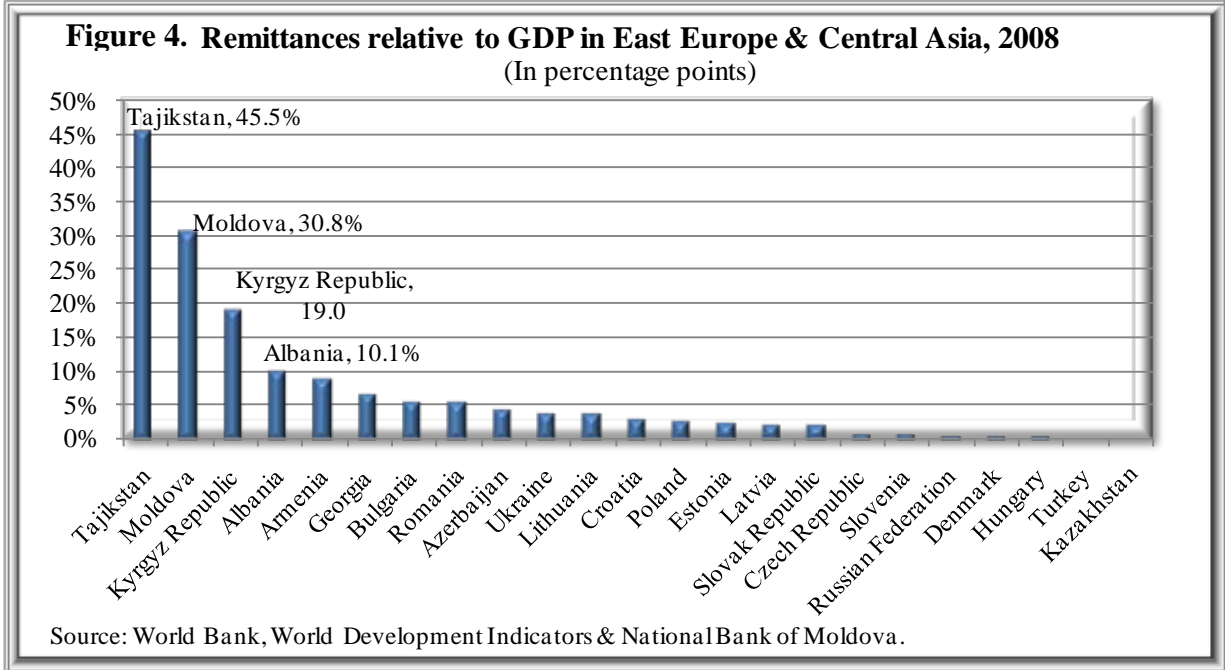
<sup>5</sup> World Bank computation from Household Budget Survey of 2007.

<sup>6</sup> National Bureau of Statistics, *Labor Force Migration in the Republic of Moldova*. .April2009.

<sup>7</sup> World Bank computation from Household Budget Survey for 2007.

<sup>8</sup>For remittances, the source is the National Bank of Moldova; for GDP the source is the National Bureau of Statistics.

<sup>9</sup> World Bank. *Poverty Update*. 2006. The estimate for 2006 is based on a World Bank consultant's interpolation of 2005 and 2006 data. The poverty information for 2007 is from the Ministry of Economy and Trade.

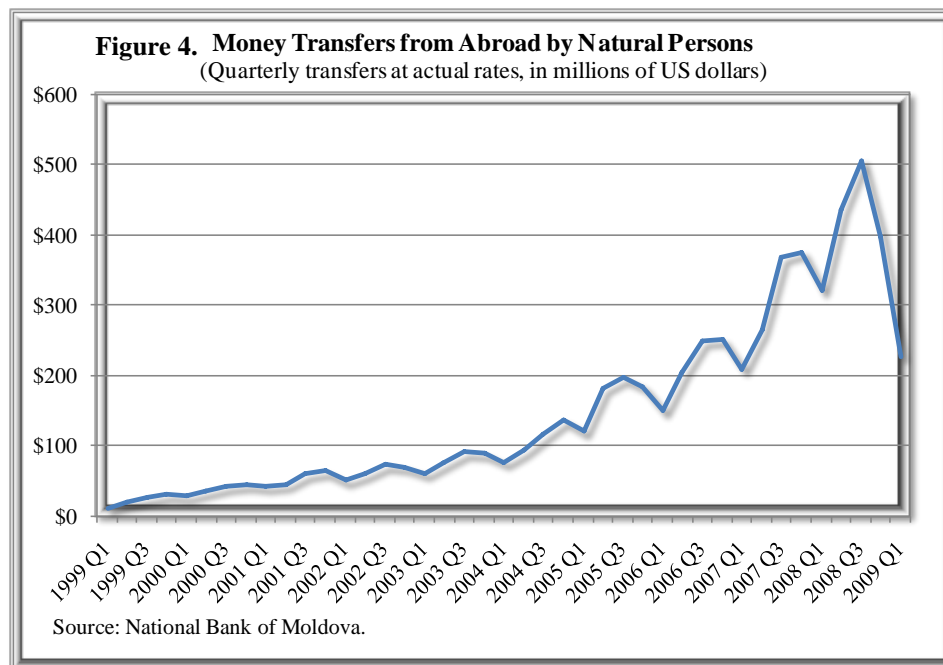


**Challenges**

6.3 **However, money transfers homeward from people through the financial system have declined sharply and were 29 percent lower in the first quarter of 2009 than in the same quarter a year earlier** (Figure 5). These money transfers through banks and other financial agencies are the main means of sending money home. Moreover, money transfers – and remittances- will probably decline further, compared to previous years, as many seasonal Moldovan workers stay home rather than travel to Russia, where the financial crisis has deflated the construction boom and reduced the demand for labor.<sup>10</sup>

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<sup>10</sup> Transfers of wage income from seasonal labor abroad are not formally considered workers’ remittances. However these are counted as remittances in the Balance of Payments because of the difficulty of distinguishing the origin of the transfers.



6.4 **This is part of a broader trend among developing countries in Europe and Central Asia (ECA).** The Ratha and Mohapatra's base case forecast is for a decline in remittances in ECA of over 10 percent in 2009; the low case forecast is for a decline of almost 13 percent (Table 2).

**Table 2. World Bank Base Case Forecasts of Growth Rates of Remittance Flows to Developing Countries by Region**

(In percentage points)

	2008e	2009f	2010f	2011f
Developing countries	8.8%	-5.0%	2.9%	6.3%
East Asia and Pacific	6.6%	-4.2%	1.9%	5.6%
Europe and Central Asia	5.4%	-10.1%	4.2%	7.5%
Latin America & Caribbean	0.2%	-4.4%	2.3%	5.6%
Middle-East & North Africa	7.6%	-1.4%	2.9%	5.6%
South Asia	26.7%	-4.2%	3.4%	6.8%
Sub-Saharan Africa	6.3%	-6.3%	3.5%	6.7%

Source: Dilip Ratha & Sanket Mohapatra, World Bank web blog: [peoplemove.worldbank.org](http://peoplemove.worldbank.org), Notes: e means estimate, f means forecast.

6.5 **While short-term migrants reduce payments, long-term migrants are less likely to cut their remittance payments during a crisis.** Ratha and Mohapatra argue that remittances typically form a small fraction of migrants' income and are therefore less likely to decline during

a crisis.<sup>11</sup> However IOM survey data for Moldova show that more than half of migrants transfer more than half of their income home –leaving remittances vulnerable to the financial crisis.

**6.6 Furthermore, Ratha and Mohapatra argue that the duration of migration may increase with the tightening of border controls during a recession, so the duration of migration may lengthen, and those staying back are likely to continue to remit income.** And when migrants do return, they are likely to bring back part of their accumulated savings. This may well apply to long-term Moldovan migrants.

**6.7 The migrants that return are likely to go mainly to rural villages, where the cost of living is relatively cheap.** Furthermore, seasonal migrants who cannot leave because of the collapse of the demand for labor in construction in Russia are likely to stay in their village homes. With opportunities for migration diminished, young people will be forced to rely on domestic labor markets at a time of falling labor demand. They will have to compete with returning migrants, who may have better experience and skills. Youth entering the labor market will have greater difficulty obtaining their first job and in an unfavorable labor market, youth may be more vulnerable to exploitation.

**6.8 A further concern is the likely impact of reduced remittance payments on children’s well-being, as households find themselves less able to pay for children’s nutrition, medical care, and school costs.** Children who return to Moldova may require assistance integrating into the education system. Finally, economic stress may sometimes induce family conflict and even domestic violence.

**6.9 The challenge for policy is to mitigate the immediate shocks in rural areas and among youth and children and to limit the negative effects on poverty.** Safety nets are modest and agriculture is unlikely to absorb large amounts of labor. The best response may be to rely on the most efficient social assistance program and to prepare public works and youth programs.

## POLICY SUGGESTIONS

**6.10 The Government should avoid cutting the targeted social assistance program.** International and donor agencies support full implementation of the new Law on Social Assistance. The newly introduced targeted social assistance program provides the Government with a powerful tool for offsetting adverse impacts on poverty of the decline in remittances and increase of poverty particularly in rural areas, as the result of increasing unemployment and higher social pressures. Newly poor households could apply to the local public authorities, through the social assistants, for grants. If enough resources are available, the Government could correlate the standard targeted transfer to the cost of living.

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<sup>11</sup>Delip Ratha and Sanket Mohapatra, web blog, March 23, 2009. URL: <https://peoplemove.worldbank.org/en/content/remittances-expected-to-fall-by-5-to-8-percent-in-2009>

**6.11 Public works could absorb skilled construction workers.** With sufficient donor funding, the Government could accelerate planned government investment in hospitals, schools, roads, water supply, natural disaster management, and other priority infrastructure. This would require careful planning to assure that, for example, under-utilized schools and hospitals are not rehabilitated, and also to set fast but fair procurement procedure. The Social Investment Fund has demonstrated its capacity to absorb skilled construction labor in small-scale civil works in villages and small towns. The Fund also has had a good record in rapid and fair procurement.

**6.12 The UNDP Integrated Local Development Program covers about a third of the country (about 13 rayons) and supports priority public works such as water supply systems, reparation of schools or kindergartens etc.** The Program can expand works quickly and generate much needed employment because of its presence in the field, its network of contacts with local authorities, and public works already identified through community development plans.

**6.13 Launching a youth program would mobilize youth for suitable public works, for sports, and would prepare them for the labor market.** For instance, youth employment could be created through “green activities,” such as planting tree belts, working on erosion control, and participating in natural disaster management projects. Employment skills training would improve the capabilities and marketability of young people to allow them better access to job markets. This could build on the support already provided by UNDP through the Social Reintegration Centers across the country. Also, youth could receive information about the labor market, on risks facing migrants, even in areas such as sexually transmitted diseases, alcoholism and drug abuse, and conflict resolution. An education component could consist of reinforcement of the secondary school curriculum.

**6.14 Over the medium and long-term, the development of the off-farm rural economy, and especially agro-processing, would do much to reduce emigration and to absorb returning migrants.** The most important constraint is the business environment. Agro-processors face obstructions and corruption in licensing, obtaining permits, and at border crossings. Moreover agro-processors are generally small and face constraints in finance, management, marketing, logistics, and in obtaining high quality agricultural inputs. Improvement of logistics and transport would also promote agro-processing.

**6.15 A comprehensive migration policy strategy is needed.** Even after Moldovan growth strengthens, the high ratio of foreign to domestic wages will still motivate Moldovan workers to migrate. Therefore, the Government might wish to increase the benefits and minimize the social costs of migration. For example, it could expand legal employment opportunities for Moldovans abroad through circular migration schemes. It could provide information and support services to migrants, thereby strengthening their ties to Moldova. More formal links between the Moldovan society and the Diaspora could promote their investment of remittances in Moldova and giving

for home village development projects. Finally the Government could, when possible, harmonize tax and social insurance systems between host countries and Moldova.<sup>12</sup>

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<sup>12</sup> IOM study “Labour Migration and Remittances in Moldova: Is the Boom Over? Trends and Preliminary Findings from the IOM CBSAXA Panel Household Survey 2006-2008.

## VII. PUBLIC SECTOR REFORM

### PUBLIC FINANCIAL MANAGEMENT

#### Context

7.1 **The Ministry of Finance (MOF) has worked since 2005 to bring the Public Financial Management (PFM) system closer to international standards.** The ongoing PFM reform agenda has been supported through coordinated donor assistance, most of which will continue to be available to the beneficiary institutions in 2009-2011.

7.2 **Although the reform agenda is not complete, these past efforts have brought noticeable improvements in PFM performance.** The 2008 PFM assessment based on Public Expenditure and Financial Accountability (PEFA) methodology highlights improvements in cash management, accounting, recording and reporting as a consequence of the introduction of the Single Treasury Account. Development of the Medium-Term Expenditure Framework (MTEF) as a strategic budget planning instrument has achieved a closer link between government policies and budgets. The comprehensiveness of the budget was improved through integration of the special funds into the main budget (Box1).

7.3 **Some important weaknesses still remain to be addressed. Reporting standards are fragmented and do not correspond to modern requirements.** Budget information is available with delays and to a limited range of users. Substantial effort is required to introduce internal control and audit systems. The external audit capacity is weak.

7.4 **The PFM project, implemented by the Ministry of Finance with support from the World Bank, Dutch Government and the Swedish International Development Agency, is the core instrument supporting the reform.** The Department for International Development (UK) will provide additional assistance to the line ministries for strengthening the MTEF. UNICEF is also planning targeted assistance to MoE and MSPFC in this area. Multi-donor technical assistance is available to the Court of Accounts for strengthening its institutional capacity. The International Monetary Fund and the European Union are actively monitoring selected PFM reform areas.

#### Key Challenges

7.5 **The budget situation is projected to worsen.** The impact of the ongoing crisis on the Moldovan economy will pose a challenge for the MOF in managing the budget situation and will test the robustness of the recent improvements in the PFM system. Unlike the previous few years, 2009 revenues are unlikely to exceed the approved budget figures and upwards revisions of the budget aggregates during the year will not be possible any more. On the contrary, downward adjustments will most probably be required. The cash position of the Government is expected to become tighter and cash rationing practices might become a necessity. Medium-

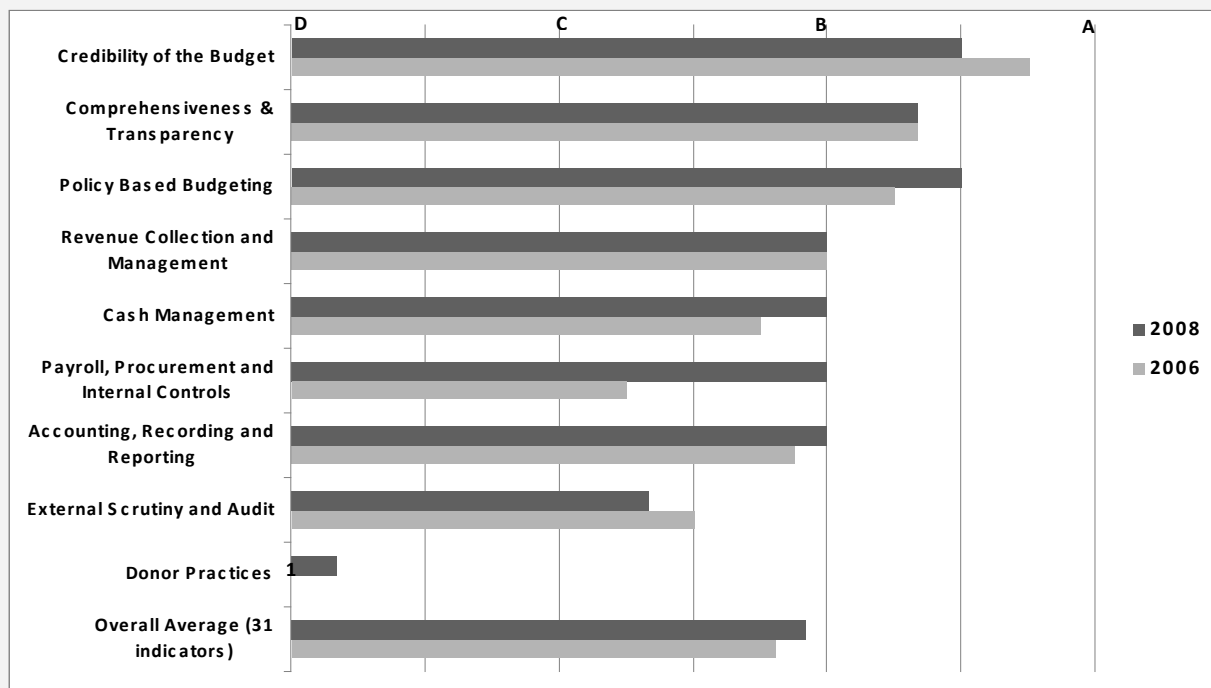
term budget projections for future years will pose a challenge because of the highly unpredictable external environment.

**Box 1. Moldova PFM performance scores**

Solid progress in the quality of PFM systems and processes has been achieved between 2006 and 2008, as measured by the Public Expenditure and Financial Accountability (PEFA) PFM performance measurement framework. PEFA framework is an internationally recognized tool that allows monitoring of country performance under various dimensions of PFM reforms over time. It is based on a set of high level indicators which measure performance of PFM systems, processes and institutions. Moldova was the first country in the Europe and Central Asia region to have completed two PEFA assessments and the process has provided a robust platform for an assessment of PFM reform progress over the last years.

The most significant development which influenced the change in Moldova’s scores between 2006 and 2008 was the development of the Single Treasury Account which improved the overall scores in Cash Management and Accounting, Recording and Reporting.

