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**Moldova: Opportunities for Accelerated Growth**  
*A Country Economic Memorandum for the Republic of Moldova*

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US\$1 = 12.58 MDL

## FISCAL YEAR

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## ACRONYMS AND ABBREVIATION

ARIA	Agency of Enterprise Restructuring and Assistance	MDL	Moldovan Lei
ATMs	Automated Teller Machines	MoE	Ministry of Economy
	Business Environment and Enterprise Performance Surveys	MoF	Ministry of Finance
BEEPS	Balance of Payments	MSTQ	Metrology, Standardization, and Testing Quality
BoP	Central and Eastern Europe	MTEF	Medium-Term Expenditure Framework
CEE	Central and Eastern European Countries	MTS	Machinery and Technological Stations
CEECs	Central and Eastern European Countries and Baltic States	NBM	National Bank of Moldova
CEEBS	Country Economic Memorandum	NHIC	National Health Insurance Company
CEM	Commonwealth of Independent States	NPV	Net Present Value
CIS	Cost of Doing Business Survey	PER	Public Expenditure Review
CODB	Citizens Network for Foreign Affairs	PPG	Public and Publicly Guaranteed
CNFA	Domestic Resource Cost Ratio	OECD	Organization for Economic Co-operation and Development
DRC	European Bank for Reconstruction and Development		Report on Observance of Standards and Codes
EBRD	Economic Growth and Poverty Reduction Strategy Paper	ROSC	Savings and Credit Associations
EGPRSP	Europe and Central Asia	SCAs	Small and Medium Enterprises
ECA	European Union	SME	State-Owned Enterprise
EU	Foreign Direct Investment	SOE	Total Factor Productivity
FDI	Moldova Financial Sector Assessment Program	TFP	Universal Commodities Exchange
FSAP	Former Soviet Union	UCE	United Nations Development Program
FSU	Gross Domestic Product	UNDP	US Agency for International Development
GDP	Gross National Disposable Income	USAID	Value Added Tax
GNDI	Gross National Income	VAT	Vertical Coordination
GNI	Investment Climate Assessment	VC	World Development Indicators
ICA	International Financial Statistics	WDI	World Integrated Trade Solution/United Nations Statistical Division (UNSD)
IFS	International Monetary Fund	WITS/	Commodity Trade Database
IMF	Less Developed Country	COM	World Trade Organization
LDC	Ministry of Agriculture and Food	TRADE	
MAFI		WTO	

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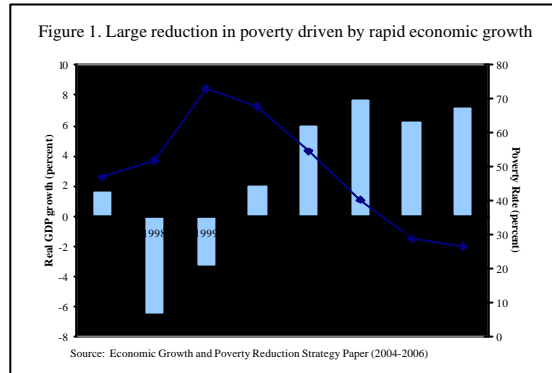
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# Executive Summary

## Introduction

1. Since 2000, Moldova's strong growth performance has reversed a decade of economic decline and rising poverty. Between 2000 and 2004, real GDP has increased by more than 30 percent and the poverty rate has been cut by more than half. The current economic recovery, underpinned by the maintenance of macroeconomic stability, has established a firm foundation upon which to build a sound strategy for medium and long-term growth. Moldova's agricultural resources and skilled labor forces, when combined with its attractive geographic location - close to the bigger CIS countries and the much larger European Union (EU) market – and the emerging networks of migrants in important overseas markets provide the country with ample opportunities for continued economic expansion.



2. Continued strong economic growth will be crucial to Moldova's efforts to reduce poverty further, recuperate income per capita lost during the transition, and remain on a convergent path with the countries of Central and Eastern Europe. While the relatively abundant inflow of workers' remittances that have led to the current consumption driven growth is likely to continue, it is unreasonable to expect that these flows will continue to grow at the same rapid rate. Similarly, it will become increasingly difficult to sustain the past growth in labor productivity since the opportunities provided by labor shedding and factor reallocation in the economy are gradually being exhausted. Thus, while remittances have helped fuel the current expansion, only continued increases in productivity can be the driver of sustained long-term growth. If Moldova does not build the foundation for this future growth, the country will likely enter yet another troubling economic period as the growth stimulus from remittances wanes and the domestic supply response weakens. Since it is much easier to undertake economic transformation in a period of economic growth, Moldova needs to start addressing these challenges now.

3. This Country Economic Memorandum (CEM) explores how Moldova can confront its emerging challenges to growth and position itself strategically to take advantage of the opportunities by using its strengths more effectively. The focus of the CEM, therefore, is on the identification of the critical binding constraints to growth that can be addressed through public policy.

## Moldova's Recent Growth Experience

4. The export of labor and the resulting inflow of workers' remittances have come to dominate the economic and social landscape of Moldova. Some 25 percent of Moldova's economically active population is now working abroad. Workers' remittances, equivalent to 27 percent of GDP, have increased disposable income and fueled a rapid growth in final consumption expenditures – the primary driver of the current economic recovery. The contribution of investment (18 percent of GDP) to growth has been modest. Public investment (less than 2 percent of GDP) has been particularly low. While export growth has been rapid, the

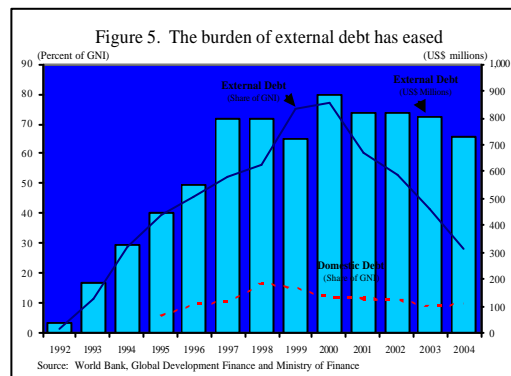
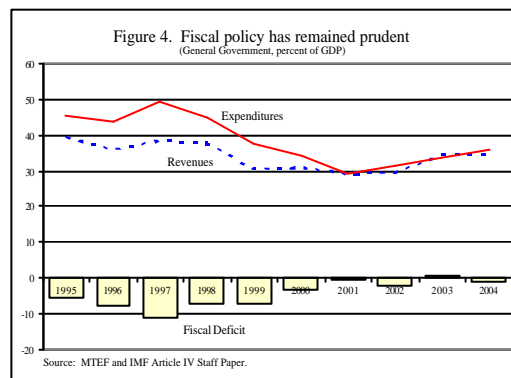
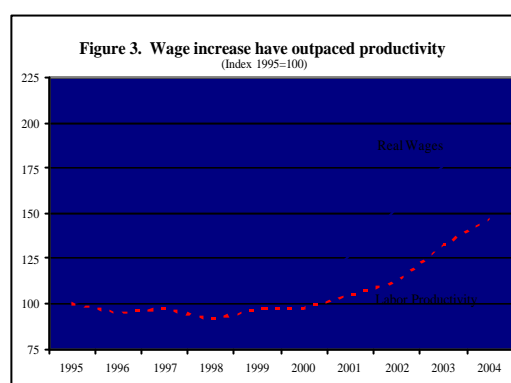
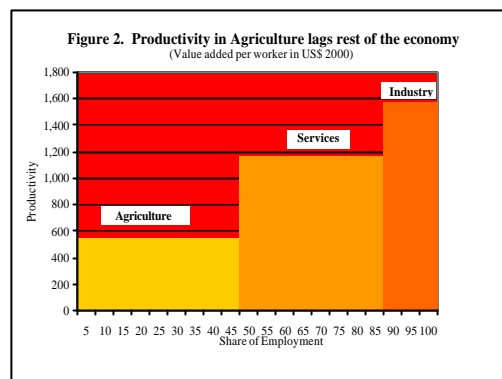
remittance driven increase in consumption has led to an even faster increase in imports. As a result, net exports have remained a drag on economic growth and the trade deficit has widened considerably – reaching 32 percent of GDP in 2004. Given the large remittance inflows, however, the current account deficit is considerably smaller (5 percent of GDP and maybe even smaller if unrecorded remittance flows are included).

5. The industrial sector has grown (at about 11 percent per annum) while the agricultural sector has remained stagnant (growing at less than 3 percent per annum). Contributing nearly 20 percent of GDP and employing 45 percent of the labor force, low productivity and growth in the agricultural sector have been a drag on the rest of the economy.

6. Labor shedding in the industrial and service sectors appears complete. In the agricultural sector this process started later and is still ongoing. Migration and the withdrawal of discouraged workers have led to a decline in employment which, when combined with the increase in output, has resulted in a sharp increase in labor productivity. The growth in real wages, however, has outpaced the gains in productivity. The possibility of generating further productivity increases by additional labor shedding may well be diminishing. Continued increases in productivity, therefore, will require the creation of conditions that will encourage increased investment and innovation.

7. Recovery-induced increases in tax revenues have given Moldova some fiscal space to increase public expenditures. The bulk of the revenue increase has come from the taxation of consumption - primarily the value added tax (VAT). The VAT now supplies nearly 50 percent of total consolidated budget revenues. Increased Government spending has focused on those programs that were cut dramatically at the end of the 1990s and earlier - spending on health, education and social protection increased by nearly 6 percentage points of GDP from 2000 to 2004. With limited access to external financing, the Government has maintained a prudent fiscal stance (average deficit of only -0.1 percent of GDP from 2000 to 2004).

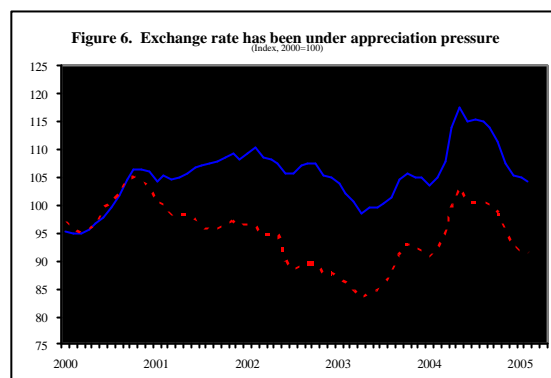
8. Active debt management, lower interest rates and the appreciation of the exchange rate relative to the US dollar have eased the burden of debt servicing on the budget. Since 2000, Moldova's debt indicators have improved considerably, easing concerns about medium-





term debt sustainability. At the same time, Moldova has accumulated arrears on external debt (amounting to 3 percent of GDP). Thus, while Moldova's debt profile has improved, the lack of a credible plan to deal with the continued accumulation of arrears has impaired access to much needed external debt flows.

9. After depreciating in real terms during 2001-02, the leu has come under fairly constant appreciation pressure since the beginning of 2003. Interventions by the monetary authorities have contributed to a rapid increase in both reserve and broad money, increasing the risk of fueling inflationary pressures. Empirical analysis suggests that the leu remains undervalued indicating that further appreciation of the exchange rate is likely. Combined with rising real wages, the maintenance of international competitiveness will require faster growth in productivity.



## Key Challenges for Accelerated Growth

10. Sustained economic growth and increased international competitiveness will require a set of policies which encourages faster gains in labor productivity. The recommendations provided by the CEM focus on improving the macroeconomic supporting environment, enhancing the opportunities presented by the large inflow of workers remittances, creating a more dynamic and diversified private sector - particularly in the agricultural sector – and increasing the effectiveness of the Government.