**Moldova: Comparison of PEFA scores 2006 to 2008.**



*Note: A is the highest rating under the PEFA scoring methodology, and D is the lowest. Scores B and higher are indicative of good performance.*

**7.6 Some of the recent PFM accomplishments might be helpful in managing the budget situation under the new circumstances.**

- *The Macroeconomic modeling tool* developed recently for the Ministry of Economy could help analyze the impact of the ongoing world crisis on Moldova's economy, as it allows for an in-depth look into the factors affecting the external sector projections.
- *Availability of the MTEF as a strategic budget planning instrument* should help in considering the necessary adjustments to the 2009 budget and developing budget scenarios for future years. It could guide the alignment of expenditure adjustments with policy priorities to avoid ad hoc or across-the-board expenditure cuts.
- *Efficient cash management* will become especially important in the short-to-medium term. Consolidation of budget balances at the Single Treasury Account gives the Ministry of Finance the necessary flexibility for managing the tightened cash position.

## Policy Suggestions

**7.7 Priority activities for 2009-2011 are well defined and present a logical continuation of the past efforts to reform the PFM system.** Most suggested activities are already in progress. It is essential not to lose the momentum and bring these activities to completion without major slippages in the implementation timetable. The availability of targeted donor assistance reduces the need for allocating additional domestic budget resources to support the PFM reform agenda in the near future.

- *The revision of methodologies for budget preparation and budget execution will continue in 2009-2010.* A major objective will be to reflect related business processes in the functionality of the new financial management information system expected to be ready for launch in 2011. The introduction of the new integrated budget classification and chart of accounts system will underpin the revised budget reporting formats aligned with international standards.
- *A new Law on Budget System and Budget Process is expected to be developed and submitted for Parliamentary approval in 2011.* The fundamental importance of this Law for the entire public sector operation dictates the need for careful conceptualizing and thorough consultations with all the interested stakeholders as part of the drafting process.
- *A new integrated Financial Management Information System (FMIS) will be developed and is expected to become operational in 2011.* The system will replace the existing fragmented and semi-automated system currently used by the Treasury only for budget execution. The FMIS is expected to reduce transaction time and processing errors, provide timely and secure access to budget information for a broad range of users inside and outside the MOF, and enable reliable audit trails.
- *Work will continue on establishing the legal and institutional foundation for a public internal financial control and audit system based on EU standards.* A new law on Public Internal Financial Control is expected to be developed by the end of 2009. The MOF is expected to take a strong lead in supporting line ministries and central agencies in establishing and developing their systems of internal control and audit to ensure a more effective and efficient use of resources in achieving policy objectives.

- *The Court of Accounts will continue to build internal capacity to transform itself into a modern external audit institution operating on the basis of internationally recognized professional standards. The recently enacted new Law on the Court of Accounts will serve the basis for this transformation process.*

## PUBLIC ADMINISTRATION AND CIVIL SERVICE REFORM

### Context

7.8 **In 2005, public administration reform became a policy priority for the Government of Moldova that would promote European integration and improve effectiveness and performance of public administration.** In December 2005, a medium term Strategy of Central Public Administration Reform (CPAR) was approved. The CPAR Strategy stipulated the following main objectives:

- an effective institutional system, that is better governed, performs better; and costs less;
- a professional and well-paid civil service;
- a streamlined decision making process;
- better links between policies and resource allocation; and
- improved communication between the Government and the society.

7.9 **The reform agenda proved to be very ambitious for the two-year period.** The donor partners supported CPAR agenda through a World Bank-administered Multi-Donor Trust Fund. Yet the reform process was slow due to low initial reform management capacity and some resistance to changes. During 2008-2009 the pace of reforms accelerated due to better organization of reform management and support from the Prime Minister. The reform achievements to date include: (i) approval of the Civil Service Law, compliant with the European traditions and values; (ii) initiation of better coordinated policymaking and improvement of policy prioritization; (iii) initiation of strategic planning and policy analysis; (iv) better alignment of policy and budgeting; (v) improvements in civil service training; and (vi) advancement toward establishing a fair and transparent civil service pay system.

### Challenges

7.10 **The success of the public administration reform is viewed by the European Commission (EC) as a test of whether the country is ready for integration or closer coordination.** When assessing readiness of the country for EU integration, the EC emphasizes the rule of law, predictability, good policy coordination (ability of the public administration to speak in one voice), professionalism, transparency and stability of the civil service, effectiveness and efficiency of the public administration in delivery of services. Moldova still has a long way to go to achieve the acceptable level of public administration to be considered for EU integration.

7.11 **Persistent administrative weaknesses include:**

- *Low attractiveness of the public administration for skilled specialists*, which relate to two issues:
  - The salary structure is neither competitive nor transparent, and
  - a weak system for personnel management leads to uncertain career opportunities.

Competitive recruitment of civil servants still meets covert resistance from hiring managers, and the percentage of competitively selected and appointed civil servants remains way below 50 percent.

- *Continued weakness in the capacity to strategically plan, budget, implement and account for the achievement of policy decisions.* This is a result of limitations related to skills, processes for central management and coordination, and how the public administration is organized and managed. All sector entities should function as a single organism with one center. The present practice and law still emphasize a disjointed administration with weak accountability of the administration to the sector minister, and the proliferation of independent agencies is a symptom of the weak cohesion of the administration.
- *Problems are addressed only at the legislative level and insufficient attention is given to enforcement, monitoring and accountability.* The institutional system is fragmented and accountability mechanisms for policy implementation are not well functioning. This often leads to unsatisfied or poorly informed citizens complaining about the performance of the public administration, which means that the administration is frequently engaged in managing these crises rather than designing good systems to start with.
- *The crucial element of inter-sectoral collaboration remains secondary in the reform process.* Policy documents related to reforms in separate sectors (health, education, social protection, for example) are still designed and implementation in individual sectors, with little interest, ownership and accountability from other, equally relevant (though not the leading) sectors. This unnecessarily impedes the progress of sector reforms.

**7.12 Important first steps have been made to develop policy coordination, impact assessment, and strategic planning mechanisms.** To gain from this initiative, the Government needs to continue building sector capacity to develop policies and central capacity to coordinate and monitor policies. The recent government initiatives to improve transparency of decision-making by developing consultation mechanisms with the civil society are useful and need to be implemented.

### **Policy Suggestions**

**7.13 Considering persistent capacity weaknesses, the Government should maintain public administration reform as its policy priority.** Significant improvements in the quality of public administration can be expected within 5 to 10 years after the adoption of reforms if a concerted effort is made to implement changes. In the *short term*, the Government should maintain well performing senior managers (civil servants) to ensure continuity of reforms.

7.14 The government should implement measures that improve the attractiveness and performance of the public administration in the *medium term*:

***Short-term measures:***

- *Develop a new civil service remuneration system* and introduce it during 2010. During the economic downturn, the new pay system can be introduced through a phased approach, but the hope of receiving adequate remuneration in the foreseeable future will help attract good specialists.
- *Strengthen the coordination capacity of the Government Office*, including strategic planning, policy coordination, implementation of institutional reforms and oversight.

***Medium-term measures:***

- *Implement civil service reform*, as envisaged in the Law on Public Function and Civil Service Status and continue developing modern HR management systems.
- *Continue demand-driven training of civil servants* in coordination with the Personnel Policy Department.
- *Introduce systems of internal controls in public administration entities* (as part of the Public Internal Financial Control concept).
- *Develop and approve a legal basis for organization of public administration* that envisages a hierarchy within a policy sector, with the Minister at the top of the pyramid and proper accountability for policy implementation and the use of public resources.
- *Review the effectiveness and efficiency of service delivery systems* that are big spenders (e.g., education) and develop a strategy for streamlining service provision.
- *Introduce public consultations on policy issues* before drafting legal and normative acts that impact the interests of the civil society (citizens and businesses).

***Long-term measures***

- *Continue strengthening results-orientation of the budget* by defining annual targets and linking costs with the scope of work.
- *Facilitate the provision of information on the performance of the public administration* through institutional portals/websites to ensure that government becomes more accountable for its performance and the use of the public resources. Introduce annual performance reports.

## VIII. BUSINESS ENVIRONMENT

### CONTEXT

8.1 **Moldova's economy has been growing at an average rate of more than 6 percent between 2000 and 2008.** This growth has occurred despite the exogenous shocks in 2006 and 2007 (in particular the increase in gas prices, wine embargo, and the poor harvest). Rapid expansion of the domestic private sector underpinned this growth, with service firms growing most rapidly, followed by industry and agriculture. Private investment has increased from 14 percent of GDP in 2003 to over 22 percent in 2007, revealing growing private sector confidence in the economy. Foreign confidence in the economy has also grown with foreign direct investment (FDI) accelerating from 3 percent of GDP in 2003-2004 to an estimated 10 percent of GDP in 2007.

8.2 **The Moldovan authorities, assisted by the World Bank and other donors, have pursued an ambitious reform program aimed at achieving sustainable private sector led economic growth over the past five years.** A comprehensive reform of the business enabling environment has been at the core of the Government's efforts. This reform includes the (i) overhaul of the business registration system, (ii) streamlining of the regulatory regime through the Guillotine exercise for existing legislation; (iii) introduction of Regulatory Impact Assessment (RIA) for new legislation affecting business operations; and (iv) fiscal incentives for the enterprise sector.

8.3 **While the full impact of these actions is yet to be felt, the initial positive results are confirmed by the enterprise sector surveys.** Between 2002-2008, the time needed to register an enterprise has been reduced by 5 days, while the costs have decreased by 50 percent. Also, the average number of licenses per company has been reduced, and the time needed to issue them has been reduced to 17.5 days, while the costs have been halved. In 2008, the surveyed enterprises were inspected 9 times on average, compared to 18 inspections in 2004.

### KEY CHALLENGES

8.4 **In the short term, Moldova's private sector is facing increased vulnerabilities from the economic and financial crisis that is currently unfolding in the region.** The business climate has declined sharply in the past six months, especially for the export-oriented enterprises. There is a decreasing trend in export orders. New orders include pressures to reduce prices and extend the payment terms. Exports that were typically expected to be paid in 30-60 days are now getting offers for payments in 90-120 days. Thus the exporters need higher level of working capital to be able to respond to such offers, or they need bridge loans. The increased cost of credit and generally low profitability of Moldovan exports makes external borrowing impractical. The lack of access to credit, especially for working capital finance—the capacity to accept longer payment terms—might trigger a loss of markets, resulting in bankruptcies with ripple effects in the economy.

**8.5 The sustainability of Moldova's economic growth model is uncertain in the longer run.** The recent expansion has been driven primarily by rising consumption fuelled by high remittance inflows. Moldova's economy still has not experienced sufficient systemic reallocation of resources from low-productivity sectors to higher-productivity ones, with labor productivity in 2006 amounting to just 63 percent of its level in 1990 and 40 percent of the average in Central-Eastern Europe in 2006. The European Bank of Reconstruction and Development (EBRD) Transition Indicators that assess progress of the transition economies in pursuing structural reforms in different areas suggest Moldova's transition towards a market economy lags significantly in the areas of enterprise restructuring, competition policy, non-bank financial institutional development, and infrastructure.

**8.6 Despite regulatory reform efforts, Moldova's standing in the World Bank's Doing Business ratings remains low relative to its Central European neighbors** (103<sup>rd</sup> in the 2008 report). Trading across borders, licensing (construction permits), access to credit, and paying taxes were identified as the most problematic issues. As a result of incomplete structural reforms, Moldova's industrial output and exports continue to be dominated by traditional, low value-added products and its current account is chronically in deficit. The exports are also not sufficiently diversified in terms of destination markets, which increases the risk of external shock similar to the one experienced in 2006. Moldova's overall competitiveness position was ranked 99th globally in the World Competitiveness Report 2008-2009.

**8.7 Enhancing the economy's global competitiveness is essential for achieving long-term growth in a small, open economy like Moldova.** Competitiveness is defined as the ability of an economy to participate in global trade and investment networks. Tighter trade integration into the global economy can spur sustainable growth in Moldova by ensuring greater allocative efficiency, as the economy specializes in the sectors in which it has a comparative advantage and that have higher productivity levels. Increased flows of foreign investment can also contribute to an economy's growth potential as foreign investors bring new technologies and links to foreign markets, enabling enterprises that work with them to improve their productivity and increase their sales.

**8.8 Moldova needs to produce new, more sophisticated products in its current sectors of comparative advantage and shift into more skilled labor and capital-intensive sectors.** These changes are needed to sustain competitiveness in the long term and expand export markets. First, labor productivity is higher in skilled-labor-intensive and capital-intensive sub-sectors and industries, resulting in higher real wages, and growth in exports. Second, relying on low labor costs to remain competitive in low-skilled labor-intensive sectors, such as textiles and footwear, may not be sustainable in the long run, given the increasing competition from low-wage countries and the rising labor costs in Moldova. The experience of Central-Eastern European and Baltic countries shows that the structural shift in production towards skilled labor intensive and capital-intensive exports, in combination with growing FDI in these sectors, contributed significantly to strengthening their integration in EU markets at more sophisticated levels.

**8.9 The normalization of trade relations with Russia and the introduction of autonomous trade preferences by the EU create an excellent opportunity for the Moldovan**

**enterprise sector to move to export-driven growth.** This will be achieved through: (i) increasing the quality and quantity of Moldovan exports and integrating exporters more deeply in global supply chains; (ii) attracting greater foreign investment inflows to Moldova; and (iii) developing linkages between local firms and foreign companies already in Moldova. This opportunity cannot be fully utilized without promptly alleviating existing internal constraints that prevent, or unnecessarily limit, the competitiveness of Moldova's enterprises. In addition to a sound macroeconomic policy framework, this entails continuing structural reforms and improvements of public institutions to support the establishment of a friendly and predictable business environment, enterprise restructuring, better protection of competition, a more sophisticated financial system, and better access to infrastructure.

## POLICY SUGGESTIONS

**8.10 In the *short term* (up to twelve months), it is recommended that the authorities take the following steps, listed in the order of priority, to mitigate the negative impact of the regional economic crisis on the Moldovan enterprise sector:**

- *Facilitating formal employment through further simplifying business entry/operations.* Moldova experiences the return of labor émigrés. A number of them bring back an entrepreneurial culture. Others bring improved labor skills. If the GoM wants to reap the benefit of returning migrants, it needs to (i) further simplify business entry, including streamlining construction permits procedures, and (ii) effectively reduce the costs of paying taxes stemming from overly complicated procedures (not the tax rates which otherwise are already low). Certain re-training and orientation of returned migrants would complement the facilitation of formal employment.
- *Facilitating the flow of credit.* The lack of external funding on affordable terms even for short-term working capital loans has become an acute problem in recent months. It is recommended that the Government, jointly with the National Bank of Moldova, tries to help banks to increase term funding at reasonable cost from multinational and bilateral donors, to be able to maintain the flow of credit to enterprise sector.
- *Removing the unnecessary barriers to trade.* Both *enterprise surveys and expert reports* indicate that Moldovan trade regime including customs procedures and technical barriers are impairing the great trade potential stemming from geographical location. The existing procedures are time consuming and costly both for exporters and importers, relative to similar procedures in most neighboring countries. A resolute reform effort aiming at reducing the entry barriers could produce a quick improvement in the doing business environment. That will include an *effective reform of the customs service*.
- *Improving public-private dialogue.* As shown by multiple enterprise surveys, private entrepreneurs continue to assess the regulatory environment as burdensome and unpredictable. The same surveys show marked improvements in many areas. Such disconnect between perception and reality could be reduced through a more systematic effort by the authorities to use the RIA mechanism and other available channels for regular

communication with the business community. It is very important for authorities to openly accept a private entrepreneur as a valuable societal asset and a key partner in designing and implementing anti-crisis measures.

- *Accelerating the reform of the measurement, standards, testing, and quality assurance (MSTQ) system.* The ability to diversify and expand exports requires Moldovan companies to have access to an internationally recognized MSTQ system. Therefore the Government needs to accelerate the adoption of standards and technical regulations compatible with EU norms, and the refurbishment of metrology and testing laboratories.

**8.11 In the *medium to long term*, the following policy areas require attention in order to improve the internal and external competitiveness of the private enterprise sector:**

- *Improving labor skills.* The shortage of skilled labor is perceived as the most binding constraint for enterprise development by knowledge driven firms. One way to address the problem could be through reforming the educational system to make it better aligned with the needs of the national economy. At the same time, the authorities can rely on vast international experience to increase incentives for private employers to invest more in the on-the-job training and skills development.
- *Better protection of competition.* Despite its relatively small size, the domestic market offers substantial development potential to Moldovan firms if certain barriers to competition are reduced. In particular, the improvement of the public procurement system is eagerly awaited by many private entrepreneurs. Equally importantly, there is a need for a more effective competition protection regime, given the high degree of concentration in many product markets. It is also necessary to review the system of non-tariff barriers that, for example, limit the ability of farmers to export certain agricultural products.
- *Strengthening corporate governance.* The state needs to promote a deeper reform of corporate financial reporting and take a more proactive stand on the issue of full disclosure of corporate reports. It is very important that the country moves to the full public disclosure of ultimate controllers of commercial entities, including any interests held by public servants.

## IX. SOCIAL SECTORS

### EDUCATION

#### Context

9.1 **A major priority for Moldova is to increase the quality and relevance of its education system in order to improve its competitiveness in the future.** Moldova's National Development Strategy 2008-2011 acknowledges the essential role of education in reducing poverty and ensuring sustainable economic growth. The NDS stresses the importance of equitable access to quality education for ensuring equal chances for a decent life, adequate employment opportunities, participation in social life, higher social cohesion, and competitive human capital.

9.2 **Solutions will be needed for continuing education reforms under tighter budgets, particularly through the urgent adoption of efficiency and cost-recovery measures.** The economic growth experienced during the last years may decline or even cease, due to the current global financial and economic crisis. The adjustments of the student/teacher ratio, optimization of the school network and alignment of education with labor market needs are the main challenges for the pre-university education sector. In higher education, the priority is the creation of a competitive, relevant and coherent system, for full participation in the European Higher Education Area.

#### Key Challenges

##### *Demographic decline and efficiency issues*

9.3 **The education system is currently inefficient, with decreasing numbers of students but high numbers of poorly paid teachers and non-teaching staff.** During the past decade, the demographic decline continued due to low fertility rates and massive outward migration. The drastic reduction in student numbers was not accompanied by necessary reductions of teaching and non-teaching staff. Outdated norms, dating since Soviet times, allowed for unnecessary increases in the number of teachers and non-teaching staff.<sup>13</sup> Schools with few students have difficulties in meeting teaching norms that are based on the number of classes and consequently classes are artificially created through division. During the 2007-2008 school year, the student/teacher ratio was as low as 13 (European average 18). At the same time, the non-teaching staff/total staff ratio was as high as 37 percent (European average 27 percent). This resulted in a

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<sup>13</sup> In the Causeni raion, the average number of students per class is 19.5; in Riscani, the average number is 17. In individual schools from these raions the number varies between 5.3 and 22.7 students. Draft study "Present Situation in the General Secondary Education in Pilot Optimization Raions Causeni and Riscani", MEY, 2009.

highly inefficient use of funds allocated to education: a high proportion of the budget is used for personnel expenditures,<sup>14</sup> while a high number of teachers get very low salaries. Despite increases in the education budget (8.4 percent of GDP in 2008) and repeated salary increases (salaries have grown 4.4 times since 2000), teachers are still low-paid when compared with other categories of employed persons in Moldova or compared to international national averages.

**9.4 In the absence of optimization measures, fewer students leads to excess schools, unused school space and high running costs.** The number of students has decreased significantly, with 26.7 percent fewer students in 2007-2008 compared to 2002-2003. The reduction in the number of schools has been minor in comparison, with 1534 schools in 2007-2008, compared to 1580 schools in 2002-2003. One explanation may be that three quarters of schools (serving about 60 percent of students) are in rural areas, where school consolidation is more problematic given the poor transport infrastructure and greater distances. Excess space is registered in most schools leading to very low rates of use of the designed school capacity<sup>15</sup>. About 60 per cent of buildings are more than 30 years old. 41 per cent of all school buildings require thorough repairs and in only 11.2 per cent of them can ramps be built for the access by children with physical disabilities. The heating bill is unjustifiably high and, with high expenditures for salaries, little is left in budgets to cover essential education needs, such as teaching/learning materials and textbooks.

**9.5 Moldova's education system is burdened by 62 "internats", i.e. boarding schools where close to 9,000 children live and are educated.** Upkeep and functioning of these boarding schools is significantly more expensive than that of regular schools; the salary scale for staff is higher, while the quality of education is often lower than mainstream schools. More than 80 percent of children schooled in "internats" are there due to poverty and lack of appropriate parental care. Data indicates that graduates from boarding schools have poorer adult outcomes than those from general schools.

**9.6 Half of "internats" are auxiliary boarding schools,** (i.e. special education schools for children with disabilities). These schools use a simplified curriculum, and graduates from these schools are not eligible for post-secondary education. Officially, a child can be placed in one of these schools only if classified as "disabled" by a Psycho-pedagogical Committee, but in reality the majority of these children have no cognitive or other impairments. The Strategy for Reform of the Residential Care System was adopted in 2007, but its implementation is slow and uncoordinated.

**9.7 The optimization of the school network needs to be accelerated, with further reductions of an estimated 15,000 students possible in the next six years.** The optimization will lead to reductions in teaching and non-teaching staff, reduce the cost of running schools, and

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<sup>14</sup> According to the data provide by the Ministry of Finance, in 2007, 47,2 % of the budget for education was spent for teaching staff and 17,9 % for non-teaching staff.

<sup>15</sup> In Causeni schools only 62.5% of space is used and in Riscani only 52.5%, according to the study mention in reference 1.

improve the teacher/student ratio, bringing it closer to international norms. Savings could be used to increase the salaries of remaining teachers. A major part of this initiative should be optimization of the large, expensive, inefficient network of boarding schools. The Strategy for Reform of the Residential Care System Action Plan identified the appropriate action and timelines; it needs to be fully implemented.

**9.8 Access to education has to be monitored.** While enrollments in preschool education increased significantly (from 38.5 percent in 2000 to 68.5 percent in 2006), the access of children from vulnerable families is still low. Net enrollment rates have declined, possibly in the context of migrating parents leaving behind children without proper adult guardianship: (i) for primary education, from 93.5 percent in 2000 to 87.6 percent in 2006; and (ii) for lower secondary education, from 87 percent in 2000 to 86.1 percent in 2006. Primary education covers less than 70 percent of Roma children and secondary education less than 50 percent. Overall, 43 percent of Roma children at the ages of 7-15 do not attend school.

**9.9 Poverty represents an impediment for participation in education.** The absolute poverty rate of households with children is 34 percent; 20 percent live in extreme poverty. Wealthy families' education expenditures are nearly four times higher than poor families; people living in cities spend about 2.7 times more than people living in villages. The expenditures of families from the lower quintile for foodstuffs, housing and public utilities represent about 73 percent of the family budget, while expenditures on education represent only 0.4 percent.<sup>16</sup>

**9.10 Regional disparities in education also persist.** Increasing access to post compulsory education is important. In 2006, an additional year of education in Moldova led to a 9.5 percent wage increase (all other factors remaining constant)<sup>17</sup>. Urban-rural discrepancies persist and poor students are less likely to seek post-compulsory education. Persistent disparities in enrollments starting from the final years of compulsory schooling and continuing into university education reinforces the process of poverty transmission from one generation to the next.

**9.11 Education quality continues to be faced with challenges.** The reliability of data on student achievement is poor, but the persistence of quality and relevance problems is indicated by previous substandard student performance in international evaluations<sup>18</sup> (particularly students from "Școli medii") and by the fact that most graduates are not employed in their field of education/ training. Low achievements indicate the need to continue, consolidate and extend reforms in curriculum, assessment, teacher training and textbooks. There is a need to establish an independent Agency to assess and monitor students' learning outcomes, the performance of each educational establishment and of the system as a whole. Non-relevant skills and knowledge indicate the need to align the education offerings to the needs of the economy. In higher education, measures are needed to modernize education in order for Moldova to be competitive and fully participate in the European Higher Education Space.

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<sup>16</sup> Baseline Study on Basic Education from the Perspective of Child Friendly Schools, Ministry of Education and Youth and UNICEF, Chisinau, 2008

<sup>17</sup> Final Analysis of Constraints to Economic Growth, Republic of Moldova, V. Bozu, D. Caragia, I. Gotisan,

<sup>18</sup> TIMSS 2003

9.12 **Quality is also affected by outdated methods of discipline.** Corporal punishment, scolding, belittling and shaming is perceived as acceptable disciplinary methods, not only by the majority of school administrators and teachers, but by students and parents as well. It would take a focused, well-targeted, systematic and well-organized effort to change these opinions and improve the overall ethos and atmosphere in schools.

9.13 **Policymaking has to be based on evidence and needs.** Accurate and timely data and information need to be available to assure that good progress in policymaking continues. Moldova needs a good Education Management Information System (EMIS) that would include education statistics and results from various student evaluations and would allow for timely analyses to inform policy and decision making. Especially in times of economic crisis, policies have to focus on the main priorities rather than being spread in too many unrealistic directions (such as setting up an independent school inspection). Since the Ministry of Education and Youth (MEY) functions with limited staffing, delegation and decentralization are needed for effective policy-level management. There is a need to decentralize authority and increase school autonomy, giving to the school board the flexibility to use the budget, and involving parents and communities in school decisions.

## **Policy Suggestions**

### *Short-Term Measures*

9.14 **Revising outdated norms and procedures in education is urgently needed to improve quality and efficiency.** Current norms such as “up to 25 students per class” leave room for abuses such as small classes being formed in order to artificially generate more staffing needs and justify the functioning of schools with a small number of students. Stricter norms that are closer to international standards should be adopted immediately (Table 3). Part of the problem could be solved through immediate promulgation and implementation of the Education Code that states that classes should have 20-25 students (establishing a lower limit of 20 students), exemptions being allowed only with the approval of the Ministry of Finance and the Ministry of Education.. In the immediate short run, implementing the norm could create room in the education budget to assist the sector in the fiscal crisis has hit Moldova.

**Table 3. Best Case Norms on Class Sizes**

	OECD	EU	Moldova
Average class size primary education	21.7	20.3	16.6
Average class size lower secondary education	24	22.5	18.4
Students teacher ratio	18	18	11.8 (Causeni) 10.8 <sup>19</sup> (Riscani)
Percent of non teaching staff of the total teaching and non teaching staff in primary and secondary schools	30	27	40.4 (non-teaching staff in primary and secondary schools)

9.15 **Cost-recovery measures should be promoted, particularly in vocational education, preschools and higher education.** Public expenditure support and subsidies should go only to the disadvantaged categories, while students from prosperous families should be charged fees, particularly for food and lodging.

9.16 **The Strategy for Reform of the Residential Care System (optimization of boarding school system) needs to be fully implemented.** In short-term measures, this Strategy calls for retirement of all school staff over the retirement age, and moratorium on new admissions to several boarding schools with appalling conditions.

9.17 **The work of Psycho-pedagogical Committees needs to be reviewed.** Measures to prevent children with no impairments affecting their learning abilities from being placed in special schools need to be enforced immediately. Reversely, the measures to adequately educate children with mild/moderate impairments in general ed. schools, i.e. introduction of resource classrooms, need to be implemented

#### *Medium-Term Measures*

9.18 **The optimization of the school network should be accelerated to release funds currently blocked by maintaining schools with excess space, excess teachers and non-teaching staff and high recurrent costs.** Released school space could be used for compatible activities (e.g. setting up preschools or Community Centers<sup>20</sup>). Where conditions permit, school

<sup>19</sup> The Ministry of Education and Youth was unable to provide data at the country level but these two rayons for which data is available are the pilot rayons for school optimization.

<sup>20</sup> Community Centers were officially included in the new Code on Education as a type of pre-school education along with kindergartens and crèches

buses could be used, but not for students in primary education. At present, 230<sup>21</sup> localities do not have preschools, and only about 52 percent of children between the ages of one to six years attend preschools (80 percent of five- and six-year olds). Excess space from schools could be used for setting up preschools or Community Centers, especially where contributions from local communities for running costs are forthcoming. Savings through optimization could also be used to increase basic salaries of poorly paid teaching staff. Evaluation of the physical condition of school buildings is needed, especially of those from localities with residential institutions, to identify the buildings that need reconstruction work in order to create appropriate conditions for physically disabled children. Channel the finances earmarked for the future maintenance of unused spaces towards the improvement of water, sewerage and heating systems.

**9.19 Measures need to be undertaken to improve the statistical data on education.** Exact definitions, computation methodologies, and procedures for collection and processing of data are needed regarding pupils' absenteeism and school abandonment, teachers' absences from classes, replacement of teaching staff who cannot teach the planned lessons, and making up missed classes. Line ministries and other central public authorities need to revise the framework of statistical indicators in the area of education, harmonizing it with European and global indicators. For valid monitoring of developments in the education field, net enrolment rates will be used again, this data being available to all stakeholders: parents, central and local authorities, local communities, teaching staff, professional associations and civil society.

**9.20 Improvements to the legal framework are needed to clearly establish the accountability of all stakeholders—parents, educational units, and local public authorities—to combat non-enrolment, abandonment and non-attendance.** The regulations of educational units and job descriptions of school managers should include provisions on reporting and combating these phenomena.

**9.21 Education management and financing should be aligned with clear levels of responsibilities.** At present, the Law of Education/Education Code, the draft Law of Administrative Decentralization and the Law on Local Public Finance are not correlated. Managerial authority should be delegated to schools, while other decision making levels play a quality control role. Normative and legal acts to explicitly regulate what school services and facilities are provided for free by the State and which of them can be provided by parents should be developed. The contributions made by parents could be depersonalized by creating funds of anonymous payments, funds that would be managed by external tutorial committees. Provisions oriented towards combating informal payments should be included in the school regulations, job descriptions, and activity guidelines.

**9.22 The introduction of an adequate financing formula will ensure a more equitable and efficient distribution of resources to increase access to education.** The reform processes recently initiated in preschools should be continued, paying particular attention to the access of children from vulnerable families. Measures to increase teacher salaries should also be

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<sup>21</sup> Source: MEY, 2009

continued, provided they are accompanied by measures to align the number of teachers with the declining student population and to link payment to teaching performance. Social protection measures should focus on disadvantaged students (particularly those left behind by migrant parents) and promote cost-recovery measures.

**9.23 The curriculum reform needs to continue, capitalizing on the good progress achieved so far.** Improving the quality of the curriculum in the basic and general secondary education should include ensuring the relevance of the skills of graduates, revising assessments to align them to a competence-based curriculum, and assuring effective participation in international evaluations. Curriculum revisions need to address persistent issues, including the use of a highly overloaded curriculum, the missing horizontal correlation between various subjects, outdated and overloaded textbooks, and the lack of alignment between school inspections, teaching practices and student evaluation. The revised curriculum should also include the acquisition of life skills, particularly relevant given high migration, the trafficking of women and children, and children living in single or no parent homes. Integrating ICT in education, as a subject matter and as a tool for the delivery of education in all areas and at all levels, holds great promise for Moldova in an increasingly knowledge-based global economy.

**9.24 Teacher training needs to be improved to respond to schools' needs.** Teacher training has been exclusively confined to traditional approaches and oriented to individual needs. The alternative, school-based teacher training needs to be promoted. This type of training is aimed at changing the school culture to promote effective schools by having teachers jointly look for solutions and work together on student-centered teaching methods. At the same time student-centered teaching methods need to be a compulsory part of teacher pre-service training.

**9.25 A system of quality assurance and accreditation is needed.** In primary and secondary education, quality assurance through standardized assessment, inspections and teacher training is efficient. In higher education, an Accreditation and Quality Assurance Agency is needed.

**9.26 The quality and relevance of vocational and higher education needs to be improved through comprehensive reform.** This process should revisit whether the public system is best situated to be the only or major provider of vocational education and training and higher education. The premature allocation of students to vocational streams should be avoided, and the strengthening of secondary education should be the primary focus. Of particular importance in the reform effort are partnerships with interested actors, especially with employers who should be actively involved in education and training. Deeper ties with the private sector can improve the quality of education and increase employability, while providing firms easy access to skilled workers.

**9.27 Inclusive education must be introduced.** All pre-schools and primary and secondary schools must be equipped and prepared to appropriately address the needs of children with mild/moderate learning impairments. That includes introduction of resource teachers and classrooms, adaptations and modifications to regular curriculum and grading system and training of teachers in effective teaching methodologies that best suit all student's learning needs. The Strategy for Reform of the Residential Care System medium term measures must be implemented. This includes the closure of 5 boarding schools over the next 5 year period, and the

transformation of 12 boarding schools into community centers. The work of Psycho-pedagogical Committees needs to be reviewed. Measures to prevent children with no impairments affecting their learning abilities from being placed in special schools need to be enforced.

## HEALTH

### Context

9.28 **Moldova embarked on a health sector reform at the end of the 1990s.** At that time, health sector indicators were deteriorating and public financing of the health sector accounted for only 2.9 percent of GDP. The reforms focused on extending and strengthening the primary health care (PHC) network. Health infrastructure was consolidated to increase efficiency; health insurance was introduced to make health care more affordable for the population; and hospitals became autonomous institutions. By 2008, public health expenditures recovered to 5.6 percent of GDP. Average per capita health spending at 1833 lei has reached the highest levels since independence. Key improvements in health indicators have also been realized.

### Key Challenges

9.29 **Despite improvements, health indicators remain well below EU averages.** Moldovan average life expectancy is 69 years, 10 years shorter than the average for EU countries, and 5 years shorter than for new EU-10 nationals, respectively (Table 4). Moldova's health sector reforms, while substantial, are not yet complete. There has been notable progress: for example, child and maternal mortality has declined. Nevertheless, there are inequities across the country related health indicators, for example the infant mortality rate varies from 3,9 per 1,000 live-births to 18,9; chronic diseases such as cardiovascular diseases and cancer cause double the share of avoidable mortality in the working age population as in the EU-10. The re-emergence of tuberculosis and the emergence of HIV/AIDS pose serious risks to the population. An economic and financial crisis could worsen health outcomes. There is therefore a need for continued improvements in efficiency and equity in health financing and provision.

**Table 4: Life Expectancy, Mortality and Morbidity relative to EU and new EU-10**

Indicators	Republic of Moldova	EU	EU-10
Life expectancy at birth	68.95 years	10 years higher	5 years higher
Male	65.15	10 years higher	5 years higher
Female	72.74	10 years higher	5 years higher
Under 5 mortality rate	14.04	Almost 3 times lower	1.6 times lower
Infant mortality rate	11.27	2.5 times lower	1.5 times lower
Maternal mortality rate	18.43	3 times lower	2.5 times lower
TB incidence	135.79	9 times lower	3.5 times lower
HIV incidence	17.32	3 times lower	7.5 times lower
Cancer incidence (2005)	193.37	2.5 times higher	2.1 times higher

*Improving Efficiency, Quality, and Equity in Health Financing and Provision*

**9.30 Introduction of health insurance has improved access and financial protection, but there are gaps in coverage.** Health insurance now covers 74.2 percent of the population and state budget contributions account for nearly 60 percent of total National Health Insurance Company (NHIC) revenues<sup>22</sup>. However the introduction of health insurance has not broadened the base of contributors to include adequately the self-employed and the non-working population of working age not covered by the state (only 5 percent have policies). Furthermore, the current system has resulted in adverse selection (i.e. the purchasing of policies by persons at high risk of illness). One-third of those in the poorest income quintile have no insurance coverage. Uninsured persons have poor access to health services – in 2007, only 9.1 percent among this group utilized health services (including inpatient care use) compared with 13.2 percent among employees, 16.6 percent among the non-working insured population, and 23.7 percent among the self-insured. Additional expenses for treatment, and in particular for the procurement of medicines, limits the access of children from poor families to medical care services.<sup>23</sup>

**9.31 Out-of-pocket payments are high and drug costs are a major contributor to the lack of financial protection.** The public subsidies for health insurance helped decrease the share of private expenditure in total financing of the health system from 50 percent in 2005 to 46.8

<sup>22</sup> State budget contributions to NHIC cover the certain population groups including students, children, pregnant women, unemployed, non-working pensioners and disabled.