### Macroeconomic Management for Growth

- ✍ *Increase emphasis on growth-inducing expenditures in public investment and economic services; over the medium term, greater pro-growth spending will require improved access to external financing by developing a satisfactory plan to address external payment arrears;*
- ✍ *Broaden the tax base by simplifying the tax structure, reducing tax exemptions, and improving tax administration and enforcement mechanisms;*
- ✍ *Minimize risk to macroeconomic stability by making inflation the primary objective of monetary policy and letting the real exchange rate adjust toward its long-term equilibrium.*

11. The economic collapse that took place following independence had serious implications for macroeconomic management. Sizeable fiscal deficits were financed by external borrowing leading to the rapid accumulation of external debt. When this external financing evaporated in the wake of the regional financial crisis, significant adjustment in the fiscal accounts was required and public expenditures were cut drastically. The increase in fiscal revenues that accompanied Moldova's economic recovery has given Moldova the fiscal space to increase public expenditures. At the same time, the Government has successfully maintained a very prudent fiscal policy stance with negligible fiscal deficits.

12. The Government has concentrated its increased spending efforts on those social programs that were reduced during the 1990s– education, health and social protection. Expenditures on

public investment and economic services, however, have remained compressed. The low level of rural infrastructure and extension services provided to the agricultural sector is particularly worrisome. Given the poor and deteriorating state of public infrastructure in Moldova, this low level of spending will begin to inhibit future economic growth prospects. While higher expenditures can be achieved by improved resource mobilization and better targeting of social expenditures, ultimately any increase in fiscal space will require improved access to external financing. However, despite having reduced the level of the external debt significantly, the country faces difficulties in accessing financing on advantageous terms given that a final arrangement on arrears has not been reached with all bilateral and commercial lenders.

13. The bulk of Moldova's increased tax revenues come from the taxation of consumption, primarily the VAT. To broaden the tax base and increase tax revenues coming from direct taxation, the Government has begun to reduce tax rates. To be consistent with medium-term fiscal sustainability, tax rate reductions should be accompanied by efforts to broaden the tax base by simplifying the tax structure, reducing tax exemptions and continuing to improve tax administration and enforcement mechanisms.

14. Monetary policy has strived to achieve a number of objectives, including maintaining a competitive exchange rate, keeping inflation and interest rates low and accumulating a precautionary level of international reserves. The large inflow of remittances, however, has complicated the attainment of these often conflicting objectives. While the National Bank of Moldova (NBM) has intervened aggressively in the foreign exchange market to halt the appreciation of the nominal exchange rate, the resulting rapid increase in the money supply has put the Government's inflationary targets at jeopardy. Indeed, the inflation rate in Moldova is now among the highest in the region. With prices and wages below the level that reflects their true economic value, the leu remains undervalued by between 20 to 40 percent. Under these circumstances, resisting the real appreciation of the exchange rate by slowing the nominal appreciation will be ineffective and will only result in a real exchange rate appreciation being realized by higher inflation. Since, ultimately, the monetary authorities will be unable to successfully influence the trend in the exchange rate it should place greater emphasis on maintaining macroeconomic stability.

### **Maximizing the Benefits from Migration and Remittances**

- ✍ *Negotiate well structured bilateral labor agreements to help Moldovans abroad formalize their legal status and increase the domestic benefits from migration.*
- ✍ *Encourage increased financial intermediation of remittance flows by offering a wider range of savings options, including in foreign currency. Reduce the cost of formal transmission channels by allowing non-banking financial institutions to compete in this marketplace.*

15. Migration outflows increased dramatically in the aftermath of the 1998 regional financial crisis. While some 371,000 Moldovans, or 25 percent of the economically active population, were estimated to be working abroad at the end of 2004, this estimate ignores much of the seasonal or temporary migration flows. Over the course of 2003-04, nearly 600,000 Moldovans, or about 40 percent of the economically active population, worked abroad at some point in time. With the majority of migrations coming from district towns or rural villages, areas with the highest concentration of poor, migration has been an important poverty coping mechanism.

16. A significant proportion of Moldova's migrants are young, highly educated and skilled. To avoid suffering from permanent "brain drain", Moldova needs to create incentives for these

migrants to return home and use newly acquired skills for the benefit of local economic development. The set of policies that improve the investment climate at home will be the same ones that encourage “brain gain” and not “brain drain”. Further, international evidence suggests that legal migrants are more likely to return home and become economically active. The majority of Moldovan migrants, however, do not have legal work permits. The negotiation of bilateral labor agreements, by increasing the proportion of migrants with legal status, will increase the economic benefits to Moldova (and the host countries) from migration.

17. At 26 percent of GDP in 2004, Moldova’s dependence on remittance flows are among the highest in the world. Over 80 percent of Moldova’s migrants remit funds and over 70 percent of these remit over half of their earnings. The majority of these flows are used to fund basic household consumption, consumer durables, purchases of housing and debt repayment. Very little of these flows - less than 7 percent - are being used to finance business investment. Further, while some 20 percent of these flows are being “saved”, less than 5 percent is saved using bank accounts. There is, therefore, considerable scope for these funds to be mobilized directly into further business investment or indirectly through increased intermediation by the formal financial system. International evidence indicates that policies and endeavors to “channel” remittances into investment and savings have had, at best, mixed success. It is clear, however, that economic policies must favor savings and investment so that at the margin some of these flows will be put to more productive use. Banks can be encouraged to expand their product offerings and create new savings instruments to attract remittances. Expansion of foreign currency denominated instruments may help increase financial intermediation of remittances flows by drawing savings from “under the mattress” into the formal banking system. The Government itself can take advantage of these flows by issuing foreign currency denominated bonds. Further financial mobilization can be realized by lowering the cost of transferring money through formal channels. Increasing competition in this marketplace can be achieved by allowing non-bank financial institutions to offer these services.

### **Increasing Diversification and Competitiveness**

- ✍ *Increase competition in the market by reducing the regulatory and administrative barriers to entry, operation and exit of firms, including foreign ones. This includes the creation of a National Competition Agency to increase the coherence and coordination of policies against market power abuse.*
- ✍ *Improve access to overseas markets by addressing costly and time consuming domestic constraints on trade and investment. This includes increasing trade facilitation by streamlining customs procedures, increasing the sophistication of risk management at the border and accelerating the adoption of an international, voluntary system of standards and conformity assessment.*
- ✍ *Implement measures to increase access to financing and increase the efficiency of the banking system. This includes creating a unified credit information and exchange system, allowing exporters to have increased access to foreign currency borrowing and developing a strategy to privatize the state-owned bank.*
- ✍ *Complete the structural transformation of the economy by reviving the stalled privatization program.*

18. Economic reforms and the structural transformation that took place during the 1990s have allowed the Moldovan enterprise sector to respond positively to growing domestic and international demand. Enterprises in the industrial sector have experienced healthy growth in production, particularly in the areas of food processing, textiles and wine production, while growth among service enterprises has been even faster. Only in the agricultural sector, where

reforms efforts were delayed, has growth remained stagnant. While faster growth has been accompanied by increased profitability, the level of investment activity has remained low with only about 11 percent of all enterprises undertaking some form of investment during the recovery. Instead, most firms have managed to raise production by increasing the capacity utilization of existing plants and equipment. As a result, productivity has increased significantly but employment generation by the economy has remained weak. The ability of Moldova to achieve productivity growth combined with employment generation will depend on the extent to which firms address the current low levels of investment and innovation.

19. In addition, the economy has remained relatively undiversified with domestic production focused on a number of key products and markets. This is particularly true for exports, where the majority of exports are still destined for CIS countries whose markets are much less driven by quality consideration. Over time, the product mix of Moldova's exports has become more concentrated with the top three products now accounting for over 50 percent of total exports. The uncertainties and vulnerabilities stemming from the insufficient diversification of the real sector of the economy are heightened by the high concentration of remittance flows from similar markets. This increases the systemic risk to the economy since an external shock will be transmitted into the domestic economy via reduced demand for exports of goods and reduced inflows of remittances.

20. There is concern that rising unit labor costs – real wages rising faster than productivity – and an appreciating real exchange rate are undermining the competitiveness of the Moldovan economy. While competitiveness of the economy might be undermined if these trends persist, labor costs in Moldova are still relatively low and the real exchange rate appears undervalued. Instead, the true constraints to competitiveness and increased diversification of the economy are largely related to domestic policy constraints and infrastructure that limit the ability of exporters to penetrate new overseas markets, inhibit domestic competition, limit access to credit and discourage foreign investment. Having to contend with, for example, costly and time consuming clearance of exports, deteriorating transportation infrastructure, the difficulties and costs of obtaining funds for working capital and investment and the difficulties caused by the current system of product regulations and conformity assessment, all undermine domestic competitiveness.

21. The main challenge for Moldova over the medium term will be sustaining productivity growth after the current gains - achieved primarily by increasing capacity utilization and shedding excess labor - are exhausted. Empirical analysis undertaken by the CEM points to a number of key variables that underpin future sources of productivity growth. Increased competition among firms, for example, is associated with higher sales, profitability and investment activity. The current regulatory and administrative framework, therefore, needs to better encourage the free entry and exit of firms, including foreign-owned firms. Similarly, export orientation is positively associated with firm performance. Reducing the domestic barriers confronting exporters will be an important element of Moldova's growth strategy. Productivity gains are also being hampered by the incomplete structural transformation of the economy. State-owned enterprises still account for a large share of economic activity in a number of sectors. Analysis undertaken by the CEM show that these firms generally have lower profits per worker and invest considerably less than their private counterparts. In addition, the soft budget constraint of these state enterprises is a drain on fiscal resources. Reviving the privatization program, therefore, will improve prospects for future economic performance. Finally, improved access to finance is essential for restructuring and better performance. Only about 9 percent of all investment is bank-financed, with most firms, particularly smaller ones, relying on "informal" or own sources of finance. Measures that reduce the cost of borrowing, such as allowing exporters to have access to foreign

currency borrowing, and addressing informational constraints on credit history will be necessary to increase access to formal bank financing.

### **Unleashing the Potential of the Agricultural Sector**

- ✍ *Address market failures in output and input markets, by removing interventions such as export restrictions, adapting Moldova's standardization and certification systems to EU standards, encouraging the further development of farmer-processor linkages, facilitating improvements in marketing infrastructure and producers' organizations, and improve access to improved seeds by radically simplifying and accelerating the seed certification process.*
- ✍ *Reallocate scarce public agricultural spending away from input subsidies to larger farm operators and toward public investment and economic services in farms that support the needs of Moldova's emerging comparative advantage.*
- ✍ *Improve access to credit by promoting and scaling up lending efforts of Savings and Credit Associations; alleviate current constraints on commercial bank lending by improving the legal framework for collateral and encouraging the development of financial instruments for sharing and reducing price and quantity risk.*

22. Given the importance of the agricultural sector to the overall economy and the preponderance of the poor that live in rural areas, improving the performance of this sector is a prerequisite for accelerating economic growth and poverty reduction over the medium term. The main problem with agricultural markets in Moldova is that they are poorly organized and suffer from market failures and distortions on both the output and input side. These problems are creating significant disincentives for increased production and investment, and are reducing the ability of farmers to use purchased inputs to increase yields. Farmers of high valued-added crops, the area of Moldova's emerging comparative advantage, are particularly affected by these market failures. Output prices of these crops are some 10 to 40 percent lower relative to international parity prices. Agricultural policy, however, currently concentrates on supporting and rehabilitating low productivity sectors. Increased attention needs be paid to the elaboration of appropriate and affordable sector policies that will enhance the growth prospects in the high productivity small farm sector by reallocating government spending on agriculture and removing market imperfections that reduce farmers' terms of trade.

23. Land privatization has resulted in the emergence of a large number of small, independent farms. Compared to large farms, and using only half of Moldova's agricultural land, these small farms produce about 75 percent of agricultural output. Much attention has been paid to the impact of land privatization on agricultural performance by the Government. In reality, however, the constraints to improved performance has very little to do with farm size. Attempts to preserve the large-scale corporate farm structure in other former Soviet republics (whether as agricultural cooperatives or as new corporations with market sounding names) have not produced positive results. Instead, the most impressive recovery efforts have come in those countries which have made a clean shift to the small-scale, individual farm structure. Moldova, therefore, should desist from policies that favor large, corporate farms, and instead create a level playing field in which the most efficient farms are allowed to develop. This will bring Moldova's farm structure in closer conformity with the pattern of land concentration found in market economies, which is based on the family farm.

24. A number of steps can be taken to encourage the improved functioning of agricultural markets in Moldova. The first priority, which is cost effective, is to improve the business environment for agriculture and remove price-depressing market interventions such as formal and

informal export restrictions on agricultural commodities. Next, since Moldovan agricultural producers generally do not meet international standards, their access to high-value export markets (i.e., the EU), domestic supermarkets and even their traditional CIS markets can be improved by adapting Moldova's standardization and certification systems to EU standards. Improved product quality, as well as increased farm productivity, can also be encouraged by increasing the linkages between farmers and processors (vertical coordination) in the agri-food chain. Increased investment in collection points, cold storage, packing houses, wholesale markets and rural transportation can increase both the temporal and spatial options available to farmers to obtain higher prices. The development of producer organizations would increase the market power of small producers and help them integrate in supply chains. Technological improvement in agriculture can be jump started by radically simplifying and accelerating the Government's seed certification process. The access of smaller farmers to credit can be improved by modifying the legal framework to allow movable property to be used as collateral and encouraging the development of financial instruments for sharing and reducing price and quantity risk such as forward and futures markets.

### **Enhancing the Effectiveness of Government Policy**

- ✍ *Undertake only public sector governance reforms that are well-defined, realistic and sequenced. To strengthen the contribution of good governance to growth, and to prepare for possible EU accession, the Government must strengthen its credibility by adopting practical and feasible measures to make central and local governments responsive, enhance transparency and accountability, provide better public services, and reduce corruption.*
- ✍ *Make use of three key entry-points to public sector governance reform: (a) strengthening the MTEF as a tool for transparent decision-making by Government and a framework for public services prioritization; (b) strengthening performance-based accountability for public services by providing incentives (rewards/sanctions) to the actual service providers; and (c) consolidating the achievements of decentralization by creating space for citizen demands and participation in local governance.*

25. Good governance is fundamental for economic growth. An effective state must ensure an attractive and stable investment climate and allocate scarce resources efficiently and equitably. Failure to deliver services in an efficient and transparent manner increases the risk of corruption and reduces the credibility of public policy in the eyes of citizens and investors alike. In Moldova, initial institutional constraints contributed to poor transition performance. Over time, corruption, constant political and institutional change, and weak implementation of stated policies and programs have contributed to an environment of policy uncertainty that has reduced the credibility of the Government to manage the country's structural transformation effectively. During the 1990s, Moldova successfully undertook many of the first generation economic policy and public sector reforms that were needed for transition toward a market economy. The second generation reforms include sustained good governance measures needed to enhance government effectiveness and accountability, reduce corruption and political instability, ease the regulatory burden, and strengthen citizens' voice and the rule of law. This agenda is more demanding than the first generation reforms. While Moldova's quality of governance compares favorably to other former Soviet republics, it lags behind East and South-East European countries, particularly those that have recently joined the EU. Given Moldova's European aspirations, this poor relative performance represents a major challenge.

26. While the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) is the first officially approved government program that explicitly includes, among government priorities, a

comprehensive public sector reform agenda, a number of earlier policies and actual institutional changes have aimed at the good governance agenda. Most often, the reforms have been limited to ambitious policy statements and ad hoc changes in organizational structures. When public sector governance reforms are not fully and effectively implemented, and occasionally are exposed to policy reversals as in the case of decentralization, they are costly for government credibility, providing an image of bad governance. This is detrimental to growth, since it creates disincentives for active economic participation by citizens and foreign investors, including Moldovans living abroad. While the EGPRSP pursues the right good governance objectives, it appears too comprehensive and ambitious to be implemented effectively within the stated timeframe. Its non-implementation is likely to cause two interrelated problems: the good governance agenda is not advanced, and the government's credibility is further undermined.

27. The Government needs effective entry-points to public sector governance reforms that are feasible and yield results in both the short and medium term. The Government is successfully seeking enhanced transparency and predictability in the management of public resources, particularly through the medium-term expenditure framework for the annual budget. The MTEF now serves as a solid foundation for explicit political priority-setting in the context of the EGPRSP; for the analysis of service delivery needs, resources and affordable standards; for the allocation of public resources through the state and local government budgets, and potentially, for monitoring and financial control of the use of public money. The Government is committed to pursuing realistic reforms in public financial management, with the support of the Bank and donors.

28. Moldova's changing governments have also pursued decentralization to local governments of responsibility for public services in the social sectors and infrastructure. While the decentralization legislation is relatively clear, intergovernmental fiscal relations are unnecessarily complex and create a disincentive to resource mobilization efforts at the local level. With the emphasis on meeting norms and not on responding to direct demand, the accountability of service providers has been reduced. In the absence of outcome monitoring and feedback mechanisms, such as user surveys or citizen score cards, the performance of service providers is unknown. There is a significant gap between the service responsibilities assigned to elected local officials and the resources made available to them. The reason is that the decentralization reforms of 1999-2001 were never fully completed; the present Government reversed the structural changes to local governments, after it took power in 2001; different procedures of intergovernmental fiscal transfers are applied in the key sectors of education, health and roads maintenance; incentives and simple mechanisms to hold service providers accountable are not being applied; and there are very few attempts at involving the private sector and citizens in the provision and management of public services. These are examples of missed opportunities on the governance agenda. The Government must clarify its decentralization policy, remove inconsistencies, introduce simple performance- and accountability-enhancing incentives, and create space for the active involvement of citizens in local governance and of the private sector in service delivery. In addition to providing citizens with better public services and the economy with a more active and better educated labor force, effective implementation of decentralization contributes to enhanced government credibility which will improve the investment climate.

## **Conclusion**

29. While economic performance has been strong since 2000, the CEM highlights the erosion of several important factors that have driven this recent growth. Unless action is taken to address these emerging constraints, the Moldovan economy faces a considerable risk that growth and poverty reduction will slow and international competitiveness will erode. To ensure that growth

and competitiveness is sustained over the medium term, a number of policy adjustments are necessary. The following matrix summarizes the results of the reports' analysis and its recommendations.



**Table 1. Summary of Report's Analysis and Recommendations**

Objectives	Risks/Constraints	Recommended Actions/Measures
<b>MACROECONOMIC MANAGEMENT</b>		
<ul style="list-style-type: none"> <li>✍ Stable macroeconomic policies support economic growth and provide clear signals to economic agents;</li> <li>✍ Government policy contributes to productivity gains.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Conflicting monetary and exchange rate policies threaten to destabilize the economy;</li> <li>✍ Problematic access to external financing because of the accumulation of arrears;</li> <li>✍ Very little fiscal space for increased public investment;</li> <li>✍ Low efficiency in the delivery of public services.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Increase emphasis on growth inducing expenditures in public investment and economic services; Over the medium term, greater pro-growth spending will require improved access to external financing by developing a satisfactory plan to address external payment arrears;</li> <li>✍ Broaden the tax base by simplifying the tax structure, reducing tax exemptions, and improving tax administration and enforcement mechanisms;</li> <li>✍ Minimize risk to macroeconomic stability by making inflation the primary objective of monetary policy and letting the real exchange rate adjust toward its long-term equilibrium.</li> </ul>
<b>MAXIMIZING THE BENEFITS FROM MIGRATION AND REMITTANCES</b>		
<ul style="list-style-type: none"> <li>✍ Increase the potential contribution to economic growth provided by large remittance inflows.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Uncertainty over the expected evolution of remittance flows;</li> <li>✍ High degree of informality in remittance flows reduces opportunities for financial intermediation.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Negotiate bilateral labor agreements to help Moldovans abroad to formalize their legal status and increase the domestic benefits from migration.</li> <li>✍ Encourage increased financial intermediation of remittance flows by offering a wider range of savings options, including in foreign currency. Reduce the cost of formal transmission channels by allowing non-banking financial institutions to compete in this marketplace.</li> </ul>
<b>INCREASING DIVERSIFICATION AND COMPETITIVENESS</b>		
<ul style="list-style-type: none"> <li>✍ Create conditions for sustained productivity growth thereby increasing income, employment and competitiveness.</li> </ul>	<ul style="list-style-type: none"> <li>✍ FDI and competitiveness of exports limited by behind-the-border barriers;</li> <li>✍ Lack of product and market diversification in exports;</li> <li>✍ Impediments to entry and exit of firms reduce the positive impacts of competitions on the economy;</li> <li>✍ Structural transformation is incomplete.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Increase competition in the market by reducing the regulatory and administrative barriers to entry and exit of firms, including foreign ones. This includes the creation of a National Competition Agency to increase the coherence and coordination of policy against market power abuse.</li> <li>✍ Improve access to overseas markets by addressing costly and time-consuming domestic constraints on trade and investment. This includes increasing trade facilitation by streamlining customs procedures, increasing the sophistication of risk management at the border and accelerating the adoption of an international, voluntary system of standards and conformity assessment;</li> <li>✍ Implement measures to increase access to financing and increase the efficiency of the banking system. This includes creating a unified credit information and exchange system, allowing exporters to have increased access to foreign currency lending</li> </ul>

		<p>and developing a strategy to privatize the state-owned bank.</p> <ul style="list-style-type: none"> <li>✍ Complete the structural transformation of the economy by reviving the stalled privatization program.</li> </ul>
<b>UNLEASHING THE POTENTIAL OF AGRICULTURE</b>		
<ul style="list-style-type: none"> <li>✍ Improve performance of the agricultural sector</li> </ul>	<ul style="list-style-type: none"> <li>✍ Underperforming sector is a drag on economic growth;</li> <li>✍ Large wedge between farmgate and international parity prices;</li> <li>✍ Government policies support least productive sub-sectors;</li> <li>✍ Key areas of public investment and economic services are under funded;</li> <li>✍ Standards and regulations reduce productivity and inhibit innovation.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Address market failures in output and input markets by improving the business environment and removing export restrictions, adapting Moldova’s standardization and certification systems to EU standards, encouraging the further development of farmer-processor linkages, facilitating improvements in marketing infrastructure and producers’ organizations, and improve access to improved seeds by radically simplifying and accelerating the seed certification process.</li> <li>✍ Reallocate scarce public agricultural spending away from input subsidies to larger farm operators toward public investment and economic services that support the needs of the small farm sector.</li> <li>✍ Improve access to credit by promoting and scaling up lending efforts of Savings and Credit Associations; alleviate current constraints on commercial bank lending by improving the legal framework for collateral and encouraging the development of financial instruments for sharing and reducing price and quantity risk.</li> </ul>
<b>STRENGTHENING GOVERNANCE FOR GROWTH</b>		
<ul style="list-style-type: none"> <li>✍ Governance provides rule of law, a credible and predictable investment climate, and an enabling environment for citizens’ active participation in the economy.</li> </ul>	<ul style="list-style-type: none"> <li>✍ The gap between policy statements and implementation of governance reforms undermines the credibility of the Government.</li> <li>✍ Sub-optimal decentralization misses opportunities for effective public services and active citizen participation in the economy.</li> </ul>	<ul style="list-style-type: none"> <li>✍ Undertake only public sector governance reforms that are well - defined, realistic and sequenced. To strengthen the contribution of good governance to growth, and to prepare for possible EU accession, the Government must strengthen its credibility by adopting practical and feasible measures to make central and local governments responsive, enhance transparency and accountability, provide better public services, and reduce corruption.</li> <li>✍ Make use of three key entry-points to public sector governance reform: 1) strengthening the MTEF as a tool for transparent decision-making by Government and a framework for public services prioritization; 2) strengthening performance-based accountability for public services by providing incentives (rewards/sanctions) to the actual service providers ; and 3) consolidating the achievements of decentralization by creating space for citizen demands and participation in local governance.</li> </ul>

# CHAPTER 1. AN OVERVIEW OF GROWTH IN MOLDOVA

## INTRODUCTION

1.1 The importance of growth in achieving economic, social and even political development cannot be overstated. Cross-country empirical evidence shows that economies which have grown strongly and for sustained periods of time have been able to reduce poverty levels significantly. Further, a remarkably diverse set of indicators shows that growing levels of per capita income are positively associated with an improved quality of life. Indeed, at higher levels of income, civil liberties and democracy are strengthened, and health, education and environmental outcomes are improved. Further, higher income is also associated with an improvement in the quality of public institutions which, in turn, increases the freedom from expropriation, contract repudiation, and corruption and strengthens the rule of law.