<sup>23</sup> Child Poverty Report, NBS, 2008

percent (98% of which was direct out-of-pocket payments to facilities) in 2008. However, as only a few medicines and consumables are compensated for under the health insurance benefit package, medicines and consumables account for a large share—over 72 percent—of out-of-pocket spending. This is further exacerbated by poor prescribing patterns and corrupt practices.

**9.32 The present provider payment system funds inputs and does not reward performance.** Improvements in budget management and contracting could enhance the benefits from the reforms in health financing. The NHIC has established basic structures for contracting and paying providers. Contracts that pay for meeting specific objectives in terms of costs per unit of service and the quality of service motivate managers of health facilities. The NHIC needs to strengthen its capacity to manage such contracts.

**9.33 Access to quality health care services remains skewed in favor of the largely better-off urban and insured population.** At the primary care level, a network of 2,066 family physicians delivers basic services, and 89 percent of the population visits a family physician. However, coverage rates vary from around 99 percent in Chisinau to less than 65 percent in Cantemir, Rezina, Cimislia, and Falesti districts. Furthermore, a significant number of primary care centers, especially in rural areas, lack standard medical equipment.

**9.34 Further consolidation of the health care infrastructure is still needed.** At present, excess capacity is concentrated in cities and especially in Chisinau, as past hospital consolidation focused on rayon hospitals. Hospitals are in poor condition. The level of equipment obsolescence ranges from 60 percent in Republican institutions to 80 percent in rayons. In rayonal facilities, 20 percent of medical equipment is not working, while in Republican hospitals 10 percent of the equipment is not working.

**9.35 The lack of nurses and doctors leads to poor quality care.** At municipal hospitals, the low ratio of nurses to doctors is a concern. Just as seriously, the number of family doctors in Moldova decreased by 3 percent over the past several years and almost 30 percent of rural primary care facilities have no doctors. The average age of family physicians is about 47 and few young physicians are entering family practice. As a result, urban families visit doctors 80 percent more often than rural families. Doctor shortages could be addressed through incentives, such as increased wages, to encourage new medical graduates to enter family practice or to locate in rural areas.

**9.36 Informal payments for healthcare are commonplace.** Informal copayments totaled around 284.6 million lei in 2007, a large amount for a relatively small country.<sup>24</sup> Twenty-two percent of payments to hospitals and 32 percent of payments for out-patient consultations were unofficial. While user satisfaction with health services increased with the introduction of health insurance, dissatisfaction persisted as more than 60 percent of households perceived that corruption is widely prevalent. The 2007 study completed by the Joint Project of the European Commission and Council of Europe against corruption, money laundering and terrorism

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<sup>24</sup> Household Budget Survey, 2007.

financing in the Republic of Moldova<sup>25</sup> revealed that households believe the main causes of corruption are: low salaries of public servants (23 percent), a lack of internal controls by institutions (18 percent) and imperfect legislation (13 percent). Evidence from the Kyrgyz Republic shows that good contract management combined with a transparent co-payment structure can help reduce informal payments (Box 2).

## Policy Suggestions

**9.37 Key national public health programs should be protected from budget cuts in the event of a financial crisis.** These include: i) immunization programs; (ii) insulin for diabetic patients, and (iii) TB and HIV/AIDS programs covered by the budget (in Moldova, a bulk of these expenses are covered by the Global Fund). In addition, the Government currently does allow some free provision for the uninsured, co-financed from the national budget and subsidized by NHIC's pool for the uninsured. This too should be protected.

9.38 Ongoing reforms in the sector which aim to address the key issues mentioned above should also continue. These include the following:

- *Increasing insurance coverage and improved targeting of state contributions to the NHIC.* The government is currently developing a strategy for increasing insurance coverage for the uninsured as well as improving the targeting of current budget transfers to NHIC. Some options have already been initiated. Recently, the government revised the health insurance law to cover under the state budget those currently under the new targeted social assistance scheme. Given the important differences in access between insured and uninsured populations, improved insurance coverage in rural/disadvantaged areas would have an important impact on equity of access.
- *Strengthening the purchasing capacity of the NHIC.*
  - *In the short term:* (i) inclusion of risk adjustment principles should be included into norms of per capita funding of primary health care, (ii) development of new case based payment systems in hospitals to ensure that perverse incentives are not introduced either to over-provide or under-provide care given the possibility that current tariffs do not cover the full cost of treatment, (iii) development of health insurance and health care provider information systems to capture all services provided for both insured and uninsured, (iv) further development of the accreditation process and link results to the contracting of providers and (v) normalizing informal payments through a simple and well advertised co-payment formula.

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<sup>25</sup> As reported in Ostaf, Burlacu and Menon (2007) "Establishing accountable health institutions in Moldova".

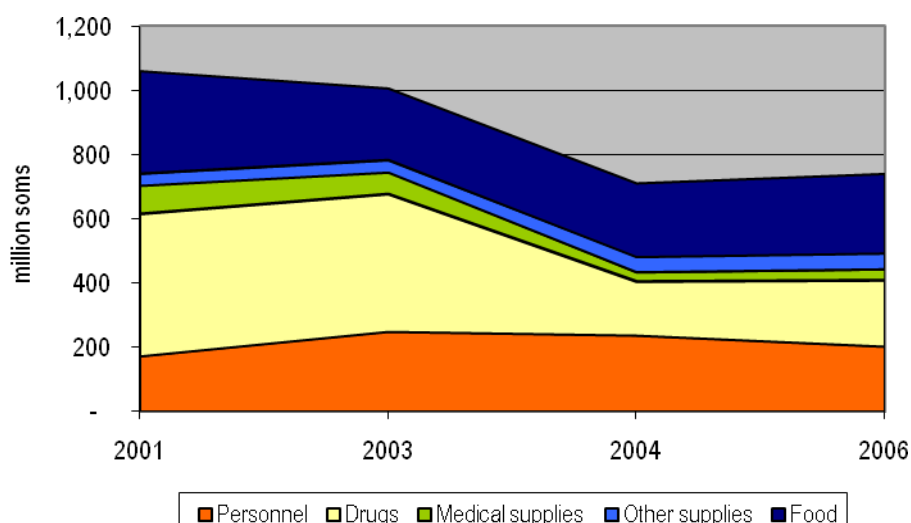
## Box 2. Reducing Financial Burden in the Health Sector, the Case of the Kyrgyz Republic

The Kyrgyz Republic introduced far reaching health financing reforms starting in 1996 as part of its comprehensive Manas and Manas taalimi Health Sector Reform Programs. Reducing the financial burden of health care seeking was one of the objectives of the reforms. Given the limited fiscal space it was clear that the health sector will not have additional public funds to reduce patient expenditures. The large hospital sector had to be downsized in order to achieve efficiency gains and re-channel savings to medicines, medical supplies and better paid personnel in order to reduce out-of-pocket payments for these items.

The reforms thus aimed at reducing informal payments and patient financial burden including four building blocks: pooling of health financing, introduction of prospective payment mechanisms, downsizing of the hospital sector and regulating entitlements through an explicit definition of a State Guaranteed Benefit Program. To increase the effectiveness of implementing the co-payment policy, public relations campaigns were conducted mostly through the mass media informing patients of their rights. Co-payment rates were displayed in all health care facilities next to the cashier's office. Hospital departments were requested to publicly hang a poster with a list of drugs they ought to have in stock and a daily checkmark on whether they do have it on stock. Hotlines numbers of the Mandatory Health Insurance Fund were displayed in hospitals to report abuse.

Evaluation of the co-payment policy shows that overall informal payment for hospitalizations reduced significantly between 2001 and 2006 from over KGS1.06 billion soms to KGS740 million in real terms (see Figure below). This reduction was driven by a reduction in informal payment for medicines and medical supplies. In contrast, there has been no reduction in patient payments to medical personnel. In addition, despite the introduction of formal copayments, the total volume of patient payments declined to KGS740 million (at 2001 prices) by 2006, a decline by KGS319 million in real terms or by 30%.

**Trends in total volume of informal payments in Kyrgyz Republic, 2001-06**



Source: Jakab, M. and J. Kutzin (2009). "Improving Financial Protection in Kyrgyzstan through Reducing Informal Payments: Evidence from 2001-2006," WHO.

- *In the medium term:* (i) incorporating a standard set of quality/performance indicators into all contracts with providers, differentiated by provider, and the results linked to incentive payments. (ii) gradually rolling out the national programs, including chronic and infectious diseases, into the budget of the NHIC; (iii) introducing incentives for insured members to reduce risk behavior by offering subsidized health promotion programs or financial incentives for employers; and (iv) transferring capital budgets increasingly to health care providers through the health insurance fund payments. Introducing approaches to promote efficiency, quality, and user satisfaction in the provider network.
  - *In the short term:* (i) continued focus on enhancement of primary care facilities and ensuring availability of basic medical equipment in all centers; (ii) introduction of the concept of hospital networking (iii) investment in Republican hospitals identified as Centers of Excellence while facilitating consolidation of the republican and municipal facilities in Chisinau and (iv) encouraging a role for the private sector in funding as well as provision of services, (y) strengthen intersectorial collaboration in order to reach the most vulnerable population
  - *In the medium term:* (i) changing internal remuneration schemes so that incentives are aligned with performance of the facility in the context of NHIC contracts with performance-based incentives; (ii) consolidation and restructuring of hospitals based on the national hospital master plan; and (iii) mainstreaming ICT into the provision and management of healthcare to extend reach, improve health outcomes, and enhance efficiency.
  
- Reducing unnecessary out-of pocket spending on pharmaceuticals.
  - *In the short term,* prescribing, pricing and reimbursement mechanisms should be reviewed. For reimbursement, the lists of drugs could be established based on the evidence of therapeutic value and cost-effectiveness. The regulation on private sector pharmacies should be strengthened, using certification and licensing mechanisms to promote quality control and minimum standards.
  - *In the medium term,* the benefits package should be expanded to cover drug costs for the poor. In addition, pharmaceutical audits by NHIC could be introduced to review prescribing patterns and to reduce corrupt practices such as kickbacks from pharmacies to providers which encourage over-prescribing.

## X. INFRASTRUCTURE

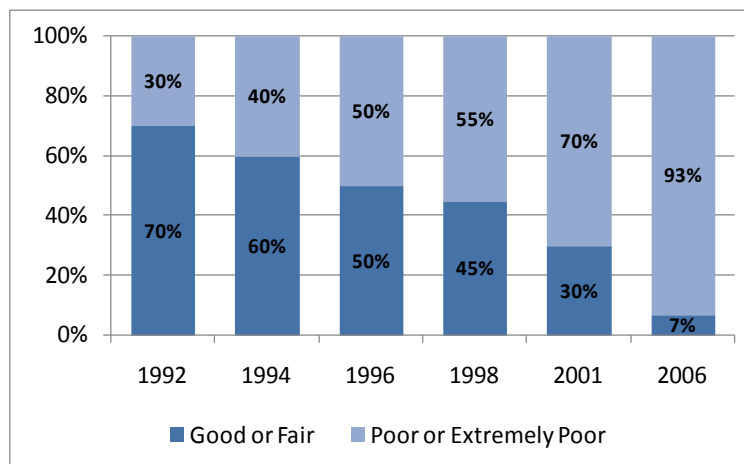
### ROAD SUBSECTOR

#### Context

10.1 Considering the size of Moldova and its population, the road network size is roughly adequate, with little or no need for expansion. Moldova has a road network totaling about 16.800 km, of which 22 percent are classified as National Roads and the remainder of 78 percent as Local Roads. This network has been built up gradually over the past seventy years through massive public investments. If Moldova had no roads and today's network needed to be constructed from scratch, it would cost at least US\$ 12.7 billion. This figure shows the huge magnitude of investment and sacrifice which was made in the past in order to be able to reap the benefits from today's road network.

10.2 **Moldova's road network is not in good condition.** If Moldova's road network had been maintained adequately, most roads would be in good condition, a few in fair condition, but none in poor condition. In that hypothetical case, the asset value of the Moldovan road network would be close to US\$ 12 billion. However, about 58 percent of national roads are classified as poor. For local roads the situation is worse, with 75 percent estimated to be in poor condition. Only 10 percent of national roads and about 5 percent of local roads are in good condition. For any country, and especially for a European country, this is a very bad situation. It is the direct result of severe neglect of the road network, mostly during the past 15 years. Very few resources have been spent for road maintenance and rehabilitation since 1991. About 400 km of formerly paved roads have lost their pavement and have reverted to unpaved gravel or earth roads. Figure 5 shows the evolution of road conditions in recent years.

**Figure 5. Condition of National Roads**



**10.3 The lack of road maintenance and rehabilitation in the past 15 years has led to a massive physical deterioration and therefore to a heavy loss of road network asset value.** The present asset value of the Moldovan road network is only about US\$ 8.4 billion; instead of the US\$ 12 billion it would be if the network was well-maintained. This means that the loss of road network asset value which resulted from insufficient maintenance and rehabilitation amounts to roughly US\$ 3.6 billion, equivalent to almost the entire average annual GDP of Moldova over the past five years.

**10.4 An urgent and important effort is needed to save what is left and to gradually improve the road network, without which sustained economic and social development will not be possible.** There is no doubt that the road network is still Moldova's single most important national asset, larger in value than all power plants, railway lines and the electricity grid combined.

### **Key Challenges**

**10.5 In the short and medium term, there are four main challenges for the Government of Moldova in the Road Sector:** (i) to mobilize the investment funding needed to rehabilitate the road network, (ii) in parallel, to mobilize the funding needed for the current maintenance of roads, (iii) to reorganize the way road maintenance is carried out, and (iv) to establish a system of axle load controls, to avoid overloaded trucks continuing to destroy the roads. All these four challenges are linked, and they have been defined by the Government as key priorities in the Government's "Land Transport Infrastructure Strategy" of 2007 and also in the "National Development Strategy 2008 – 2011."

- *Challenge 1. Mobilization of road investment funds.* Moldova cannot mobilize the massive investment needs for road rehabilitation from internal sources. External resources are needed. Given the present circumstances of the global financial crisis, private sector funding for roads is unlikely to materialize for some time. International Financial Institutions (IFIs) therefore seem to be the only possible source for the needed large-scale investment funding in the road sector. In fact, since 2005, several external partners and IFIs have geared up to provide coordinated funding for Moldova's roads: the World Bank, EBRD, EIB, MCC and the EC. With the support from those partners, the Government has prepared the Land Transport Infrastructure Strategy (LTIS), which includes a prioritized investment plan that also defines the key sector reforms needed. The challenge for the Government is to ensure the continued support by those external partners, by actually implementing its own LTIS and demonstrating good management in the Road sector. There has been very little action by the Government towards the actual implementation of the key sector reform measures outlined in the LTIS, and external partners are increasingly concerned about this fact. The Ministry of Construction and Territorial Development (MCTD) is responsible for the Road Sector but has shown very little leadership in actually implementing the reforms outlined in the Government's LTIS.
- *Challenge 2. Mobilization of road maintenance funds.* The Government's LTIS identifies the fuel excise tax as the principal revenue source for road maintenance. Present tax levels could generate sufficient revenue to adequately fund road maintenance. The Prime Minister

of Moldova confirmed in a 2007 letter to the IFIs active in the road sector that at least 80 percent of the fuel excise tax would be allocated for road maintenance, resulting in at least MDL 450 million for road maintenance. However, this has not materialized, and in the 2009 budget, only about 30 percent of the fuel excise tax is allocated for road maintenance. This has seriously eroded the confidence by Moldova's external partners that the Government will be able to assure the sustainability of the investments in roads funded by them.

- *Challenge 3. Reorganization of the road maintenance system.* The MCTD is in charge of the general planning and oversight of Moldova's roads; it has a very small Roads Department within its organizational structure. The MCTD controls the State Road Administration (SRA), a corporatized road agency responsible for executing road maintenance, road investments and road safety. The SRA controls 40 (essentially state-owned) district road maintenance firms located throughout the country. Every year, the SRA allocates relatively small amounts of money to each of those firms through a maintenance contract, which the firms use for routine maintenance tasks. In their present form, these firms are not viable as commercial entities; they operate without making any profit and are unable to replace their old and mostly obsolete equipment. It is unclear how they can survive for much longer. The district road maintenance firms do however play a very important role, because they assure routine maintenance and winter maintenance at a basic level and at a low cost, and thus ensure at least a minimum service level for road users. A reform of the system is also indicated as a priority measure in the Government's LTIS, but little or no action towards this goal has taken place since the LTIS was formally adopted.
- *Challenge 4. Establishment of a system of axle load controls, to avoid overloaded trucks continuing to destroy the roads.* Most of Moldova's roads were designed for axle loads of about six to eight tons. Today's legal axle load limit in Moldova is however ten tons for National Roads and six to eight tons for other roads, and it is certain that many trucks circulate with axle loads significantly higher than that. (The EU axle load limit is 11.5 tons.) At the same time, the lack of investment and maintenance of Moldova's roads over the past 15 years has led to a weakening of existing road structures, making the roads highly vulnerable to structural damage from overloaded trucks. The only public vehicle weight stations in Moldova are at the borders, and they are used exclusively to determine transit fees for trucks, but not to protect the road network. The LTIS identifies the design and implementation of an axle load control system as a priority reform measure, which is to be carried out under World Bank funded Road Sector Program Support Project. The introduction of an axle load control system (possibly through mobile brigades to carry out axle load controls throughout the road network) has to be combined with the introduction of a legal framework to cover this activity and the imposition of sanctions for overloading. These measures should be put in place in consultation with major road users such as truckers associations, and factories which are sources of heavy cargo (cement and steel factories, etc.). The decisive leadership of the MCTD will be needed to bring this activity to a successful implementation.