*The CEM focuses on identifying the critical binding constraints to growth that can be addressed through public policy.*

1.2 This CEM explores how Moldova can confront its emerging challenges to growth and position itself strategically to take advantage of the opportunities by using its strengths more effectively. The CEM focuses on identifying the critical binding constraints to growth that can be addressed through public policy.

*Chapter 1 focuses on macroeconomic challenges.*

1.3 This first chapter focuses on the macroeconomic challenges that the country must address in order to assure the continuation of economic growth and contribute to an even stronger macro-economic position upon which to anchor the long term. As long as a solid macroeconomic framework remains in place, in the immediate to short-run, economic growth will continue, underpinned by increases in workers' remittances and further productivity gains. This chapter reviews Moldova's recent growth experience and outlines the policy challenges, particularly the risks to the fiscal position, and points to the need for increased attention to public infrastructure and the provision of economic service.

*Chapter 2 examines the policy initiatives that can increase the formalization of remittance flows.*

1.4 Given their importance in the growth process, a solid understanding is needed of the scope and characteristics of the migratory flows and the resulting remittances' patterns. Chapter 2 examines these patterns and compares Moldova's experience with that of similar countries. The chapter utilizes this analysis to draw some conclusions on the expected evolution of the remittance flows, the policy initiatives that can increase the formalization of these flows in order to increase their stability and enhance the opportunity they represent for the country.

*Chapter 3 explores the firm characteristics that explain the productivity variations in the economy and identifies underlying constraints that require immediate attention.*

1.5 Besides attention to macroeconomics, a solid understanding of the microeconomic conditions under which economic agents operate is needed to develop the policy measures that help set the institutional basis for further productivity increases. Chapter 3 examines the firm characteristics that explain the productivity variations in the economy and identifies underlying constraints that require immediate attention. There is abundant evidence that the simplicity of the rules for creating, operating and closing enterprises, the fairness of their enforcement and the extent of competition are at the heart of productivity gains at both the national and sectoral level. Chapter 3 also addresses the

potential for economic diversification so that the country does not have to continue to rely on a few export markets or products thereby reducing some of the systemic risks confronting future growth.

*Chapter 4 investigates the microeconomics of the agricultural sector.*

1.6 Since agriculture is the dominant sector of the economy and represents a significant potential for future growth – potential that currently is underexploited as the low productivity of the sector demonstrates - Chapter 4 examines in greater detail the microeconomics of the agricultural sector. The chapter outlines a policy strategy that combines both incentives for private farming as well identifying priority areas for future public support of the sector.

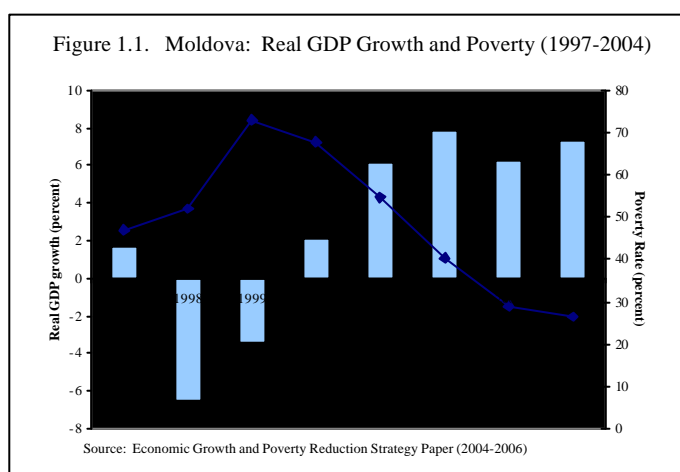
*Chapter 5 explores the governance challenges facing Moldova*

1.7 Finally, the CEM argues that since long-term growth has to be predicated on increased innovation and investment, it will be necessary to drastically improve the credibility of economic policy and the Government’s effective functioning. The wavering approach to reform since independence has clouded Moldova’s reputation at home and abroad, thereby further handicapping the country as it confronts its development challenges. Chapter 5 explores the governance challenges Moldova faces and presents an approach to improve governance by focusing on key entry points that will increase the credibility of the Government and the country thereby enhancing its EU aspirations.

### MOLDOVA’S RECENT GROWTH EXPERIENCE

*The collapse in economic activity in the decade following independence transformed Moldova from a middle-income country to a low-income country. By the end of the 1990s, per capita GDP had fallen to US\$350 and more than 70 percent of Moldovans were poor.*

1.8 Growth and Poverty. The continuous decline in economic activity in the first decade following independence led to a sharp increase in poverty, transforming Moldova from a middle to low income country. By the end of the 1990s, over 70 percent of Moldovans were poor - nearly 60 percent extremely poor – with per capita GDP having fallen to about US\$350. Moldova’s social



indicators were also among the worst in the region. According to the 2000 UNDP Human Development Index, Moldova ranked 102 out of 174 countries, the lowest of all transition countries except Tajikistan and Uzbekistan.<sup>1</sup>

1.9 Moldova’s transition recession ended in 2000 when the economy finally began to experience sustained economic growth. Between 2001 and 2004, the Moldovan economy grew by more than 30 percent, with GDP growing by an averaging of 6.9 percent per annum. The rebound in growth has resulted in a marked decline in poverty rates. As shown in Figure 1.1, by 2004 the poverty rate in Moldova is estimated to have fallen by more than half the peak level recorded in 1999. While Moldova’s growth rates are

<sup>1</sup> See Human Development Index in [Human Development Report 2004](#), United Nations Development Program (available on-line at [hdr.undp.org](http://hdr.undp.org)).

impressive, most of the transition countries have experienced strong economic growth over this period. Indeed, among CIS countries, Moldova's recent growth rates are below the regional average.

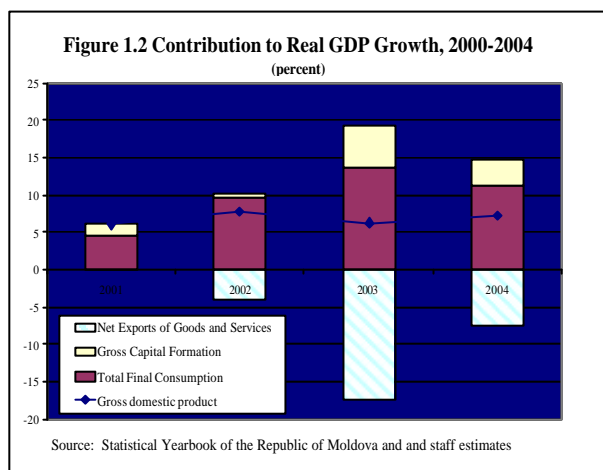
*The export of labor and the resulting inflow of workers' remittances have come to dominate Moldova's economic and social landscape of.*

1.10 The export of labor and the resulting inflow of workers' remittances have come to dominate Moldova's economic and social landscape of. In the aftermath of the 1998 regional financial crisis, the inflow of workers' remittance accelerated as an increasing number of Moldovans emigrated in search of higher-paying job opportunities abroad. According to the 2004 population census, some 357,000 Moldovans - 25 percent of the labor force - are currently working abroad. As a result of increased migration, between 1999 and 2004 officially recorded remittances increased from about 5 to nearly 27 percent of GDP, making Moldova among the most remittance dependent economies in the world.<sup>2</sup>

### Demand Contributions to Economic Growth

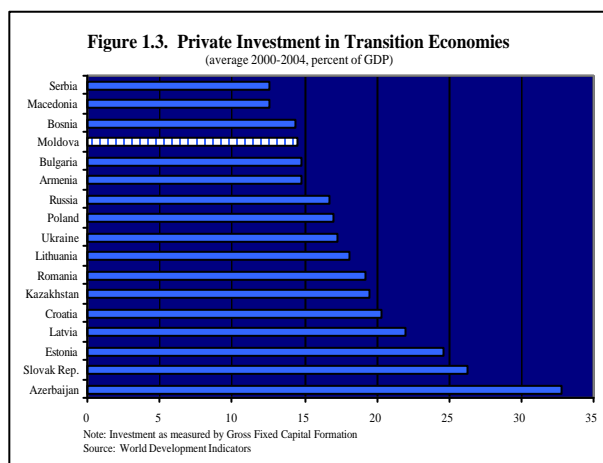
*The economic recovery has been driven primarily by final consumption expenditures fueled by the inflow of worker's remittances*

1.11 The rapid increase in workers' remittances has played a major positive role in spurring Moldova's economic recovery. Along with the growth in real wages, the large inflow of remittances has led to a significant increase in income which, in turn, has fueled consumption growth. While US dollar GDP per capita has grown, on average, by 18 percent per annum since 2000, Gross National Disposable Income (GNDI) per capita – the income available to domestic residents for consumption including remittances - has grown even faster (21 percent per annum). The analysis of the expenditure components of GDP, presented in Figure 1.2, illustrates the extent to which the economic recovery in Moldova has been driven primarily by final consumption expenditures.



*The contribution of investment to current economic recovery has been modest with private and public investment levels remaining quite low.*

1.12 In contrast to consumption, the contribution of investment to current economic recovery has been modest (see Figure 1.2). As a share of GDP, fixed capital formation has

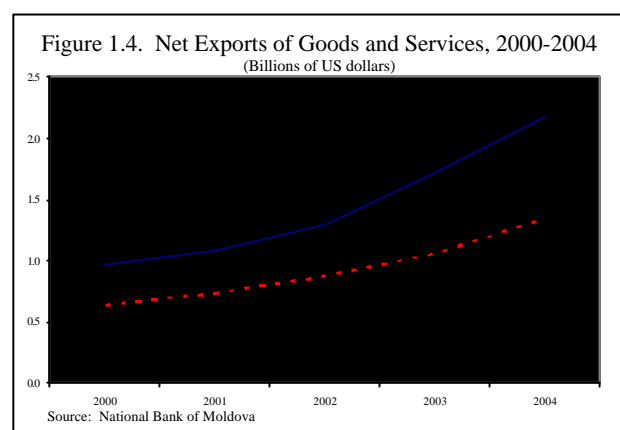


<sup>2</sup> Only Tonga, Haiti and Jordan have a higher ratio of worker remittances to GNI (See World Bank, Global Development Finance, 2004)

remained quite low - averaging less than 17 percent between 2000-04 - and have been slow to recover from the impact of the regional financial crisis. While investment has been gradually increasing over the last few years, largely the result of a remittance-financed construction boom, gross fixed capital formation still only constituted about 18 percent of GDP in 2004. Of this, private investment is about 16 of GDP while public investment is very low at about 2 percent of GDP. Even when compared to other transition economies, private investment levels in Moldova are low (Figure 1.3). More globally, among the average-performing OECD economies, investment rates are between 20 and 25 percent of GDP while investment rates for the East-Asian “miracle” economies reached an average of 30 percent of GDP.

*Net exports have remained a drag on economic growth.*

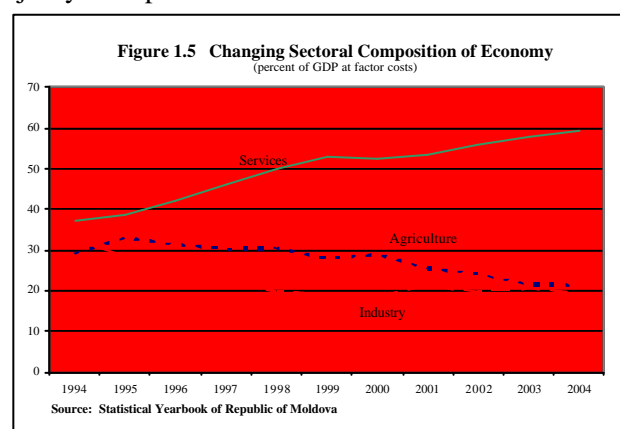
1.13 While strong economic performance in Moldova’s main trading partners has encouraged a rapid increase in exports (averaging a 21 percent annual growth during 2001-04), the remittance-driven increase in consumption has led to an equally rapid increase in imports (averaging 23 percent annual growth over the same period). As a result, net exports in Moldova have remained a drag on economic growth (see Figure 1.2). Further, with the value of imports amounting to more than one and half times that of exports, the result has been a significant widening of the resource balance. From a deficit of roughly 24 percent of GDP in 2001, the gap has steadily grown reaching just under 32 percent of GDP in 2004. The market and commodity composition of exports increases the vulnerability of Moldova to external shocks. Nearly 60 percent of Moldova’s exports are in the form of agricultural products (including from the agro-processing industry), and mainly from the wine and beverage sector. Though the direction of trade has been slowly redirected toward the EU, given the nature of Moldova’s exports this transformation has been much slower than in other transition countries. As a result, the majority of exports are still bound for CIS members and Russia in particular.<sup>3</sup>



### Structural Transformation and the Supply Response

*During the recovery, the industrial and service sectors have grown, while the performance of the agricultural sector has remained poor.*

1.14 The structure of Moldova’s economy has changed dramatically since independence. As with many transition economies, the service sector was considerably underdeveloped and the industrial sector had to contend with the legacy of outdated industrial



<sup>3</sup> Problems associated with the redirection of Moldova’s exports are the topic of the Moldova: Trade Diagnostic Report, World Bank, 2004.

*The structure of Moldova's economy has changed dramatically since independence.*

*The process of labor shedding in the industrial and service sectors now appears complete. In the agricultural sector, however, this process began later and is still ongoing.*

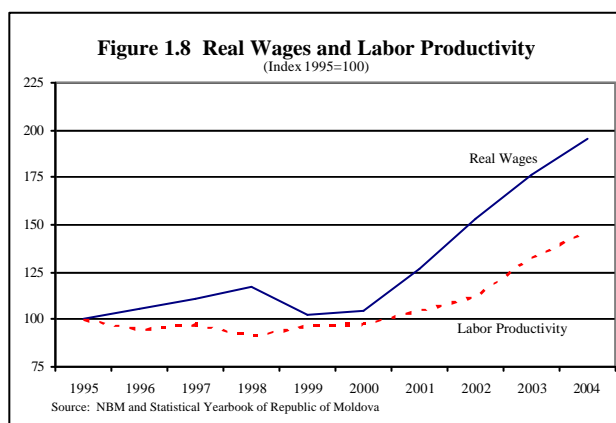
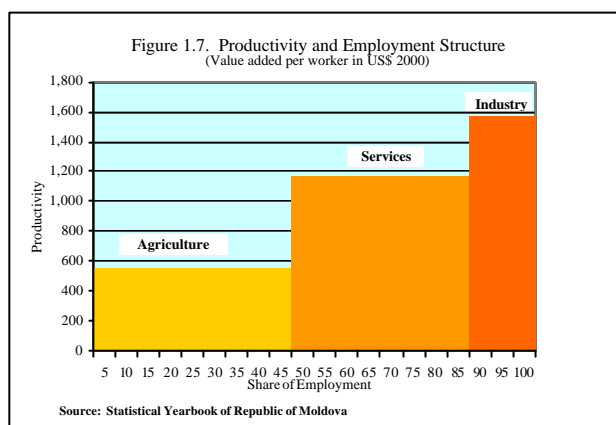
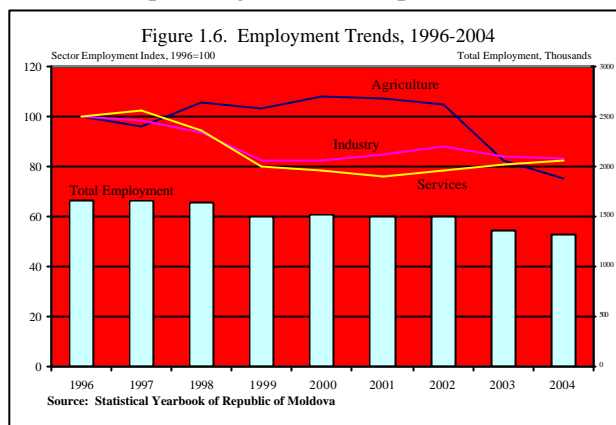
*Labor productivity is highest in the industrial and service sectors, but in the sector with the largest share of total employment, the agricultural sector, productivity has lagged considerably.*

structures. The structural transformation that has occurred during Moldova's transition has resulted in the service sector significantly increasing its share of economy activity. Throughout most of the 1990s, the industrial and agricultural sectors shrank in both absolute and relative size. With the onset of the economic recovery, however, the industrial sector has grown by an average of 11 percent per annum and has stabilized its share of domestic output at around 20 percent of GDP. The performance of the agricultural sector has, however, continued to be poor. Agricultural output has been volatile and has grown, on average, at only 2.7 percent per annum since 2000 with its share in the overall economy continuing to decline.

1.15 The resumption in economic growth that began in 2000 has not been accompanied by an increase in total employment. Instead, total employment in Moldova has declined by over 13 percent during the recovery. As in all transition economies, the pressure of market forces has led enterprises to shed the excess labor inherited from central planning. While the industrial and service sectors reduced employment during the 1990s, the process of labor shedding in those sectors now appears complete. In the agricultural sector, however, this process began later and is still ongoing. Indeed, the recent decline in total employment has been almost entirely concentrated in the agricultural sector.

Employment in this sector, which supplied 41 percent of all jobs in 2004, has dropped by more than 30 percent since 2000. Migration and the withdrawal of many discouraged workers from the labor force have resulted in a relatively low unemployment rate – 8.1 percent in 2004.

1.16 The decline in employment and increase in output has resulted in a sharp increase in labor productivity. Real GDP per employee has increased by over 50 percent since the beginning of the recovery (Figure 1.8). Across economic sectors, labor productivity is highest in the industrial and service sectors, but in



the sector with the largest share of total employment, the agricultural sector, productivity has lagged considerably. The possibility of generating further productivity increases by additional labor shedding may well be diminishing. Continued increases in productivity, therefore, will require the creation of conditions that will encourage increased investment and innovation.

1.17 Migration and the inflow of remittances have contributed to an increase in domestic labor costs, with real wages almost doubling since 2000. The ability of Moldovan workers to move abroad at relatively low cost and command higher earnings has increased the equilibrium wage (by increasing the capital/labor ratio) in the domestic labor market. Remittances, by increasing the reservation wage of workers – the wage rate that will motivate workers to participate in the labor market - have also put upward pressure on the wages in the domestic labor market. As can be seen in Figure 1.8, since 2000 unit labor costs in Moldova have increased with growth in real wages outstripping growth in labor productivity.

### **Structural Reforms and Policy Consistency**

*For most of its history structural reform efforts have followed a decidedly stop and go pattern.*

1.18 While Moldova was considered a leading reformer among CIS countries in the early 1990s, for most of its history structural reform efforts have followed a decidedly stop and go pattern. The promise of rapid reform that accompanied initial stabilization efforts and first generation structural reforms was not sustained. Instead, for most of the 1990s, restructuring in the real economy was undermined by continued access to preferential credits, the accumulation of arrears and widespread rollover of non-performing loans, and weak financial discipline in the energy sector. Performance of the emerging private sector was hampered by weak corporate governance. In the agriculture sector, land privatization was legally suspended and very little progress was registered in farm restructuring.

1.19 A revival of structural reforms efforts were launched after the 1998 Parliamentary elections. The moratorium on land privatization was eliminated and bankrupt farms were liquidated. The electricity sector partially privatized to a strategic investor, energy subsidies were largely abolished and the legal and regulatory framework was substantially improved. Pension reforms helped restore financial viability to the system. While cash privatization was accelerated, strategic sectors like wineries, tobacco and military-industrial companies were left out of the privatization program. Despite the significant reforms undertaken during this period, the continued decline in GDP and living standards at the end of the 1990s once again led to a diminution of these efforts.

*To generate credibility about its commitment to improved governance and reform, the Government will need to demonstrate its capacity to effectively implement reform.*

1.20 By the time the economy started to grow in 2000, structural reform efforts had waned. The Government that took office in 2001 had a more cautious view toward privatization and a more interventionist attitude toward the economy. Initially, this attitude created a great deal of unease and uncertainty about the direction of economic policy. In the end, wholesale policy reversal did not take place and macroeconomic stability has been maintained. Starting in 2004, the Government began to recognize the importance of continued structural reform to economic growth. In the EGPRSP and the EU-Action Plan, the Government articulated a significant realignment of the domestic policy framework. Moldova's checkered track record with structural reforms, however, continues to undermine the credibility of the reform efforts. To generate credibility about its commitment to improved governance and reform, the Government will need to demonstrate its capacity to effectively implement reform.



## Economic Recovery and Policy Adjustment

1.21 The economic collapse that occurred during the 1990s had serious implications for macroeconomic management. Between 1995 and 1999, Moldova's sizable fiscal deficits were largely externally financed leading to the rapid buildup of external public debt. When this financing evaporated in the wake of the regional financial crisis, significant fiscal and exchange rate adjustment were required. At the end of the 1990s, a time when the economy was still contracting, both expenditures and taxes were substantially reduced as a share of GDP. As a result, by the time Moldova's economic recovery began, large fiscal deficits had all but disappeared.

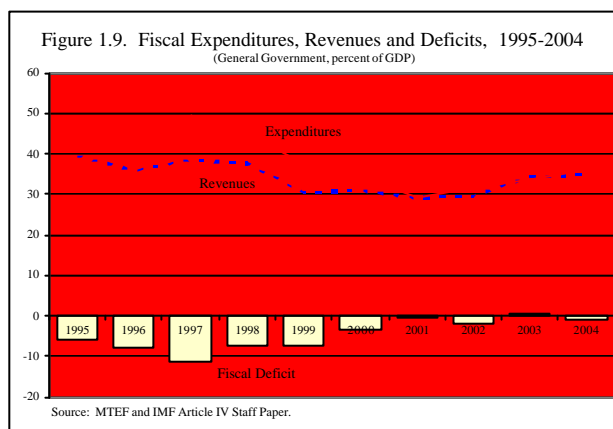
*Recovery-induced increases in tax revenues have given Moldova the fiscal space to increase public expenditures.*

1.22 **Fiscal policy and debt.** Recovery-induced increases in tax revenues have given Moldova the fiscal space to increase public expenditures. Since 2001, both expenditures and revenues have increased faster than GDP (Figure 1.9). At the same time, the Government has maintained a prudent fiscal stance, with the overall cash deficit of the general government averaging only -0.1 percent of GDP.