## Policy Suggestions

10.6 **At the present time of economic and financial crisis, the Government should not succumb to the temptation to cut most of the spending for maintenance and rehabilitation of roads.** The effect of such a policy was already demonstrated in the years after Moldova's independence and it has led to the widespread and serious deterioration of the road network that we still see today. A return to a policy of little or no road maintenance and rehabilitation, at a time when roads are already bad, could lead to an even more profound future road infrastructure crisis, which may thwart future economic recovery for many years to come.

10.7 **The Government should implement the key policy measures to which it has already committed itself in the 2007 Land Transport Infrastructure Strategy.** The 2007 LTIS continues to constitute a valid and up-to-date platform that includes all the key policy orientations and measures for Moldova's Road Sector. The LTIS was developed in close coordination with Moldova's external partners (WB, EBRD, EIB, MCC and EC) who are in principle ready to support the Government through very substantial funding for road investments.

10.8 **The procurement of road works must be handled in full accordance with the applicable procurement guidelines.** The recent misprocurement of two major works contracts which were to be funded by the World Bank and the EBRD has led to the cancellation of already committed external funding of about €1 million. This has sent a very negative signal to other actual and potential external partners, who are starting to question their planned future involvement in Moldova's road sector. The State Road Agency, which is in charge of handling procurement for roads, must be allowed to operate without interference.

10.9 **The leadership role of the Ministry of Construction and Territorial Development should be strengthened.** The very small Roads Department within the MCTD seems to be fully absorbed in the daily routine tasks of road administration, without having the capacity to actively take on its intended role of defining and implementing Road Sector policy and strategy. This has led to the situation in which the implementation of the policy measures adopted through the LTIS has not moved forward. This in turn has resulted in doubts by Moldova's external partners about the Government's true commitment to its own Road Sector strategy. Additional qualified staff with good knowledge of the road sector are needed and should be hired as soon as possible. This weakness of the MCTD's Roads Department and the need to hire additional staff is also identified in the LTIS.

## ENERGY

### Context

10.10 **Moldova's economy is vulnerable to external energy price shock.** This vulnerability is due to the country's dependence on imported natural gas which covers about two thirds of the country's primary energy needs. Despite a relatively low level of energy consumption per capita, Moldova's economy has high energy intensity, using twice as much energy per unit of GDP (at PPP rate) than Romania and three times more than the EU average. While significant

institutional reforms in the late 1990s helped improve the performance of the energy sector, improve the regulatory environment and attract private investors (three out of five power distribution companies were privatized in 2000), the sector reforms are far from being complete. The recent increase in energy import prices has contributed to the accumulation of new debts, mainly in the district heating in Chisinau where current heating tariffs cover only about 70 percent of the cost. The price of imported natural gas is expected to reach the EU parity level by 2011. Despite the price increase, natural gas will remain the most competitive fuel for heating and electricity generation given the existing energy infrastructure. Pricing reform and support for the downstream impacts need to be urgently addressed.

**10.11 In 2009, Moldova will have a window of opportunity to reduce its energy vulnerability.** The price of imported natural gas reached US\$332 per mcm (thousand cubic meters) in the first quarter of 2009, but it is expected to decline to about US\$170 per mcm by the fourth quarter of 2009. The price of gas imports in 2010 is difficult to forecast because it will depend on the price of oil at the world market in the second half of 2009, but it is likely that it will not decline further. Therefore, Moldova has a window of opportunity to adjust energy tariffs (primarily for the heat supply in Chisinau) to the cost recovery level and eliminate subsidies in a favourable environment of declining gas prices which would help minimize the risk of negative impacts on the most vulnerable consumers. This would also help achieve objectives of the Government's Energy Strategy (adopted in 2008) including full membership in Energy Community Treaty (ECT).

### **Key Challenges**

**10.12 Energy prices need to be put on a sustainable path as soon as possible.** The country needs a sustainable growth strategy, recognizing that it is unlikely that remittance flows will continue to grow very rapidly. If Moldova is to reduce poverty and improve the standard of living of its citizens, growth will need to accelerate and be sustained. When the world emerges from the current financial/economic crisis, it is expected that the level of competition will be much more acute, necessitating that a robust investment climate be established now, to position Moldova to compete in the future. Investments in infrastructure now will help deal with unemployment issues (as construction is labor intensive) and help attract private investors in productive sectors in the future. Furthermore, it is important that labor, energy and investment have the right price signals to foster growth in areas where Moldova can be competitive.

**10.13 In 2009, Moldova should take steps to reduce its energy vulnerability.** The price of imported natural gas reached US\$332 per mcm (thousand cubic meters) in the first quarter of 2009, but it is expected to decline to about US\$170 per mcm by the fourth quarter of 2009. The long-term forecast for oil and gas prices are fraught with uncertainty. However, given the vulnerability of the economy to energy import prices, Moldova should adopt a four-fold strategy: (i) set prices to fully reflect the cost of supply; (ii) diversify the source of supply of primary energy; and (iii) actively support investments in high return energy efficiency options; and (iv) improve the targeting of energy price support for the poor. Given the slowdown in global economic growth and the impacts on Moldova's fiscal deficit, and hence the ability to subsidize energy prices, these reforms need to be urgently addressed. Such reforms would also help achieve objectives of the Government's Energy Strategy. The challenge will be the sequencing

of the reforms to support economic growth while providing opportunities for increased employment.

## **Policy Suggestions**

**10.14 The task of reducing energy vulnerability must focus on price reforms to include improvements in efficiency, reducing energy waste, and diversifying energy supply sources—all of which require significant investments.** In order to meet challenges in the energy sector, the policy response of the Government should focus on: (i) consolidating the energy sector reform, including the adoption of new energy legislation and further harmonization of the legal and regulatory framework with the EU energy directives and best practices; (ii) maintaining financial discipline while adjusting energy tariffs to the full cost recovery level; (iii) approving and ensuring adequate implementation of the Energy Efficiency Action Plan, including measures to facilitate investments in energy efficiency and alternative (renewable) energy resources; and (iv) strengthening institutional capacity in the government for policy making and contingency planning in the energy sector, particularly from the point of view of protecting the most vulnerable population groups.

**10.15 The first step towards implementing the reform agenda would focus on the legal and regulatory framework.** Legal harmonization of the energy sector in Moldova with the EU energy directives and membership in ECT would require adoption of new Electricity and Gas Laws. The Government prepared draft Laws which are currently under review by EC-funded experts and other donors including the World Bank. Preliminary results of this review indicate that the Electricity Law needs further improvements in aligning with the ECT requirements in several areas, including provisions for: (i) cross-border electricity trade and congestion management; (ii) balancing market and settlement rules; and (iii) gradual power market opening. In addition, a review of complementary regulatory reform and subsidiary legislation should be conducted to ensure that the implementation of the legal framework would be effective. Adoption of new electricity and gas legislation fully aligned with the ECT legislation in 2009 would pave the way for the integration of Moldova in the EU energy market and facilitate investments in the energy sector. This is particularly important for investments related to electricity and gas transits and exports.

**10.16 As energy prices are adjusted to fully reflect the cost of supply, accelerated support for energy efficiency and alternative sources of energy supply should be assigned a high priority.** The Government has not yet made progress in finalizing and adopting an Energy Efficiency Program based on the draft prepared in 2008. As indicated above, because of the global economic collapse, the implementation of reforms is urgently needed. Investments in a comprehensive energy efficiency program tend to be low cost, high return options that are labor intensive. Pricing reform is a necessary, but insufficient step in implementing such a program. Countries that have succeeded in energy efficiency programs have focused on making this a priority at the highest levels of Government, establishing institutional support as well as strong governance (Box 3). The financing of such a program could be divided among bilateral donors who could partially finance the cost of upgrading housing for the poor, along with donor financing through local banks that would focus on the wealthier households and commercial entities.

### Box 3. Vilnius Energy Heat Demand Management Program

The Vilnius District Heating Company (VDHC) supplies heat to consumers in the city of Vilnius –Lithuania’s capital and largest city. In 2002, Vilniaus Energija (VE) a subsidiary of the French company Dalkia, took charge of VDHC’s operations under a 15 year lease agreement with the Vilnius Municipality (VM). Both VE and VM, with the financial support from the World’s Bank Global Environment Facility, decided to engage in a comprehensive Heat Demand Management Project.

Activities	Results	Achievements/ Main constraints
Objective : reduce the GHG emissions from the Vilnius District Heating System trough:	Between 2002 and 2008 GHG emissions were reduced by 23%, from 718 ktCO2 to 555 ktCO2	
(i) installation of building-level substations in residential buildings	Over new 3,000 building-level substations were installed, compared to an initial target of 2,733.	Commercial losses were reduced to practically zero; quality and reliability of heat supply improved
(ii) a demand-side management program allowing heat control and metering at the apartment level	79 buildings have been equipped, against an initial target of 550. Progress slowed after political support waned.	Average decrease in energy consumption was 20%. However, challenges in obtaining homeowners’ consensus within a multi-apartment building created bottlenecks.
(iii) creation of a commercially sustainable (revolving) financial facility - ECP Commercial Fund	A viable financial mechanism involving both commercial and public funds has been implemented under the project.	The fund was able to attract the participation of commercial banks.

The main lessons learned include:

Energy efficiency improvements in multi-apartment buildings are a challenging undertaking that requires collective decision making by homeowners. It takes a concerted effort by the government and the private sector to successfully promote energy efficiency in these buildings,

- Economic incentives work in multi-apartment buildings: apartments consumption-based billing for heat consume about 20% less energy than those where billing is based on the pro-rata amount of heat consumed by the entire building,
- Creating a commercially sustainable financial facility specializing in residential energy efficiency is a complex but manageable task. Creating the incentives for commercial banks to enter the scheme is the key to scaling up a program using low-cost capital as a catalyst,
- Commercial banks are more likely to enter and stay in the scheme when the government participates by financing a considerable portion of the investment costs and/or offers guarantees for their investments.

**10.17 An important first step will be the resolution of the district heating and energy consumption issues in Chisinau.** Measures must be included to resolve long-standing problems in Termocom. Such a program would include: (i) setting prices to fully reflect supply costs before the next heating season and transfer of the responsibility for District Heating tariff setting in Chisinau to ANRE; (ii) enabling investments in energy efficiency to support a demand-side response; (iii) upgrading the heat supply system to reduce costs and improve reliability; (iv) accelerating the program of improving the targeting of subsidies to the poor; (v) investments in the CHP plants to improve efficiency and decrease supply costs, DH pipeline replacement to reduce losses and installation of control systems at the end-user level to reduce waste; (vi) improved governance of the DH systems by implementing managements contracts and the necessary oversight; and (vii) establishing a communications program to support the broad-based reforms needed to successfully implement this program.

**10.18 The Bank recommends close cooperation between the municipal and national authorities regarding social safety nets in order to verify and optimize protection of the poor during adjustment of heat tariffs to cost recovery levels.** Current heat tariffs (540 Lei/Gcal) cover only about two thirds of the economic cost of heat supply in Chisinau, but it is likely that the cost recovery level will not increase in the next heating season. From the point of view of returning Termocom to financial viability, an important positive development was a recent decision of the city of Chisinau to stop providing implicit subsidies for heat supply through below cost heat tariffs, but to introduce targeted direct subsidies to most vulnerable consumers. Early results of the new approach indicate significant savings for the city budget, but this approach has proven to be relatively ineffective in protecting the poor due to the lengthy and costly application process. Continued improvements in the effectiveness of the program are warranted.

**10.19 The most challenging next step will be the resolution of debts accumulated in the district heating sector (by Termocom to the CHPs and Moldovagaz) which currently totals about 1.5 billion Lei.** The resolution of this problem should be undertaken as a two step process. First, the prices need to be set at a level to reflect the full cost of supply so that Termocom can become current with its costs. A possible merger of CHPs and Termocom in a Joint Stock Company would help facilitate the move to depoliticize DH tariff setting and would enable an environment for improved operating practices to decrease costs. Alternatively, changes to the legal framework to move the responsibility of DH tariff setting to ANRE would be a good first step, with the merger of CHPs and Termocom happening at a later date. The cost of repaying the outstanding debt of 1.5 billion Lei is too expensive to be passed on to the consumers at this time. It is recommended that the Government structure the repayment of this debt over a reasonable period of time and that the Government, with possible donor support, address the first few years of repayment on behalf of DH customers and that the Termocom start repaying these debts after the new investments mentioned above enable cost reductions which would provide the financial headroom to repay these long-term debts.

**10.20 The measures that the government could adopt to reduce the energy costs and alternatively increase revenues are:**

- *Implementing energy efficiency activities in both private and public sectors, including residential.* This would (i) reduce energy intensity/consumption which would lead to lower energy costs, reducing the burden on the budget for public institutions and freeing resources for businesses (energy consumption improvements are estimated in the range of 20-30 percent); (ii) reduce energy consumption in the housing stock could potentially lead to lower needs for targeted subsidies from the public budget; (iii) create of new business opportunities (ESCOs); (iv) help deal with unemployment since energy efficiency projects are labor intensive;
- *Optimizing new extensions of high voltage power grid.* The government and Moldelectrica should identify transmission lines that would secure increased interconnections and strengthen the national network. This optimization could potentially lead to financial benefits over the medium and long run for the country. In addition, this would keep good opportunities for job creation;
- *Developing new projects for renewables and biomass, particularly in the rural areas.* This could potentially reduce the energy costs for the public buildings, while at the same time creating new business opportunities and jobs.
- EE improvements and use of renewables/biomass could free some budget resources as part of the costs could be taken over by the private sector.

## WATER SUPPLY AND SANITATION

### Context

10.21 **The water supply and sanitation sector presents the greatest challenges of all infrastructure sectors because of its capital intensity.** Studies show that the ratio between fixed assets and annual revenue for water and wastewater systems is estimated to vary between 10 and 12 as compared to 7 for toll roads, 3-4 for power utilities, and 3 for telephone companies. The high ratio for the water and wastewater sector reflects the sector's capital intensity and the repressed tariff levels that are frequently kept low for political reasons.

10.22 **It is necessary to recognize that the financial revenue to operate and maintain the large asset base can only come from two sources:** (i) from user charges; and (ii) from subsidies, paid by domestic government budgets and/or by foreign concessionary assistance. Only few developing countries have had the foresight to apply tariff policies that enable their utilities to pay for operations and maintenance of assets and for debt service. More typically, most developing countries are caught in a vicious circle where user charges are repressed for political reasons so that no surplus is generated to maintain and expand assets. Only after years of deferred maintenance do the consequences manifest themselves in the form of excessive energy consumption, leakage, pipe rupture, and unsafe service quality.

10.23 **The quality and reliability of Moldova's water supply and wastewater services are generally deficient.** All urban settlements (municipalities and towns) in the country have piped water systems. In contrast, only about half of rural settlements (villages/communes) have piped

water. Yet, most systems have been in operation for more than 40 years with inadequate maintenance and have now reached a state of advanced disrepair. Similarly, although all urban settlements have piped wastewater collection systems, only few are being operated sustainably, and even fewer meet wastewater discharge standards. Only 40% of rural communities have rudimentary sewerage that has long since ceased functioning. The state of disrepair of the existing water and wastewater infrastructure is such that about 45% of all systems need major rehabilitation. This is the heritage of building energy-intensive systems with little regard to energy costs, and of neglecting maintenance.

**10.24 Over the past five years the Moldovan authorities, assisted by the Bank and other donors, have pursued an ambitious path of sector restructuring aimed at improving service coverage and quality, increasing the efficiency of service provision, and improving the sector's institutional arrangements.** To this end in 2005 the Government the Moldova approved a “National Program of Water Supply and Sanitation of localities of the Republic of Moldova until 2015” with the goal of meeting the targets of the Millennium Development Goals by 2015. Subsequently, the government updated its strategic agenda by approving in 2007 the “Strategy for water supply and sewerage of the localities of the Republic of Moldova, which determined the investment priorities based on three criteria: (i) the potential socio-economic benefits that water and waste water investments could produce; (ii) the costs of deteriorated services that would be avoided through maintaining the existing systems; and (iii) the technical and financial feasibility of needed investment projects.

## **Key challenges**

### *In the Short Term*

**10.25 Moldova's water supply and sanitation sector is facing increasing vulnerability due to rising energy prices.** Under the Soviet times large investments were made in water supply and wastewater systems with little thought of the costs of operating and maintaining them. The energy consumption is excessive in both production and distribution of water, as well as in the collection and treatment of wastewater. The cost of energy to run those systems designed and built to FSU may constitute up to 60% of total operating costs. New investments must help minimize the use of energy.

**10.26 Another challenge requiring prompt action is the cost recovery of operation and adequate maintenance costs of water supply and sanitation systems, and of the much needed investments for rehabilitation and extension of services.** The current mechanism of tariff setting is politicized since tariffs are approved by local public authorities. The government should take prompt actions to eliminate the political dimension in tariff setting and service regulation, as has been done in the electricity and natural gas sectors. This is imperative to ensure financial viability and sustainability of water supply and sanitation services.