*The bulk of the revenue increase comes from the taxation of consumption.*

1.23 Although some increase in revenues has come from increases in the collection of profit and personal income taxes, the bulk of the revenue increase comes from the taxation of consumption -

primarily the VAT. The VAT now supplies nearly 50 percent of total consolidated budget revenues with over 87 percent coming from the VAT collected on imports. Corporate and personal income taxes, on the other hand, each only supply about 10 percent of fiscal revenues. To broaden the tax base and increase revenues coming from direct taxation, the Government's main strategy has



been to reduce tax rates. Since 2001, the corporate tax rate has been reduced from 28 percent to 20 percent in 2004. Similarly, personal income taxes have also been reduced, with the highest marginal rate declining from 32 percent to 25 percent. The positive performance of corporate and personal income tax revenues during the recovery has encouraged the Government to undertake further cuts in these taxes rates. Both the corporate tax rate and the highest marginal personal income tax rate are scheduled to drop to 15 percent in the new few years.

*There is the risk that the Government's "supply side" approach to taxation will result in a loss of tax revenues unless accompanied by complementary efforts to broaden the tax base.*

1.24 While lower tax rates can, for example, encourage informal sector activities to be formally registered, there is the risk that the Government's "supply side" approach to taxation will result in a loss of tax revenues unless it is accompanied by efforts to simplify the tax structure, reduce tax exemptions and improve tax administration and

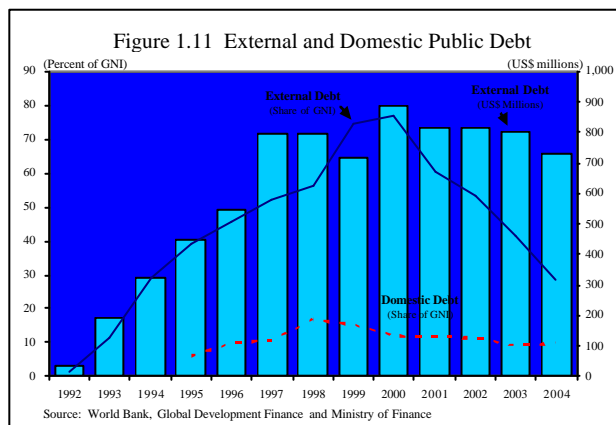
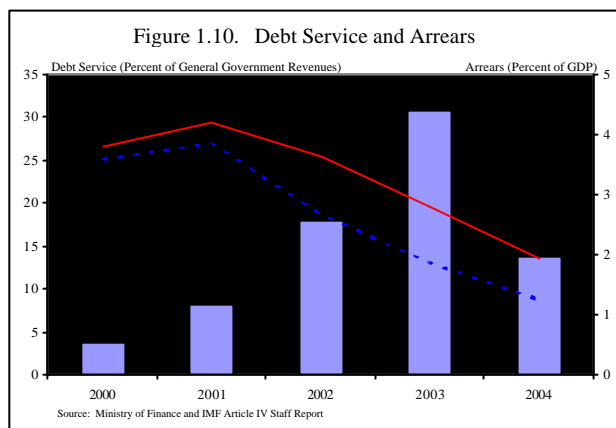
enforcement mechanisms.<sup>4</sup> Progress on external debt restructuring may also depend on the Government demonstrating sufficient revenue mobilization efforts.

*To avoid undermining medium-term growth prospects, higher public investment spending will be needed. The increased fiscal space will require improved access to external financing.*

1.25 On the expenditure side, the Government has focused spending increases on those programs that were cut dramatically at the end of the 1990s and earlier. Since 2000, spending on health, education and social protection increased by nearly 6 percentage points of GDP. Public expenditures on capital and economic services, however, have remained low and have declined as a share of GDP since 2000. In the current economic growth environment, the impact of these low expenditures is not readily apparent. To avoid undermining medium-term growth prospects, the poor and deteriorating state of Moldova's infrastructure, however, will need to be addressed. This will require increasing the fiscal space for higher public investment spending and active engagement with the private sector for the delivery of these economic services.<sup>5</sup> Given the importance of agriculture to the economy, the low level of expenditures on economic services in this sector is clearly suboptimal. While some increases in expenditures can be achieved by improved resource mobilization and better targeting of social expenditures, ultimately any increase in fiscal space will require improved access to external financing.

*The Government created some fiscal space for its spending priorities through active debt management and the accumulation of arrears on its external obligations*

1.26 The limited access to fresh external financing has placed a considerable burden on the fiscal accounts, necessitating the repayment of principal and interest out of fiscal revenues rather than from positive net debt flows. At the beginning of Moldova's recovery, scheduled interest and amortization payments on public and publicly guaranteed debt consumed nearly 30 percent of general government revenues (Figure 1.10). The Government created fiscal space for its spending priorities through active debt management. Since 2000, the Government has bought back and rescheduled debts owed to a number of commercial and bilateral creditors and has had a portion of its debt forgiven. The Government has also resorted to the accumulation of arrears on its external obligations, principally to Gazprom and bilateral and commercial creditors. As can be



<sup>4</sup> A recent IMF paper on Russia's experience with tax rate reductions ("The Russian Flat Tax Reform" by A. Ivanova et al) concluded that there was no evidence of a strong supply side effect of the reform.

<sup>5</sup> See Public Investment and Fiscal Policy, IMF, March 12, 2004

seen from Figure 1.10, since 2002 the Government has, on average, made payments on only about two-thirds of the scheduled debt service obligations. While a significant portion of the arrears were cleared (over 3 percent of GDP) through buybacks and rescheduling that took place in 2004, new arrears on principal repayments continue to accumulate.

*Economic growth, lower interest rates on debt and the appreciation of the exchange rate relative to the US dollar has helped ease the strain of debt servicing on the budget.*

1.27 Economic growth, lower interest rates on debt and the appreciation of the exchange rate relative to the US dollar has helped ease the strain of debt servicing on the budget. From 2001, debt service due has fallen in half, while debt service paid by two-thirds. These same developments, combined with efforts to reduce the stock of debt, have also improved the overall debt outlook for Moldova. Given the large fiscal imbalances, the stock of external public and publicly guaranteed (PPG) debt accelerated rapidly during the 1990s, going from US\$39 million in 1992 to a peak of US\$1,040 million in 2000 (or from about 2 to 80 percent of Gross National Income - GNI). Since 2000, external public debt has declined, falling to below US\$860 million by the end of 2004. As a share of GNI, the fall in external public debt has been even more dramatic. By end 2004, external public debt had fallen to 33 percent of GNI. The rapid reduction in Moldova's debt indicators since 2000 has eased concerns about medium-term debt sustainability. At the beginning of the recovery, the net present value (NPV) of public external debt to GDP was close to 105 percent while the NPV of debt to government revenues was nearly 340 percent. By the end of 2004, the NPV of external public debt had fallen by more than half to 42 percent of GDP and the NPV of public debt to government revenue had dropped to around 154 percent. Domestic public debt, largely borrowed from the National Bank, has remained relatively stable since 2000.

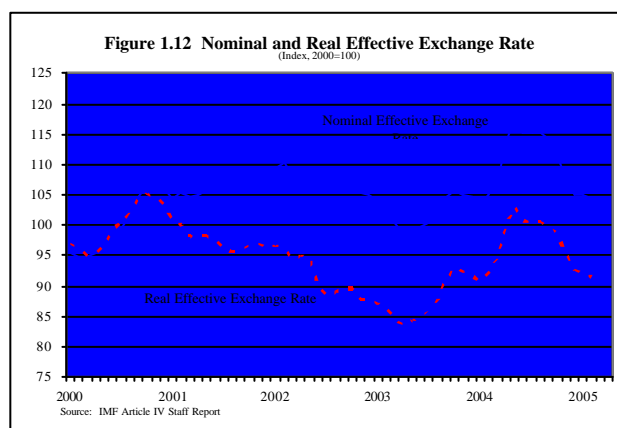
*The lack of a credible plan to deal with the continued accumulation of arrear has impaired access to much needed external debt flows.*

1.28 Although Moldova's debt profile has improved, the lack of a credible plan to deal with the continued accumulation of arrear has impaired access to much needed external debt flows. If this issue is satisfactorily addressed, it will improve the prospects of renewed access to external finance and additional concessional donor support.

1.29 **Monetary and exchange rate policy.** The official objective of monetary policy is the stability of the currency. In practice, however, the monetary policy has strived to achieve a number of objectives. It has sought to limit the appreciation of the exchange rate, keep inflation and interest rates low, and accumulate precautionary international reserves. The large inflow of remittances, however, has complicated the attainment of these often conflicting objectives.

*Since the beginning of 2003, the leu has come under fairly constant appreciation pressure.*

1.30 After depreciating in real terms during 2001-02, the leu has come under fairly constant appreciation pressure since the beginning of 2003 (see Figure 1.12). The leu appreciation has been particularly strong against the US dollar, but has appreciated against other currencies as well. NBM purchases of foreign exchange, which accelerated in the second part of 2004, have helped keep the leu from appreciating against the US



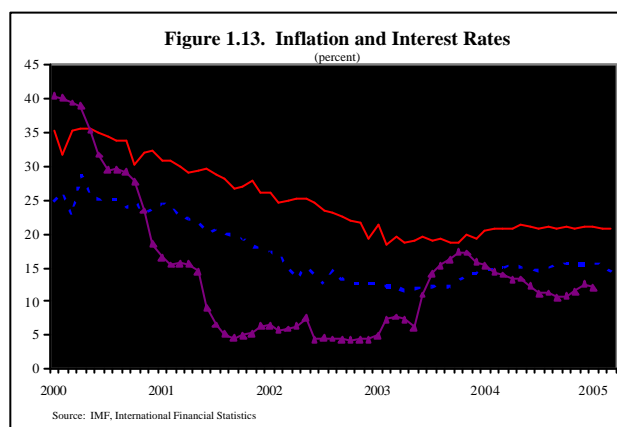
dollar. The large inflow of remittances has helped offset the depreciation pressures placed on the exchange rate by large trade deficits and accumulation of external payment arrears. Indeed, rather than depreciating, remittances have been the main source of pressure on the exchange rate to appreciate.

*The rapid growth in both reserve and broad money runs the risk of fueling inflation pressures*

1.31 The interventions by the NBM in the foreign exchange market have allowed foreign exchange reserves to increase rapidly, reaching the record level of US\$470 million at the end of 2004. Despite more intense sterilization efforts, however, the large inflows of foreign exchange have contributed rapid growth in both reserve and broad money. Since the beginning of the recovery, broad money growth has averaged 36 percent per annum, increasing as a share of GDP by nearly 15 percentage points to reach 38 percent of GDP at the end of 2004. While significant remonetization of the economy is likely taking place, the rapid increase in the money supply runs the risk of fueling inflation pressures. The economic recovery initially coincided with a period of disinflation with inflation falling to less than 5 percent per annum. Toward the end of 2003, however, inflation pressures reemerged, partly as a result of unusually large increases in food prices (related to the poor harvest), and have been slow to decline to previous lows. Indeed, in 2004 average inflation in Moldova was among the highest in the region, exceeded only by Belarus.

*The financial sector still remains small relative to GDP and many firms are finding it difficult to get access to credit.*

1.32 The decline in inflation since 2000 has contributed to a steady decline in nominal interest rates. Throughout the recovery, however, real *ex post* interest rates in Moldova have remained high, averaging roughly 7 percent in 2003 and 2004 (Figure 1.13). While the financial sector has been growing quickly, it still remains small relative to GDP and many firms are finding it difficult to get access to credit.<sup>6</sup> In 2004, total deposits were still only 25



percent of GDP - a 12 percentage point increase since 2000. On the asset side, total assets of the banking system were equivalent to 42 percent of GDP at end-2004.<sup>7</sup> The growth in assets has been driven by very rapid increases in domestic credit, averaging over 30 percent a year since 2000. The banking system is healthy, with high levels of earnings, capitalization and liquidity as well as a low level of non-performing assets. The inefficiency of the banking system, however, is evident by the high spreads between lending and deposit rates. In 2004, lending rates have exceeded deposit rates by nearly 6 percentage points. By comparison, average spreads in Central and Eastern Europe, including the Baltics, have fallen to less than 3.5 percent.

<sup>6</sup> A fuller analysis of the evolution and vulnerabilities of the financial system can be found in [Republic of Moldova: Financial System Stability Assessment](#), IMF, 2005.

<sup>7</sup> By comparison, the average size of the financial sector in the new EU members is about twice as large as Moldova's.

1.33 Moldova's anti-inflation efforts have often conflicted with its objective of maintaining a competitive exchange rate. Indeed, the pressure on the real exchange rate to appreciate has raised concerns that the exchange rate has become disconnected from the underlying competitiveness of the economy, rendering the traded goods sector less profitable and thereby discouraging the production of exports and import substitutes. While the interventions by the monetary authorities have helped ease these pressures on the exchange rate, the resulting rapid growth in the money supply poses a risk to macroeconomic stability and the attainment of low inflation.

*With the leu still undervalued by between 20 to 40 percent, resisting the real appreciation by intervening in the foreign exchange market to slow the nominal appreciation of the exchange will be ineffective.*

1.34 A number of studies, however, have suggested that prices and wages in Moldova, as well as in other CIS countries, are still below the level that reflects their true economic value.<sup>8</sup> Thus, despite the real exchange rate appreciation experienced in 2003 and 2004, according to the estimates in these studies, the leu is still undervalued by between 20 to 40 percent. Resisting the real appreciation by intervening in the foreign exchange market to slow the nominal appreciation of the exchange rate will be ineffective. Instead, such intervention will only result in a real exchange rate appreciation obtained through higher inflation. Further, given the undervaluation of the real exchange rate, it is likely that the monetary authorities will be unable to successfully influence longer-term competitive trends by exchange rate management. Instead, monetary policy should place greater emphasis on the attainment of inflation objectives.

### CHALLENGES FOR ACCELERATING GROWTH

*Moldova needs to continue growing fast to recuperate lost income per capita to further reduce poverty and to get closer to Central and Eastern European standards.*

1.35 Moldova needs to continue growing fast to recuperate lost income per capita to further reduce poverty and to get closer to Central and Eastern European standards. Since, even after accounting for growth during the recovery, real per capita GDP has fallen by some 60 percent since independence, with an average GDP growth rate of 5 percent - as envisaged in the EGPRSP- it will take nearly 17 years for Moldova to reach the level of real GDP that prevailed in 1989. To reach income levels prevailing in Central and Eastern Europe, growth must be even faster. Further, since income distribution has worsened since independence, it will take the bottom quintile even longer to regain past standards of living, not to mention those prevailing in the advanced transition countries.

*While remittances have helped fuel the current expansion, only the continued increase in productivity can be the driver of sustained long-term growth.*

1.36 The economic recovery and the continued maintenance of macroeconomic stability since 2000 established a firm foundation upon which to build a sound strategy for medium and long-term growth. Moldova's geographic location - close to the bigger CIS countries and the much larger EU market - and the emerging networks of migrants in important overseas markets, provide the country with ample opportunities for continued economic expansion. However, while the relatively abundant inflow of workers' remittances that have led to the current consumption driven growth is likely to continue, it is unreasonable to expect that these flows will continue to grow at the same rapid rate. Indeed, all international evidence points to the strong probability that these rates will slow over the medium run.

1.37 Similarly, it will become increasingly difficult to sustain the rapid growth in labor productivity of the recent past since the opportunities provided by labor shedding and factor reallocation in the economy are gradually being exhausted. While remittances

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<sup>8</sup> See, for example, Cuc (2005) "External Competitiveness" in Moldova: Selected Issues, IMF, 2005.

have helped fuel the current expansion, only the continued increase in productivity can be the driver of sustained long-term growth. Unless the foundation for this increased productivity is established, Moldova will not achieve its long-term growth objectives. The advanced transition economies of Central and Eastern Europe provide important lessons on how to achieve the required transformations to foster continued productivity gains. If Moldova does not build this foundation, the country will likely enter yet another troubling economic period as the growth stimulus from remittances wanes and the domestic supply response weakens. Since it is much easier to undertake economic transformation in a period of economic growth, Moldova needs to start addressing these challenges now.

*Moldova needs to continue improving the macroeconomic supporting environment, building on the substantive achievements thus far.*

1.38 As long as a solid macroeconomic framework remains in place, in the immediate to short-run, economic growth will continue, underpinned by increases in workers' remittances and further productivity gains. Moldova needs to continue improving the macroeconomic supporting environment, building on the substantive achievements thus far. The fact that there are no present and imminent risks can easily lead to complacency and weaken the underpinnings of future economic performance. As recounted above, attention to the fiscal, debt and monetary and exchange rate policy is needed.

1.39 Strengthening the fiscal position requires reducing the revenue uncertainty that originates from the reliance on tax rate reductions as the main policy driver of tax policy and on the reliance on consumption taxes. A greater emphasis on eliminating tax exemptions and privileges and improvements in tax and customs administration is warranted. Likewise, it is important to balance the sources of public sector revenue against a possible relative decline in consumption ahead. The level of public sector revenues in Moldova is already high compared with other countries at the same level of income and it seems prudent to maintain the current level and seek further fiscal gains by focusing on expenditure effectiveness. Moldova needs to moderate the relative growth in public sector consumption by prioritizing effectiveness through improved targeting of social expenditures and improved delivery of key services.

*An important challenge for fiscal policy is to increase public investment, which will increasingly become a binding constraint on growth.*

*The Government needs to rethink its allocation of instruments for macroeconomic management, preferably focusing monetary policy on inflation, and allowing the nominal exchange rate to fluctuate.*

1.40 An important challenge for fiscal policy is to increase public investment, which will increasingly become a binding constraint on growth. Given the large demand for repair and upgrade of infrastructure, the Government needs to develop a strategy that focuses on critical priorities and involves the private sector. It is likely that the Government will not be able to finance a public investment program with the resources available from public savings or the domestic financial markets, and that the country will have to access long-term financing in external markets. However, despite having reduced the level of the external debt significantly, the country faces difficulties in accessing financing in advantageous terms given that a final arrangement on arrears has not been reached with all of the bilateral and commercial lenders.

1.41 Moldova needs to preserve the gains made in reducing inflation in the face of a significant expansion in the monetary base. However, the use of the exchange rate policy to preserve competitiveness carries risks under the present circumstances. Mainly, attempts to preserve the nominal exchange rate can translate into rapid monetization in excess of money demand, further fueling private expenditures and most likely inflation. The Government needs to rethink its allocation of instruments for macroeconomic management, preferably focusing monetary policy on inflation, and allowing the nominal exchange rate to fluctuate. Fears that a mild real appreciation will stop growth do not

seem to be well-founded. Over the long term, increases in productivity will be the best insurance to maintain competitiveness in the face of revaluation pressures.

## **CHAPTER 2. MAXIMIZING THE BENEFITS FROM MIGRATION AND REMITTANCES**

### **INTRODUCTION**

2.1 Labor is Moldova's single largest export. Internationally-high levels of the economically-active population have worked abroad at some point since transition, with the pace of out migration increasing since the late 1990s. The country is now among the largest recipients of international remittances (as a share of GDP) in the world. The country's macroeconomic growth is highly reliant on the demand from foreign labor markets and will continue to be so in the foreseeable future.

2.2 The implications of large quantities of out-migration for economic growth and welfare are complex and the full impact of policy choices can be difficult to project. On the one hand, Moldova has experienced a drain of scarce, relatively skilled workers. The emigration of these workers may impair macroeconomic growth and business expansion where these workers generate significant positive externalities (for example, on-the-job training of other workers), deprive domestic firms of essential skills, or impair the supply of essential, non-traded services that facilitate human capital formation (especially health care and education professionals). Moreover, migration resulting from human trafficking can degrade growth by depleting human capital and contributing to public health hazards. International remittances have impacted the competitiveness of the tradable sector by appreciating the value of the leu, driven up domestic wages, and complicated the conduct of fiscal and monetary policy.

2.3 Conversely, migration has increased the income of many Moldovan households. Migration has been a key poverty coping mechanism for many unable to meet basic subsistence costs from the returns to their labor in the domestic market. For many migrants, particularly those to the EU, migration may have afforded the opportunity to invest in new skills and build investment linkages between their destination country and home.

2.4 Realizing the full benefits from exporting labor requires improving the financial and business investment climates. Improving these policies and institutions will improve the incentives for returning migrants to use their skills, knowledge, and savings and be able to facilitate trade and investment links while abroad. Policies must favor savings and investment so that at the margin some income can be saved or invested (including in human capital). The policies that are required for income convergence with industrialized countries are also the ones that increase the development impact of migration and attendant remittances.<sup>9</sup>

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<sup>9</sup> This chapter draws upon and synthesizes the empirical results of three major recent micro-surveys of migration and remittances that were conducted in Moldova in 2004: (1) A survey conducted by the Moldovan firm AXA-CBS has informed the results of the International



## MIGRATION FROM MOLDOVA: STYLIZED FACTS AND IMPACT

*Moldova is one of the largest net emigration countries in the world (as a portion of population)*

2.5 About 371,000 Moldovans or 25 percent of the economically-active population were working during the implementation of the most recent census in 2003. Yet, this point-in-time statistic provides only a partial picture of the extent of migration and it is possible that as many as 571,000 Moldovans or 39 percent of the economically-active population worked abroad at some point in 2003-04.<sup>10</sup> These migration outflows appear to have increased dramatically after the 1998 Russian financial crisis. Moldova's geographical proximity to the relatively more lucrative labor markets in Russia and Western Europe and its high population density have always created the incentives for large levels of out migration. Yet, it is believed that migration rates increased from 1998 after dropping during the mid-1990s. As many as 83 -percent of current migrants departed for the first time after 1998.<sup>11</sup>

2.6 Much of this migration is very short term or circular in character. The vast majority of migrants aim to earn money abroad and return to Moldova.<sup>12</sup> On average, Moldovans migrate for about 20 months at a time. About half migrate to Russia where the average tenure abroad is 17 months, mostly involving seasonal agricultural labor or short-term construction contracts for men. A large number of these contracts last for 3-4 months. In contrast, migrants to Western Europe tend to stay just over 2 years and are predominately women working in the tourism and home care sectors.

*Migration is more common among poorer than wealthier households*

2.7 Migration seems to especially benefit the poor. The majority of migrants are from poorer district towns or rural villages where 68 percent of all Moldovan poor lived in 2002. While 25 percent of Moldovans have worked abroad during the last two years, the figures for the urban centers are considerably smaller with only 11 percent of Chisinau residents indicating that they had migrated. Migrants from these poorer regions are considerably more likely to migrate to the CIS while migrants based in the larger urban areas are more likely to migrate to Western Europe, particularly Italy, Portugal, and Spain. On average, households with migrants in Russia earned more than those with migrants in Italy. Part of this income divide is explained by the considerably higher costs for migrating to Western Europe and the greater demand for unskilled labor in the CIS.<sup>13</sup> Also the migration destinations of family and friends helps drive migration to particular

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Organization for Migration, Food Security Program of the European Commission, and the International Monetary Fund (forthcoming) *Moldova Remittance Study*; (2) a team led by the Moldovan Microfinance Alliance produced Ghencea, B. and I. Gudumac (2004) *Labor Migration and Remittances in the Republic of Moldova*, Moldova Microfinance Alliance and Soros Foundation; and (3) a report commissioned by USAID produced Sander, C., D. Nistor, A. Bat, V. Petrov, V. Seymour (2005) *Migrant Remittances and the Financial Market in Moldova*, prepared for USAID (BASIS/CRSP). Most data not obtained from Moldovan authorities was derived from these three studies. Deviations from this pattern are indicated.