#### **Box 4. Chile is the Benchmark in Adopting Efficient Tariff Policies**

Since 1989 Chile is forcing service providers to charge metered tariffs to consumers. The tariff has abolished cross subsidies and created a powerful incentive for utilities to connect poor households since they are guaranteed revenue for the sales to all consumers. The result has been 100% coverage with water in urban areas, and healthy operational surpluses. Low income consumers are required to pay as little as 15% of their water bill with the rest being paid from the central government social budget via the municipality. Water and sewerage tariffs have been adjusted four times since 1989 in accordance with the transparent tariff and regulatory laws and have made future operating surpluses predictable. The credible regulation made it possible for the government holding company to sell its share holdings in water and sewerage utilities to strategic private operators at a price of US\$ 400 per served inhabitant. The huge windfall for the government was applied to the social sectors in the country. Chile's tariff policies arguably explains the country's success in achieving near complete coverage of both water supply and wastewater services in urban areas and in creating a financially autonomous and professional sector. Moldova and the rest of the FSU countries would do well in learning from the Chile success in depoliticizing tariff setting, in making both production and consumption efficient, and in eliminating costly public subsidies that could better be applied in the social sectors that lack the water sector's ability to charge tariffs that cover the full costs of service.

**10.27 Fragmentation of foreign financial and technical assistance is yet another challenge in achieving visible improvements in sector operations.** The government should strengthen its efforts to consolidate and coordinate donor assistance in order to underpin the achievement of its own sector objectives. While each donor's financed project in part achieves sound results on the ground, the overall impact in improving the sustainability and quality of water and sanitation services is still marginal.

#### *In the Long Run*

**10.28 The challenge will be how to discontinue the past culture of building new capacities when the existing infrastructure is not being sustained.** To this end water supply and wastewater reforms must promote efficiency in production and consumption; sustainable services; and the provision of serving the poor whose health are most at risk. In order to make wastewater treatment affordable, there is an acute need to reduce energy intensity. This is only possible by overcoming the FSU legacy, where wastewater treatment was synonymous with energy intensive activated sludge plants, and by identifying modern energy-efficient technologies.

**10.29 Making water and sanitation services affordable is another medium and longer term challenge, particularly under the declining economic and financial environment, aggravated by continuous increase of energy prices.** To mitigate the impact of increasing costs of there is a strong need to build up an efficient social safety net that will help the poor, who cannot afford to pay the full cost of services.

**10.30 Maintaining adequate institutional arrangements is crucial to achieving the targets specified in the strategic documents.** Frequent changes in the government structure and transfer and/or fragmentation of sector responsibilities along with weakened governance send wrong

signals to the investment community, both to donors of concessionary aid and even more to potential private investors.

## Policy recommendations

### *In the Short Term*

10.31 It is recommended that that authorities undertake the following steps to halt further degradation of water supply and sanitation services and set the path for recovery and sustainable development:

- *Improve energy efficiency.* The recent Bank-financed Pilot Water Supply and Sanitation Project showed that investing in higher energy efficiency can reduce energy consumption up to 35 percent. Reduction of energy costs that represent an important element of total costs could help alleviate the burden on consumers. It is therefore necessary that all investments have energy efficiency measures embedded in the project design.
- *Restructure tariff policies.* In order to eliminate the political dimension, the authority to approve the tariff has to be transferred from local public authorities to an independent regulator. The government should decide whether it wants to use the existing energy regulator, ANRE, who has already developed a methodology for water and sanitation, or create a new sector regulator.
- *Improve donor coordination.* The government should step up its effort to coordinate donors assistance in order to maximize the impact of investment funding, both for rehabilitation and for the extension of water supply and sanitation systems. These should respond to main challenges and priorities outlined in strategic documents. It is therefore necessary to set up a sustainable mechanism for coordination of donors that will allow efficient and effective implementation of government strategies.

### *In the Medium to Long Term*

10.32 Decisive action in the following policy areas would likely improve accessibility, efficiency, quality and sustainability of water supply and sanitation services:

- *Maintain efficient regulation of services.* The way forward for the Moldova sector is not difficult to identify. It will be necessary to shed the philosophy of command economies where investing in capacity to supply was thought to be equivalent to actually meeting demand; where consumers were subservient to the state; and where, as a consequence, service providers did not feel accountable to consumers. In order to redress the previous unequal relationship between the municipal water supply and wastewater utilities, the Apa-canal, there is ***first of all the need to regulate both tariffs and the quality of services*** to make service providers accountable for safe and efficient service and help them become financially sustainable. Regulation of water utilities can be accomplished by a national regulator (as outlined above), but it can also be achieved through alternative means, such as through private auditors who monitor the costs and quality of service. User charges with eventual full cost recovery can become effective if the service providers meter both

production and consumption because this will minimize the cost of service and will maximize the affordability for consumers.

- *Introduce an efficient social protection mechanism.* There is a need to consider lifeline rates for low-income segments, such as retirees or vulnerable minorities in order to make affordable tariffs that recover the full cost from consumers. But subsidies must be sharply targeted which means metering. Metering allows cross-subsidies from those who consume the most water, i.e., the wealthy, to low-income consumers who should only pay a nominal amount for their basic consumption. All consumption above the lifeline must pay full cost of service. Satisfying both targeting of subsidies and efficiency in production and consumption is impossible without metering
- *Restructure services to address weak governance:* there is the need to restructure services and address the governance weaknesses of the water sector. The municipalization of water and wastewater services was not successful in many countries in the region because economies of scale were lost and smaller municipalities lacked skilled personnel, know-how and governance to ensure safe and efficient services. A new balance must be struck to combine the greater accountability and motivation of locally controlled services with the lower cost of services through centralization and outsourcing of specialist tasks. The temptation to re-centralize and regionalize services is understandable but should not result in monolithic national water and wastewater agencies that are unresponsive to local needs.
- *Improve the efficiency of services:* there is the need to analyze what is the *least cost development path* for water and sanitation services in the country. Services must be **efficient** allowing the utility to meet the demand at least cost, so that tariffs will be affordable to as many consumers as possible. It is unjust and wasteful to force consumers to pay for the utility's inefficiencies. The degree of inefficiency is best summarized by the level of "losses"/non-revenue-water (NRW) that has been estimated as the proportion of supplied water that does not generate financial revenue. Some utilities report fairly low levels of NRW because they transfer, in the absence of metering, most losses onto consumers through the establishment of artificially high consumption norms
- *Strengthen coordination of donors and the institutional set up for further sector development:* the Government of Moldova has been able to contribute only negligible amounts towards the investments needed to restore service levels and quality. Looking forward to the coming years, national fiscal contributions are likely to remain very small. The government has started to mobilize international resources to help it reach the water and sanitation related targets of the Millennium Development Goals (MDGs). The fact that Moldova is only seven years away from the MDGs target year of 2015 also lends urgency to accelerate the sector investment through effective donor coordination. Within the context of the European Neighborhood Partnership Instrument, the European Community is considering a grant of € 57 million for a National Action Program for the Water and Sanitation Sector, of which at least €40 million would be provided as budget support beginning in 2009 for a period of four years. The grant would be contingent on, inter alia, a favorable assessment of the sector policy environment and institutional capacity of the government entity responsible for the

sector to manage the program. EIB and EBRD are also preparing the US\$ 30 million investment in the water sector.

10.33 **The World Bank Country Partnership Strategy aims to continue supporting the sector by addressing the rural needs through the implementation of a large-scale rural water and sanitation program where the emphasis should be on replicability and sustainability.** It is expected that the next World Bank project could aim at providing up to 1,000 rural villages with safe water supply and adequate sanitation. Such a project will pay particular attention to the environmental sustainability through the reforestation of the catchment areas that provide the water on which the rural villages depend. The reforestation program would also have the added attraction of providing employment to unemployed rural households. In order to support the rural water supply and sanitation sector development, the World Bank is currently drafting two studies: (i) a rural water supply and sanitation sector note; and (ii) a study to assess rural water supply and sanitation capacity and to propose measures to strengthen the rural institutions and rural villages. These studies will be completed before the end of FY09, and their recommendations could be discussed at a future workshop with the participation of major donors and IFIs.

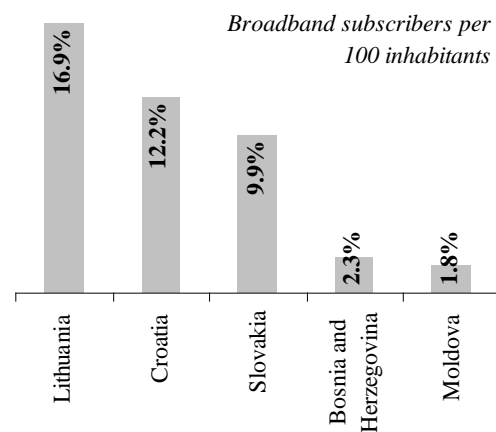
## INFORMATION AND COMMUNICATIONS TECHNOLOGIES (ICT)

### Context

10.34 **Even though Moldova’s ICT sector has grown over the past decade and is overweight relative to national GDP, Moldova lags regional peers in access to and use of ICT services.** ICT can catalyze overall economic growth through investments and job creation. Telecommunications itself has attracted \$150 billion in private investments—65 percent of the total—across Europe and Central Asia since 1997. And ICT export activity created over 200,000 jobs globally in 2007 alone. Moldova can attain similar results with a strategic response that unlocks ICT sector growth.

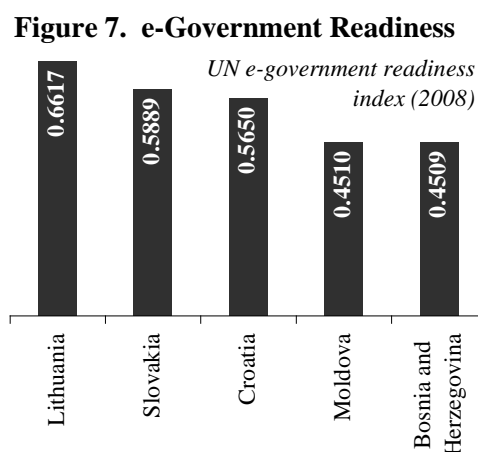
10.35 **While telephone services are widespread, access to advanced ICT such as broadband is limited.** Estimates suggest that 67 percent of the population subscribes to mobile telephone services, and 32 percent subscribes to fixed telephone service. Telephone services cover 90 percent of the population; however, market penetration of broadband Internet is less than 2 percent, most of it concentrated in Chisinau (Figure 6). Moldova thus lags its regional peers in access to and use of advanced ICT and related services. Sector revenues equal about 10 percent of GDP, much higher than elsewhere in the region. This suggests inefficiencies that act as a drag on overall economic competitiveness.

**Figure 6. Market Penetration of Broadband Internet across Region**



**10.36 Moldova's information technology (IT) sector is currently very small when compared with its neighbours and cannot effectively capture potential business opportunities.** The sector consists of about 150 companies, the largest of which has about 200 employees. In addition, an indeterminate number of individual contractors informally export IT services. A potential US\$ 450 billion market in offshore services currently exists worldwide. Moldova's IT sector, aided by the country's strong tradition in science and technology education, has the potential to grow and capture a share of this market, creating high-paying jobs and increasing export earnings. The right policy environment and industry promotion strategy is necessary to enable this growth.

**10.37 The small IT sector and limited reach of advanced ICT constrains the development and use of e-services by citizens, businesses, and governments.** Moldova scores low in international e-readiness rankings. According to the United Nations' 2008 E-Government Survey, Moldova ranked lowest among its Eastern European peers and 93 of 182 countries worldwide (Figure 7). This indicates missed opportunities to extend the reach of public services such as education and health while reducing the costs of such services. It also indicates that Moldova's economy lags in competitiveness.



### Key Challenges

**10.38 Moldova cannot realize its full potential in or through the ICT sector due to three constraints:** (i) an inefficient telecommunications market, (ii) an underdeveloped IT sector, and (iii) poor availability and adoption of e-services by citizens, businesses, and the government. Each of these constraints results from underlying challenges.

**10.39 Dominant service providers, a weak regulatory environment, and limited connectivity hold back growth in different segments of the telecommunications market.**

- *Dominant service providers.* The wireline telephony, wireless telephony, and broadband Internet markets are all heavily concentrated with a very strong dominant service provider in each. Dominance constrains competition, distorts these markets, slows development, and increases rents. The resulting non-level playing field dissuades investors from entering or expanding the market and makes the economy less competitive when compared with regional peers. The greatest impact for Moldova is that the growth of competitive Internet service providers is stifled, reducing job creation and diffusion of advanced ICT, especially outside of Chisinau.
- *Weak regulatory environment.* The regulatory environment remains weak, amplifying the existing inefficiencies in the market. The industry regulator ANRCETI has a critical role in ensuring fair treatment of all players in the market. However, limited internal technical capacity and limits on its level of autonomy prevent ANRCETI from exercising its functions

effectively. Various ministries and courts can reverse ANRCETI's decisions, diminishing credibility, while the power of the Executive in hiring and dismissing the ANRCETI Board reduces its independence.

- *Poor domestic and international connectivity.* Both domestic and international connectivity are limited in supply. This leads to higher prices for this critical resource, along with less competition and consequently lower quality. Growth in telecommunications is directly affected, and the IT sector and economic competitiveness are negatively impacted. Reliable and inexpensive international connectivity is critical for trade in services, including IT-enabled services. Without it, the rate of innovation among firms and the supply of modern value-added services reduce and stifle services growth. The low degree of domestic connectivity limits access to markets by rural communities and hampers the efficient delivery of public services to remote locations.

**10.40 The development of the IT sector is held back because of limited skilled labor, the presence of a dominant state-owned company that crowds out the private firms, and the absence of a coherent industry development and promotion strategy.**

- *Limited skilled labor.* The most important constraint facing Moldova's IT sector is the limited availability of highly skilled persons whom IT firms can employ. While Moldova can boast a strong tradition of science and technology education, some stakeholders estimate that currently only about 10 percent of students graduating from IT-related programs are employable. Consequently, IT firms face high post-employment training costs that reduce the cost-advantage Moldova could otherwise have. Two key reasons for this skills gap are (i) limited use of ICT in education generally, and (ii) limitations in university technical programs including outdated curricula, weak links with the private sector, and an outdated quota system that does not provide incentives for universities to promote healthy competition among students.
- *Crowding out of the private sector.* State-owned Registru S.A. still has preferred status for government IT contracts. This crowds-out the private IT firms who could provide similar services possibly at a lower cost. This also has the effect of reducing the competitiveness of Registru, which in turn limits its ability to participate and win international contracts. Global experience shows that governments can drive the growth of the IT sector by tendering contracts to local, private firms who grow in response to demand.
- *Absence of an IT sector strategy.* The lack of a clear national strategy for IT industry development and promotion has led to a multitude of uncoordinated and mutually conflicting initiatives. It has also led to the development of a number of small enterprises that have limited industry cohesion—there is little coordination among these firms to attract and distribute work.

**10.41 Moldova lags behind all its Eastern European peers in the adoption of e-services because of a weak information society strategy, unequal distribution of access throughout the country, and limited mainstreaming of ICT in other sectors.**

- *Weak information society strategy.* The Government had developed an e-Moldova strategy in 2005. However, it was not successful due to incomplete integration with national development strategies and a general lack of implementation capacity. Moreover, government agencies and businesses use e-services merely to automate existing processes rather than as a tool to transform and re-engineer their process.
- *Unequal distribution of access.* While Chisinau has a reasonably well developed broadband network, few other cities, and even fewer rural areas have access to low cost broadband services. The average broadband penetration across the region is 6.85 percent of the population, but for Moldova, it is less than 2 percent. Most of this access is concentrated in Chisinau. This leads to fewer opportunities for economic diversification of smaller cities and within the rural economy.

### Box 5. International experiences in ICT

As Moldova develops ICT-related strategies, connectivity interventions, and modern institutions, it can learn from the experiences of EU and OECD countries, and neighbors such as Slovenia, Greece, and Turkey.

**Information society strategies.** High-level government leadership and deep stakeholder involvement is critical to implement these strategies successfully. In Slovenia, the Prime Minister headed the *Strategic Council for the Information Society* to develop the 2003 strategy in consultation with different ministries and with public input. Since 1980, Singapore has designed six strategies responding to changing market conditions. Each was the result of consultations with industry experts and government departments that ensured support.

**Connectivity.** Promoting competition and private investment will enable rapid growth in ICT connectivity and access. Regulatory interventions can enable competition and open markets to new technologies. Greece and Ireland have seen significant growth in broadband subscriptions after regulators unbundled the incumbent's network. In Ireland, wireless and cable TV networks now comprise almost half of the broadband market.

**Institutional reforms.** A range of ICT-related institutional reforms in the OECD and EU countries have created competent and independent regulatory agencies. Now, many countries are focusing on building human capital and deepening ICT skills development. Turkey's information society strategy, for instance, aims to increase the number of ICT engineers and revise the curriculum at all levels to include ICT training.

- *Limited mainstreaming of ICT in other sectors.* ICT can serve as a transformational tool that supports the improvement and expansion of services in other sectors. For instance, mobile phone based financial services, allowing money transfers and payments, have been very successful in a range of markets. E-Health applications, allowing remote diagnosis and patient management can help reduce costs and travel, benefiting service providers and citizens. Access to commodity price information using mobile phones or computers has been very successful in increasing the incomes of agricultural communities. However, Moldova

has seen few of these benefits because of limited mainstreaming of ICT in the economy, which also limits the prospects for achieving the MDGs.

## Policy Suggestions

**10.42 Government commitment to a counter-cyclical ICT-enabled investment program will position Moldova to overcome the above challenges and benefit from accelerated growth when the current financial crisis abates. The following policy suggestions and programs are grouped into three areas—strategic considerations, connectivity interventions, and institutional modernization—each of which has prioritized actions.**

### *Strategic Considerations: An Inclusive “e-Moldova 2.0” Strategy*

**10.43 The government should accelerate the on-going revision of its information society strategy.** Maximum relevance and buy-in from all stakeholders will follow from a broad-based consultative process during revision, and from this strategy aligning and integrating with national development priorities. Completed over the medium-term, this strategy should at least include the following prioritized components:

- *ICT sector policy.* Quickly complete the on-going development of this policy. The policy should focus on sector growth led by competition and private participation, a stronger regulatory environment, and expanding access to broadband Internet, and on serving rural and social vulnerable populations.
- *National broadband program.* Designed and implemented over the short-term, this program will promote access to broadband Internet services in both urban and rural areas, with complementary programs for domestic backbone connectivity development and last-mile “universal access”.
- *E-government program.* Designed and implemented over the medium-term, this should focus both on horizontal aspects, such as a government enterprise architecture and interoperability framework to facilitate coordinated e-service delivery; and on vertical aspects, specifically high-priority e-government applications implemented through open bidding on a competitive basis to increase the participation of local IT firms in e-service delivery.
- *IT industry promotion program.* Designed and implemented over the medium-term, this program should focus on incubating innovators, providing venture capital, and developing IT parks while focusing on niche areas in the IT services sector in which Moldova has a competitive advantage.

### *Connectivity Interventions: Implementing the Broadband Infrastructure for the Future*

**10.44 Specific regulatory and investment actions are necessary to implement the national broadband program.** These connectivity interventions will position Moldova to take advantage of the opportunities that will emerge once the international economic crisis subsides. Specific, prioritized actions include:

- *Strengthen competition regulation.* Immediately build ANRCETI's capacity to ensure a level competitive playing field. With this, the regulator can design and implement specific instruments envisaged by the ICT sector policy, such as interconnection regulations, guidelines on access to facilities, and measures that promote competition such as network unbundling.
- *Domestic backbone connectivity program.* Implemented over the short-term, possibly as part of an economic stimulus package, this program will promote the deployment of next generation networks by private infrastructure providers that the country will need for global competitiveness.
- *Universal service program.* A comprehensive program designed to be competitively neutral and implemented over the short-term will (i) support the rapid expansion of rural infrastructure and ensure service to the socially vulnerable; (ii) take away pressure from Moldtelecom to serve customers in a financially unviable manner; and (iii) move the market toward tariff rebalancing and a level competitive playing field.

*Institutional Modernization: Making the ICT Sector More Efficient and Competitive*

**10.45 The Government should move to modernize its state-owned enterprises and the education system, while improving the autonomy of ANRCETI.** This will make the ICT sector more efficient, with firms and a labor pool that are globally competitive. Specific actions include:

- *Improve the autonomy of ANRCETI.* Done over the short-term, this should include: (i) nomination of the Board through Parliament, (ii) the establishment of objective rules for dismissal of the Board, and (iii) internal restructuring in ANRCETI to separate the Board from day-to-day administration and operation. These reforms will align the structure of the regulator with EU best practices.
- *Modernize the state-owned enterprises.* Over the medium-term, the Government should work to modernize and restructure both Moldtelecom and Registru S.A., allowing them to compete effectively in a private-sector led market, while separating their management from the Government's policymaking bodies.
- *Reform and modernize the education system.* In the medium term, the Ministry of Information Development should work with other relevant Ministries to reform and modernize the education system, and improve the use of ICT in both education and technical programs. For this, the Government should phase out subject-area student quotas in technical universities, encourage private training institutes, modernize the technical syllabi, strengthen links among private sector firms and universities, and expand the SALT program to deepen the use of IT in schools.

## XI. AGRICULTURE, FORESTRY, AND NATURAL RESOURCE MANAGEMENT

**11.1 Rural economic development, including agriculture sector development along with sustainable use of natural resources, should be a priority for Moldova.** A majority of the population lives in rural areas (nearly 60 percent), while approximately 33 percent of the labor force works in the agricultural sector (not including agri-food processing). Important factors for rural development are the provision of public services and expansion of infrastructure in rural areas. However, fostering growth in the agricultural sector and ensuring the sustainable use of natural resources are key for economic growth in rural areas—an essential component of Moldova’s overall economic growth—and for diminishing existing disparities between urban and rural incomes. The current global financial crisis is likely to pose additional challenges in rural areas due to decreased domestic and international demand, a decrease in available capital, and an increase in available labor. Investments in rural infrastructure can make important contributions in terms of job creation.

### AGRICULTURE

#### Context

**11.2 Moldova’s agriculture sector is characterized by sluggish growth and low efficiency that derives from its weak link to the markets and the low competitiveness level of the output produced.** With favourable climatic conditions and fertile soils, Moldova should be able to benefit from comparative advantages in the agricultural sector. However, multiple constraints, such as low level of investments, deficient access to finance, slow institutional transition, and limited market opportunities have contributed to Moldova’s agricultural sector currently operating far below potential.<sup>26</sup>

#### Key Challenges

**11.3 Frequently changing policies and regulations create uncertainties among producers, investors and traders, and impose high risks for actors in the sectors.** Previous Government approaches to agriculture and food security have at times been inconsistent and often focused on keeping food in the country rather than on promoting trade, investments, increased productivity and competition within the production and processing sectors, which would be a more efficient way to ensure Moldova’s domestic production in the long run. Maintaining national self-

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<sup>26</sup> Many of the constraints in the agri-food sector are the same as for the rest of the private sector and it is important to recognize that Moldova’s agricultural sector has a lot to benefit from an improved business environment for the over-all private sector. Thus, the policy recommendations in Chapter IV on Private Sector Development in general also apply to the agri-food sector.

sufficiency through export bans and administrative price controls increases the disparity between domestic and international prices, works as a disincentive to local producers, and reduces incomes in rural areas, resulting in reduced domestic production and increased food insecurity at the household level.

**11.4 Agricultural expenditures (including subsidies and services) need further streamlining and optimization to better support investments and increased productivity in the agricultural sector.** In spite of efforts made to diversify and improve targeting of agricultural subsidies, continued reorientation is required to enhance and optimize agricultural public services. This is especially urgent given the planned budget cuts and the foreseen budget constraints over the next years. Moldova's agricultural expenditures should be allocated towards public goods that help develop the sector's competitive advantages and promote its further integration into regional and international trade systems, creating an enabling environment and incentives for private investments.

**11.5 Ensuring a favorable business environment for commercial farmers and for new businesses is likely to be a key factor for further improvements in the competitiveness of the sector, increasing agricultural growth and economic development in rural areas.** Non-discriminatory policies seem to have promoted investments among smallholders and a new group of medium-size commercial farms is rapidly emerging. These are farms of sizes between 5 and 50 hectares with an average of about 20 hectares, whose number (despite the 2007 drought) has increased in just two years from a few hundred to over 5,000. Increased rural entrepreneurship and business skills coupled with land market enhancements are factors that have led to these commendable developments, in parallel with improved access to both finance and subsidies for smallholders (individual farms have since profited especially from investment subsidies), and strengthened extension services.

**11.6 Poor access to markets is currently a key constraint for the sector.** This includes both infrastructure constraints for physical access to markets (incl. effective network of wholesale markets around the country) as well as the inability to adhere to quality standards and food safety regulations on both export and domestic markets. In addition, post-harvest handling that is an essential stage in delivering high quality (fresh) produce to the market is still highly underdeveloped in Moldova, which poses an obstacle for domestic products to move farther up the value chain. There is a critical need for modern post-harvest infrastructure, such as cold storage facilities and packing houses dealing with post-harvest treatment, grading, sorting and handling of high-value horticultural produce.

**11.7 Dependence on the CIS market (especially Russia) has also made the sector's exports highly vulnerable and there is a need for Moldova's agricultural producers to find alternative export markets.** Given new trade opportunities in high value markets and especially to the EU, Moldovan agri-food businesses have now the possibility to diversify exports, benefit from participation in modern value chains, and establish themselves as competitive actors within the international trading systems. Exploiting and making use of these opportunities (i.e. overcoming the non-tariff barriers – complying with standards and certification requirements) on the highly competitive EU markets, however, pose a great challenge to Moldovan producers and exporters of agri-food products.

**11.8 Insufficient access to quality inputs remains a constraint for competitiveness in a number of subsectors.** Producers of high value crops (fruits and vegetables) that rely mainly on imported seeds and seedlings seem to be most affected by the lengthy and costly variety registration procedures. The testing and registration requirements regulating imports of seeds and seedlings are perhaps the most critical constraints and are currently singled out by stakeholders as an obstacle to production of more competitive crop varieties due to the costs involved and the delay in access that these requirements create. This also poses an obstacle to the access to quality inputs for the agro-food processors.

**11.9 Degradation of land resources reduces agricultural productivity. The area of eroded land is currently increasing with 0.9 percent per year, and agricultural land is losing about 26 million tons of fertile soil each year.** These are alarming figures, calling for an active promotion and implementation of environmentally friendly agricultural practices.

**11.10 Poor access to irrigation services due to deterioration of state-run irrigation systems over the last decade is a serious impediment in the process of transition to higher value agriculture and consequently higher returns.** This has occurred due to the lack of public investments and lack of institutional reforms since 1991 and has resulted in a situation where, in 2007, only about 16 percent of the irrigable land actually received irrigation and only with about 50 percent of the required water quantity. This caused crop yields to drop much below the irrigated yield potential. Especially against the background of the expected impact of climate change on Moldova (in particular more erratic and overall less rainfall), effective irrigation with high water-use efficiency will be key to agricultural development.

**11.11 Finally, continuous research and development is important to ensure a modern agricultural sector.** While prior to independence Moldova had a number of prominent research institutes, limited funding in recent years has weakened their capacity to provide effective responses to the current needs/demands of the sector. The weak liaison between the four inter-connected areas research-education-extension-private sector poses a challenge to profiting from research in the way necessary for further successful development and growth of Moldova's agribusiness sector.

## **Policy Suggestions**

**11.12 Solving most of the key challenges is a medium to long-term process, but addressing these should be initiated immediately and carried out consistently and decisively over the next years.** It should be recognized by the Government that the business climate regulated by public policies in Moldova's agri-food sector is non-compatible with a modern, competitive and productive sector. Immediate action to do away with distortive policies, especially those related to trade, is thus imperative. A competitive, market-oriented agri-food sector will make Moldova more, not less, food-secure, provide rural income opportunities, and contribute to economic growth.

**11.13 Stable pro-market and pro-trade policies are urgently needed to ensure a favourable environment for business development and investment stimulation along the agri-food chain.** The practice of frequently changing policies and ad-hoc restrictions and

controls (often informal), especially in the agri-food trade area, is seriously damaging to businesses and should be completely abolished. Trade policies should be consistent and non-distortive for both agricultural inputs and outputs. Further, measures to stimulate a friendly business environment in the sector should include improving access to rural finance (this is especially critical since available capital is likely to further decrease as a consequence of the global financial crisis), continuing expansion of rural extension services and facilitating access to latest technologies, and further directing public expenditures in a non-discriminatory manner.

**11.14 For Moldova to pursue its food security objectives most effectively, a food security strategy with a short-, medium- and long-term perspective – encouraging sector investments and innovation and reducing transaction costs – needs to be developed and adopted.** This strategy should be coherent with the already existing strategy for the Agricultural sector (for 2008-2015), and should be based on an in-depth analysis on how to best ensure availability and access to food for the people in Moldova. Such strategy would have to be a joint effort between the Ministry of Agriculture and Food Industry, the Ministry of Economy and Trade, and the Ministry of Social Protection, since food security by definition concerns areas such as food trade and social safety nets, in addition to food production.

**11.15 In view of the tightening public budget scenario (as a direct effect of the global crisis) for the current year, the Government should be prepared to prioritize the agricultural expenditures towards those areas that support investments and increase productivity.** Certain expenditures have very limited effect, if any at all, and should thus be reduced or entirely eliminated by the new Government. This includes recurrent subsidies that do not have long-term effects (such as VAT rebates on inputs and outputs) as well as the anti-hail rocket system.<sup>27</sup> Both of these are large budget posts, accounting for nearly 200 million lei or 25 percent of total agricultural expenditures. (The VAT subsidies for inputs and outputs accounts for 23 percent of total agricultural subsidies.) As a next step, it will be important to establish clear, medium to long-term priorities for expenditures and to base public resource allocation on impact evaluation of individual expenditures and lessons from other countries (Box 6). There is currently no mechanism for this in MAFI and should thus be a priority. This is not only important for efficient allocation of public expenditures but also for the Government's accountability for the use of public funds. In general, the provision of public goods should be prioritized.

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<sup>27</sup> Though highly costly, research on anti-hail rocket systems and on anti-hail cannons shows little support for the actual impacts of these systems (See for example Wieringa, J. and Holleman, I, “*If Cannons cannot fight hail, what else can?*”, *Meteorologischke Zeitschrift*, 15, issue 3, June 2006). A better alternative is anti-hail insurance schemes for crop producers, which is also the most commonly used instrument internationally.

### Box 6. Public expenditures – Lessons from other Countries

Especially when dealing with a limited budget, as in the case of Moldova, the impact from agricultural expenditures varies greatly depending on how available public resources are targeted. While agricultural expenditures often are thought of as synonymous with subsidies, these types of expenditures are not the most efficient. In particular, direct input and output subsidies have proven to be highly inefficient in terms of contributing to growth, and cause instead distortions and inefficient use of resources while being costly to administrate. With a limited budget, they also tend to be discriminatory as it is unlikely that they are made available to all farmers. Investment subsidies, on the other hand, can have some positive impacts as they encourage investments and thus contribute to growth. However, allocating expenditures on agricultural services rather than subsidies is much more efficient in terms of promoting growth. In particular investments in well-managed agricultural research and development (R&D) have shown very high return across countries. Market infrastructure and extension services have also proven efficient in terms of impacts and reach. Finally, natural resource management is often underinvested in, and the lack thereof has a negative effect on future growth.

Experience from around the world shows however that reorienting public resources can be difficult and that the allocation of agricultural expenditures often is influenced by interest groups and thus politically sensitive. A way to overcome political obstacles is to introduce more formal participatory processes and to involve a broader range of stakeholders in order to build coalitions to support reforms of public expenditures. The media can also play an important role for information and communication.

#### *Lessons for the Transition Economies drawn from EU experience*

“...The lesson that needs to be learned is that public expenditure policies must be strategically determined. That means that governments in the transition economies need to appreciate some basic factors in framing their agricultural spending plans, namely:

1. Taxpayer resources are scarce and must be used where they create the greatest impact on economy-wide growth.
2. Public expenditure should not substitute for private expenditure.
3. Public expenditure policies can only be justified if they address clear “market failures.”
4. Producer subsidies in the form of output and input-based payments do not in general address “market failures” and thus inhibit the sustainable enhancement of growth.
5. Scarce public resources should be predominantly earmarked for general service supports and producer supports should be correspondingly reduced.”

Sources: World Development Report 2008: Agriculture for Development, and World Bank, Agricultural and Rural Development Public Expenditure Choices and Management in the Transition Economies: Lessons from EU Practice and Experience, May 2008

**11.16 Improving post harvest and market infrastructure<sup>28</sup>, and supporting the implementation of HACCP, GlobalGAP, and other international standards is imperative to improving competitiveness and broadening market access.** Public-Private Partnerships,

<sup>28</sup> Other rural infrastructure, such as roads, water, and telecommunication is closely linked to this.

financial support schemes, effective market information systems, and training through the rural extension service should be policy priorities to achieve these objectives. More rapid adoption of internationally recognized food safety standards and regulations, improved labs and testing systems, as well as international accreditation of food safety institutions are important areas that need public guidance and investment support. Viable producer associations can significantly increase farmer access to markets (through increased quality of production, enhanced bargaining power and higher producer prices through larger scale) and deserve public support. Integrating ICT into agricultural communities can improve access to markets, knowledge about prices and farming techniques, and create new economic opportunities for rural communities. The development of an accessible geographic information system (GIS) developed through a public-private partnership can simplify land record management and resource planning.

**11.17 Competitiveness requires access to quality inputs.** Further reform and liberalization are necessary in the area of plant variety registration for Moldovan farmers to have immediate access to latest technologies and thus obtain the flexibility and capacity necessary to participate in international supply chains targeting export markets and to compete against imported produce on the domestic market. Allowing un-restricted transfer/import of seed and seedling varieties listed in the EU Catalogue of plant varieties would be an important step forward in this direction.

**11.18 Urgent measures are needed to slow or reverse the degradation of land resources.** These include information dissemination and training activities on best agricultural practices among farmers and the broader public, the implementation of an efficient land market, and state support and incentives for further soil conservation. Additionally, the Government should promote an integrated approach to land conservation and ensure efficient implementation of the “National Soil Conservation Program”.

**11.19 Expanding access to reliable irrigation services would foster high value agriculture growth based on productivity gains and reduce vulnerability to natural hazards (drought in particular).** This would require a two-pronged approach: rehabilitation of irrigation infrastructure on one side, and institutional reform of the irrigation sector on the other side. The focus should be on: (i) institutional reform of the water agency “Apele Moldovei” to ensure more efficient management and operation (M&O) of irrigation infrastructure, including changing the role of the agency towards allowing a higher degree of user participation in M&O of central irrigation systems; (ii) the priority rehabilitation of energy-efficient systems/stations where irrigation has been found to be economically viable; (iii) ensuring the availability of credit to finance annual operational expenses, to invest in on-farm irrigation equipment as well as in distribution (tertiary) networks; and (iv) supporting a capacity-building program aimed at improving access to markets for high value crops produced on the irrigated lands.

**11.20 Experience around the world shows that investment in research and education generates very high returns and is critical for the development of a modern agricultural sector.** Continuing and deepening the on-going reform of Moldova’s research institutes towards ensuring an effective two-way communication between research, rural extension services and the private sector should thus be a focus for the new government. Strengthening agricultural education system, including vocational training, in order to bring it into the equation of

adequately serving the private sector needs is a medium to long term task that however should be approached the sooner the better.

## FORESTRY

### Context

**11.21 Low levels of forest coverage in Moldova contribute to soil erosion, floods, and landslides which have resulted in large areas of totally degraded agricultural lands.** Thus, continued afforestation should be a priority in accordance with the National Development Strategy (NDS), which foresees an increase in forest areas from 10.3 percent in 2002 to 13.2 percent in 2015. In order to accomplish this, Moldsilva needs to renew its technical capacities. Investments in special agricultural machinery equipment for soil preparation, planting activities, combating diseases and forests pests, as well as irrigation equipment for nurseries, improving seeds base for further plantings, are needed. It is also necessary that afforestation activities are linked with the development of new Clean Development Mechanism (CDM) carbon sequestration projects so that Moldova can benefit from the global carbon market.

### Key Challenges

**11.22 With climatic changes, Moldova's forests are likely to be increasingly affected by various pest and diseases as well as by more frequent and severe droughts.** To minimize these impacts the Government should improve forest pest and disease management, as well as fire control.

**11.23 The problem of illegal logging persists, mainly due to poverty in rural areas and to weak institutional capacity.** To ensure sustainable forestry, forest governance and the control of illegal logging needs to be improved.

### Policy Suggestions

**11.24 With the support of the World Bank, the recently prepared National Action Plan for Combating Illegal Logging and Improving Forest Governance identifies priority actions, including:** (i) further improvement of existing forestry legislation; (ii) conducting analytical studies, in particular a country assessment on real consumption of wood products, timber consumption forecasting, and import-export trend as well as on the volumes of illegal logging, causes, and vulnerable zones; (iii) training and capacity building, especially at the level of forestry enterprise, in particular on forest governance issues; (iv) raising public awareness on forestry and forest governance issues; and (v) establishment of a forestry regime and adequate management of lands covered with forest vegetation and forests managed by communities. In improving status of the country's forests and forestry governance Moldova may rely on the existing international best practices, including experience obtained from WB-supported Projects in Albania (Box 7).

**Box 7. World Bank projects addressing governance weakness  
in forestry-related sectors are in Albania<sup>29</sup>**

- **Legal and Judicial Reform Project** - aims to contribute to the legal and justice system reforms, thereby contributing to the strengthening of the rule of law in Albania. The activities include, among others, improvement of the court and case management systems, provides judicial training, strengthens the enforcement of judicial decisions, and reinforces inspection services in the justice system.
- **Public Administration Project** - aims to strengthen Albania's weak institutional and governance capacity. The project supports, among others, project management and implementation, including supporting all the required project administration capacities (accounting, audit, procurement, disbursement management, monitoring and evaluation) and supports several specific initiatives for monitoring and publicizing the intermediate impacts of the government's institutional and public administrative reform program.
- **Natural Resources Development Project** - aims to establish or maintain sustainable, community-based natural resource management in about 218 communes in upland and mountainous erosion-prone lands. One of the two components is focused on forests and pastures. The project builds on the Albania Forestry Project and Albania Private Forestry Development Program.

**11.25 A special program on forest regeneration and rehabilitation should be designed and implemented.** This program should rely on appropriate and cost effective cultural practices, encouraging multi-functional sustainable forest management. A first step should be to carry out a study on the impacts of climate change on forestry. A long term action plan could then be developed based on the findings.

**11.26 Especially with a view towards the expected impact of climate change, a forestry policy paper, outlining the strategy towards meeting these new challenges, should be prepared.** This document should be based on a review of existing policy documents in this domain and should stipulate a new forest strategy for how to best meet the needs of the sector in support of economic development and poverty alleviation. It should also reflect a more active involvement of the private sector in forestry activities along with the development of the communities and private forestry. It is also imperative that this document include a costed plan for its implementation, along with implementation arrangements and monitoring responsibilities.

**11.27 The proposed activities might be prioritized as follows:** (i) revision/designing of a new forestry strategy with an attached pragmatic action plan which would clearly stipulated urgent

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<sup>29</sup> Savcor Indufor Oy. 2005b. Ensuring Sustainability of Forests and Livelihoods through. Improved Governance and Control of Illegal Logging for Economies in Transition. Country Report - Albania. Prepared for the World Bank. Helsinki.

measures in all forestry areas and first of all with regard to improving forestry governance and creating public – private partnerships in the domain, as well as with regard to immediate forestation needs; (ii) urgent investments in special agricultural machinery equipment for soil preparation, planting activities, combating diseases and forests pests for ensuring high quality of forestation activities and forest protection; and (iii) designing and implementing a long term program on forest regeneration and rehabilitation for ensuring forests sustainability.

## NATURAL RESOURCE MANAGEMENT

### Context

**11.28 The Government has recognized the significance of natural resource management in Moldova’s National Development Strategy, but the status of the environmental and natural resources in the country continues to worsen.** This threatens both production and health in Moldova, which could have a negative impact on growth. It also threatens natural habitats and biodiversity.

### Key Challenges

**11.29 Pollution of Moldova’s water sources is a threat to domestic access to clean water.** The quality of surface water resources ranges from moderately polluted to polluted, and underground waters do not meet the drinking water quality norms. The situation is especially unfavourable in rural areas, where most people use water from the phreatic waterbeds and only 17 percent of families use the water from centralized water supply sources. The dilapidated state of the municipal water supply and wastewater treatment plants and the lack of investments in this area have contributed to depreciated potable water supply and sanitation systems throughout the country.

**11.30 Waste management is currently unsustainable and most of the existing waste disposal sites do not meet the required sanitary standards.** About 60 percent of the waste sites around Moldova are unauthorized and a large number of current disposal sites have already reached their capacity and need to be closed. The practice of waste recycling is in its inception phase and implemented only in few districts in Chisinau city.

**11.31 In recent years, Moldova has increasingly been affected by weather/climate-related hazards like floods, droughts, hail, soil erosion, and landslides.** Existing climate change predictions foresees an increase in mean temperature of 2.7-4.5 degrees centigrade, a decrease in total precipitation but with increased winter precipitation, which will result in a decrease of river water flows. Reducing the vulnerability to natural hazards must be a priority. This would require the Government to strengthen its ability to assess, prepare for, mitigate, and respond to these challenges.

### Policy Suggestions

**11.32 Preventing water resources pollution and their efficient usage should be a priority for the country.** This includes promoting good agricultural practices, information dissemination and training for farmers to prevent water pollution stemming from nutrients and manure.

Furthermore, the country should implement a special program on waste water treatment. Some localities in Moldova, discharge water without any treatment into the country's rivers and lakes. In this regard, it is imperative to find low-cost and efficient alternatives to existing conventional water treatment systems in the country (see also water and sanitation policy note).

**11.33 Special attention should also be given to improving waste management.** It is recommended that the Government update the existing National Waste Management Program which should specify, along with regulatory and policy reforms, a series of economic incentives for the private sector to invest in modernized regional waste management systems. Optimally, these investments should be linked with the Clean Development Mechanism Carbon Finance Projects, based on methane recovery. The existing international practices with regard to waste management might provide good advice in implementing such activities in the country (Box 8).

**Box 8. A Regional Approach to Solid Waste Management in Bosnia & Herzegovina<sup>30</sup>**

The World Bank has recently approved a credit of US\$14.3 million for improving solid waste management for several localities (Tuzla, Banja Luka, and Mostar) in Bosnia and Herzegovina. The main idea of the project is to consolidate waste disposal in a few regional landfills instead of a large number of smaller-scale waste disposal sites.

Past practice of waste management in the country was to create a landfill for each locality. However, municipalities with limited financial capacities were not in a position to build and maintain waste disposal sites at levels dictated by technical, environmental, and sanitary requirements. As an alternative, the project will create regional landfills that can serve several municipalities. It was clear that formation of such landfills through cooperation between different numerous municipalities in Bosnia and Herzegovina was necessary in order to afford improved sanitary landfill standards. The approach takes advantage of economies of scale: the cost of maintaining a regional landfill is lower than the sum of the costs of maintaining individual smaller landfills at the same standards. It was estimated that landfills are affordable and allow cost recovery only when daily waste input is in excess of 200–300 tons. Lower costs are likely to induce more budget-constrained municipalities to invest in upgrading solid waste management, which is a acute problem in Bosnia and Herzegovina and in the Balkans in general.

**11.34 The Government should prepare and adopt a Natural Hazards Risk Management and Adaptation Strategy that identifies short- and medium-term actions to be undertaken.** However, not all natural hazard risks can be mitigated and thus climate change adaptation is essential to reduce vulnerability, especially with regard to rural development and agricultural activities. This requires also a program for modernizing the national hydro-meteorological services, to provide timely and high quality weather, climate and hydrological forecasting, and to

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<sup>30</sup> World Bank. Europe and Central Asia Region. Environmentally and Socially Sustainable Development. Serbia and Montenegro. A Country Environmental Analysis. 2003.

monitor changes in the natural environment. As a good practice in this regard might serve Russian Federation National Hydromet Modernization Project, supported by the WB.

**11.35 Taking into account the existing and forthcoming financial problems the Government should strengthen National Environmental Fund (NEF) and improve its activity.** As NEF is capable to collect significant amount of resources and finance large environmental projects, it is recommended to enforce the existing legislation with regard to environmental payments and taxes and thus generating additional financial resources. At the same time it is imperative to reorient its spending from a large number of small scale environmental projects to fewer, larger and focused on priority areas, which might produce in short term clear results. In improving efficiency of NEF activity as well as public environmental financing it is advisable to take into consideration best international practices as well as guiding materials prepared under the auspice of OECD<sup>31</sup>.

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<sup>31</sup> OECD. **The Good Practices of Public Environmental Expenditure Management** 2003;

## XII. DONOR COORDINATION

### CONTEXT

**12.1 The National Development Strategy (NDS) is the main medium-term strategic planning document which defines the developmental objectives and will guide the budgetary process over the period 2008-2011.** The NDS was adopted by the Moldovan Parliament in December 2007. It was discussed along with the Joint Staff Advisory Note (JSAN) by the Boards of IDA and IMF in March 2008.

**12.2 Moldova is collaborating increasingly with European institutions and receiving aid from a wide range of donors.** Under the NDS, the Government will seek to better prioritize its policies and to establish a clear funding mechanism from both domestic and external sources, with European integration as a central objective. The Government and its development partners have expressed interest in a joint approach to help Moldova, using the newly designed NDS as the overarching framework in this process.

**12.3 Effective donor engagement requires strong coordination and harmonization with other development efforts.** Moldova has worked with donors to harmonize development efforts and has achieved some progress since 2006 (Box 9). The harmonization process was carried forward through a Development Partnership Framework designed to implement the Paris Declaration on Aid Effectiveness. The framework, “Co-ordination and Harmonization of Government and Donor Practices for Aid Effectiveness in the Republic of Moldova,” was signed by the Government, IDA, Netherlands, United Kingdom, Sweden, UN, IMF and EU in Chisinau on May 29, 2006. This Partnership Framework commits the parties to joint reviews, harmonization of indicators, and synchronization with government budget cycles to reduce the transaction costs of assistance to the country. It also contains performance indicators for both government and external partners to assess progress towards measures for increased aid effectiveness.

#### **Box 9. Milestones for Donor Coordination and Harmonization**

- Moldova signatory to Paris Declaration on Aid Harmonization in 2005.
- Development Partnership Framework between Government and major donors signed in May 2006.
- Brussels Consultative Group meeting hosted by the EC and World Bank in December 2006, with US\$1.2 billion pledged.
- National Development Strategy fully aligned with ENP Action Plan.
- Donors and Government developing new coordination mechanisms, including a mapping exercise for a joint NDS response, to provide a useful, high-level overview of ODA support to the new NDS and map and align projects/programs with the results of the NDS to better ensure coordination, avoid duplication, and make development assistance more efficient and effective.

## KEY CHALLENGES

12.4 **The Paris Declaration on Aid Effectiveness remains critical, but more progress is needed toward the goals of harmonizing donors' policies and aligning them with the Government's priorities.** The whole exercise relies on principles of Ownership, Alignment and Harmonization, and the 2008 Survey indicated shortfalls in the following areas:

- ***Building capacity through coordinated support.*** Joint evaluations confirmed a fragmented approach to capacity building was still maintained in 2007. Some national programs include capacity building components, others do not. There is no comprehensive national capacity building strategy. While progress has been made in the area of public finance management, central public administration reform, social system reform, and social investments fund, the share of coordinated technical assistance is still very small in the overall framework of external technical assistance. On the other hand many line ministries like Ministry of Education and Ministry of Justice lack of capacities to better coordinate the external aid in their sectors. Sector approaches are still at an incipient phase and the existing programs have not been launched in the real sense of sector-wide approaches. Instead, donors continue to apply their own development aid management procedures outside of the national systems.
- ***Increased aid predictability.*** Information on planned assistance is not adequately available to the Government for preparing the Medium-Term Expenditure Framework (MTEF). Not all external funding is reflected in the budget. Specifically, while loans and some grants are reflected in the budget, technical assistance is not, in part because the Government lacks information on external partner commitments and their estimated breakdown by year. The MTEF and increased coordination between the Government and external partners are expected to help ensure that all external assistance is reflected in the budget.
- ***Common frameworks.*** The main constraint to channeling development assistance in program-based approaches is the lack of commitment to coordinated support by partners, including both donors and public authorities. This coordinated support should be based on cooperation in implementing national development programs, strategies, sector programs, etc. In practice, even if the assistance provided by a donor comes to support one or another national program, the budgetary systems, reporting, financial management, and procurement systems are individual for each donor. The Government encourages increased volumes of direct budget support, hence using country accounting, reporting and procurement systems and reducing transaction costs. The Development Partnership Framework calls for the advancement of common arrangements and procedures, including Sector Wide approaches, pooled financing and silent partnerships.
- ***Division of Labor.*** A pragmatic approach to the division of labor at the country level is one of the commitments of the Paris Declaration. For donors and government, the division of labor has wide-ranging implications. Aid selectivity and complementarity are critically important as needs increase and resources decrease, particularly in light of the emerging economic crisis. In support of this, EU and DFID launched a division of labor and mapping exercise to: (i) provide a useful, high-level overview of Official Development Assistance

support to Moldova's new NDS, and (ii) map and align projects/programs with the results of the National Development Strategy to better ensure coordination, avoid duplication, and ultimately to make development assistance more efficient and effective.

**Results-oriented Frameworks.** In most cases, the evaluations of donor programs are carried out by individual donors, in line with internal monitoring and evaluation systems. These evaluations often do not contribute to the identification and resolution of major deficiencies in the implementation of donor-supported programs and do not assess the contribution made by the entire donor community to the implementation of national development strategies. An intensified effort is needed to consolidate reporting requirements and integrate disparate monitoring and evaluation systems to implement this country-level results framework.

## POLICY SUGGESTIONS

**12.5 Steps should be taken to further enhance donor coordination in Moldova.** As a first step, the Government should work with donors to renew the 2006 Development Partnership Principles to take into account new developments, including the results of the 2008 Accra Harmonization meeting, the National Development Strategy, the emerging question of how to deal with Transnistria, etc. The renewed partnership principles would include issues such as: establishing a regular exchange of information between donors and government, promoting a pragmatic division of labor, strengthening country systems, and improving the focus on monitoring for results.

### *Regular Exchange of Information*

- *The Government should move forward with the practice of convening semi-annual high-level donor forums, chaired by the Prime Minister.* Holding the forum at the beginning of the next Government's term would send the right signal about country ownership and renewed donor cooperation and coordination. The forum is an opportunity for the Government to discuss its priorities for donor support and exchange information with donors on key issues.
- *To facilitate greater coordination at the sector-level and advance the use of program-based sectoral approaches, sector ministers should hold monthly or bimonthly meetings with the key donors working in the sector.* This practice is currently being implemented in the social assistance sector and has proven to be an effective mechanism for: a) ensuring donor alignment with government priorities, b) facilitating coordination and information exchange between donors and between donors and government; c) discussing sectoral priorities and proper budget allocations; and d) agreeing on appropriate division of labor within the sector.

### *Division of Labor*

- *The next government should work with donors on a more effective use of external aid.* To assist in this process, donors should conduct a mapping and main areas of intervention exercise to ensure the most effective and efficient use of development resources and to ensure an optimal level of complementarity. The exercise should be conducted based on principles of selectivity and comparative/collaborative advantage. The donors should consult with Government on the findings of the exercise and seek advice and guidance.

- *Government should insist that donors intensify efforts to decrease the number of uncoordinated missions.* Donors should encourage policies that reduce the total number of country missions and promote joint missions.

#### *Strengthened Country Systems*

- *Country systems should be increasingly used and strengthened to reinforce country ownership and place the country in the driver's seat.* Accountability over development resources can be strengthened by implementing the recommendations of the recently completed Public Expenditure and Financial Accountability Update. Strengthening internal accountability systems will facilitate domestic accountability in the use of development resources and mutual accountability between the country and donors. Rep.

#### *Focus on Results and Monitoring and Evaluation (M&E)*

- *The Government should continue to strengthen its Monitoring and Evaluation systems to track progress under the NDS.* Donors should continue to support the strengthening of these systems and should avoid establishing parallel M&E systems. Government should insist that donors align their own programs with the expected results under the NDS. Moldova has started to strengthen its results focus in strategic planning, expenditure management, and building national capacity for results-based M&E. The future effectiveness of donor engagement in supporting Moldova's development agenda would benefit from increased focus on managing for results that allows tracking progress, taking corrective actions and undertaking a fruitful dialogue with the government and other stakeholders.