<sup>10</sup> International Organization for Migration, Food Security Program of the European Commission, and the International Monetary Fund (forthcoming) *Moldova Remittance Study*.

<sup>11</sup> International Monetary Fund (2005) *Republic of Moldova: Select Issues*, January 21, 2005.

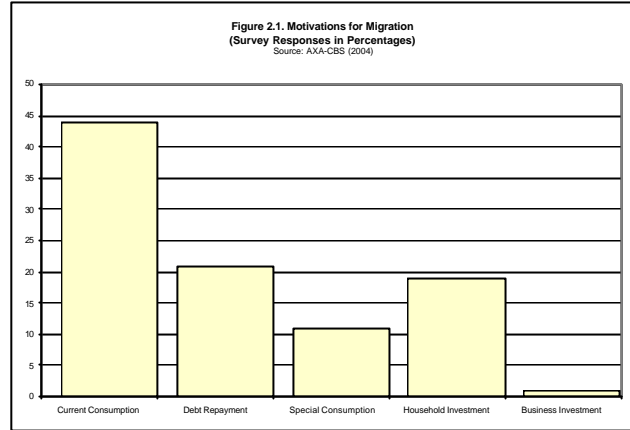
<sup>12</sup> About 67 percent of migrants in a recent survey reported that they intended to return to Moldova after earning money abroad. See CBS-AXA (2004) *Moldova Remittance Study*, December, p. 10.

<sup>13</sup> The migration costs (including transportation, document preparation, and visa) to Russia are US\$96 compared with US\$2,048 for Italy. International Monetary Fund (2005) *Republic of Moldova: Select Issues*, Washington.

countries as over 60 percent of migrants indicated that such “networks” were established in their choice countries.

*Migration is largely driven by the need to meet basic subsistence costs*

2.8 The key motivations for migration include a desire to earn more money to meet basic subsistence needs, repay debts, and fund consumption (Figure 2.1). The majority of migrants do not appear to be driven abroad by the inability to find work at home but by the desire to earn more and fund a higher quality of life. On a purely microeconomic basis, migration has clearly served as a poverty coping mechanism for many

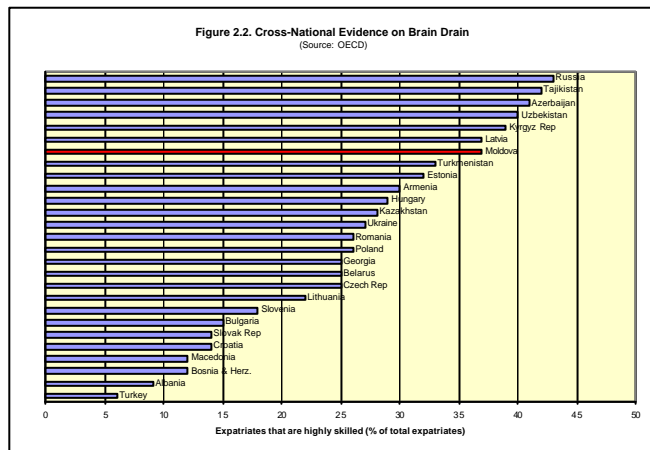


Moldovans, a fact borne out by the high levels of basic household consumption financed out of remittances (discussed below). Moreover, there is evidence that Moldovans are building human capital abroad that is allowing them to increase their earnings in the Moldovan market. Migrant families’ monthly incomes have been found to increase six-fold after migration.

2.9 Yet, beyond income differentials, migration from Moldova is driven by the perception that opportunities for personal and professional development (i.e., quality of life) are not present at home. Evidence from the accession of the Southern and Central European countries suggests that out migration rates can be low, even in the face of large expected income differentials, if there is a perception that the quality of life at home is not improving.<sup>14</sup> These quality of life concerns might encompass a broad range of economic, structural, social equity, and governance factors that create incentives to work and invest at home. Moldova’s relative performance in these policies is discussed in later chapters. Yet here it is important to point out that improving quality of life creates

*Migration is also driven by the generally poor quality of opportunities at home*

incentives for migrants to return home and invest in Moldova. Interviews with many households suggest that these incentives are not in place. Many reported that migration was necessary to not only fund current consumption but to feel more independent and secure.<sup>15</sup> Thus, the policies that improve the incentives for business investment, financial deepening, and the exercise of



<sup>14</sup> World Bank (forthcoming) *Enhancing Gains from International Migration in Europe and Central Asia*.

<sup>15</sup> CBS-AXA *Moldova Remittance Study*, December, p. 14.

entrepreneurship are the same that reduce the incentives for migration. Improving these policies creates the incentives necessary for maximizing the benefits from existing migration flows.

*There is evidence of a 'brain drain' resulting from the high levels of migration by the highly skilled and educated*

2.10 Migration can build up a country's human capital by resulting in a 'brain gain' or 'brain circulation' effect or it can "drain" an economy of essential skills. In this regard, migration can induce two growth effects: (i) an *ex ante* 'brain effect' (migration prospects drive investments in education because of higher returns abroad); and (ii) an *ex post* 'brain drain' resulting from actual migration flows. An empirical assessment of which effect dominates has produced mixed results. Some studies suggest that most countries combining low levels of human capital and low migration rates of skilled workers tend to be positively affected by the brain drain. By contrast, the brain drain appears to have negative growth effects in countries where the migration rate of the highly educated is above 20 percent and/or where the proportion of people with higher education is above 5 percent.<sup>16</sup> Moldova would seem at risk for a brain drain on this basis. As Figure 2.2 indicates, among the stock of labor migrants abroad, Moldovan Diaspora are among the most educated and highly skilled relative to other countries in Eastern Europe and the CIS as 37 percent were deemed 'highly skilled' according to a recent OECD study.<sup>17</sup> In fact, regionally only the diasporas of Azerbaijan, Russia, Tajikistan, and Uzbekistan are more highly skilled than that of Moldova.

2.11 It is essential that domestic policies and institutions create incentives for migrants to return home after migrating and use any newly acquired skills in Moldova. This is critical for Moldova as the new generation of post-1998 migrants seems to be drawn from the youngest and best skilled and educated Moldovans. About 45 percent of the migrants that departed in 2004 were below 20 years of age and, more generally, the majority of migrants are young as over 70 percent are under 40 years old and nearly 40 percent under 30 years.<sup>18</sup> About 50 percent of migrants have obtained qualifications from a university or professional school and another 23 percent had graduated from high school. Only 10 percent of migrants do not have any educational qualifications.<sup>19</sup> Moreover, about 32 percent of surveyed migrants used to be employed in education, medicine, and in other public institutions.

*Migration does not seem to be motivating higher levels of investment in education*

2.12 It is not clear if the potential to migrate has driven investment in education at home. Evidence from some countries suggests that migrating abroad has led to increased enrollment in higher education as migrants hope to earn higher returns on qualifications abroad. As Table 2.1 illustrates, educated migrants do earn more abroad than uneducated migrants, though destination country legal status also influences wages earned abroad. Yet, projections for school enrollment do not indicate that these are increasing despite the income differentials for educated and less educated migrants. Further reforms to the education system have been identified as a constraint on human capital development in

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<sup>16</sup> Beine, Michel, Frédéric Docquier, and Hillel Rapoport (2003) "Brain Drain and LDCs Growth: Winners and Losers," IZA DP No. 819, July. Beine, Michel, Frédéric Docquier, and Hillel Rapoport (2001) "Brain drain and economic growth: theory and evidence" *Journal of Development Economics*, 64, 1, 275-289.

<sup>17</sup> Dumon, J-C and G. Lemaître (forthcoming) *Counting Immigrants and Expatriates: A New Perspective*, OECD, Social Employment and Migration Working Papers.

<sup>18</sup> Ibid.

<sup>19</sup> Ghencea, B. and I. Gudumac (2004) *Labor Migration and Remittances in the Republic of Moldova*, Moldova Microfinance Alliance and Soros Foundation.

Moldova. Addressing these will also improve the returns from migration.<sup>20</sup> The Government could also play a larger role in ensuring that migrants have the necessary skills to acquire positions abroad. Migrants cited language barriers as the key constraint on obtaining employment abroad. This would naturally be a larger constraint in acquiring better remunerated positions in Western Europe.

*The Government should continue its efforts to negotiate bilateral labor agreements with Western European countries*

2.13 Increasing the returns to migration will also be aided by further facilitating the legal migration of Moldovans. A majority of Moldovan migrants work illegally abroad. About 70 percent of migrants working in the CIS do not have a legal work permit. For the majority of these, migration abroad was conducted on a legal basis, yet the migrant moved into illegal work as their work visas expired or they entered the destination country on a tourist visa that prohibited domestic employment. Legal migrants have been found to remit larger quantities and it seems likely they will have greater opportunities to establish investment and trade opportunities

between contacts in the host country and Moldova. Moreover, facilitating legalization through the signing of bilateral agreements reduces the risk that increased immigration controls on undocumented migrants will shut Moldovans out of these labor markets.

2.14 Increasing the opportunities for legal migration also reduces the opportunities for the forced trafficking of Moldovans, particularly young women. Though, by its nature, there is little statistical information on the extent of trafficking, Moldova has been considered the worst affected country in South Eastern Europe. In the absence of legal opportunities for work abroad (particularly in Western Europe), many migrants may turn to intermediaries to secure jobs, thereby creating the opportunities for traffickers.<sup>21</sup> Trafficking can impact economic growth by depleting human capital, increasing the level of criminal activity, and creating public health hazards (e.g., the spread of sexually transmitted disease). Moreover, trafficked migrants are not likely to send significant amounts of remittances due to the exploitative conditions in which they work.

Table 2.1. Earnings of Migrants While Abroad

Average earnings by level of education & legality/ illegality		Average earnings by country	
(US\$ per Month)			
University	895	Russia	425
Vocational school / college	793	Greece, Turkey, Cyprus	597
High School	618	Portugal, Spain	897
		Italy	941
Legal	925	Israel	1,065
		France, Germany, Benelux	1,209
Illegal	649		

Source: Ghencea, Boris, and Igor Gudumac, 2004, Labor Migration and Remittances in the Republic of Moldova, Chisinau: Alianța Microfanțare and Soros Foundation.

<sup>20</sup> World Bank (2005) Moldova – Education Policy Note: Analysis in Support of Improvements in Quality, Equity and Efficiency in the Education Sector.

<sup>21</sup> Clert, C. and E. Gomart (2005) *Human Trafficking in South Eastern Europe: Beyond Crime Control, an Agenda for Social Inclusion and Development*, Social Development Occasional Paper, Conflict Prevention and Reconstruction, World Bank.

2.15 The task of assisting migrants to obtain and maintain legal work abroad may improve as the Moldovan Government has been active in agreeing to bilateral labor agreements with neighboring countries.<sup>22</sup> Negotiations for completing these agreements have commenced with 19 countries since 2002 and agreements reached with 4 (Belarus, Italy, Ukraine, and Russia). Yet, Moldova has the highest rate of out migration in the region and has signed the fewest bilateral agreements (Table 2.2). It will be important for Moldova to increase the number of bilateral agreements made with the key destination countries of its migrants. Bilateral agreements that structure labor movements between countries will reduce the incentives for many migrants to participate in informal labor markets abroad. Provided that these agreements reflect the actual magnitudes of cross-border labor flows, they will increase the incentives for migrants to return home when their legal right-to-stay abroad has expired or they become economically inactive. These agreements can transform the perception of migration from being a one-shot experience (associated with the gains of staying illegally abroad being higher than the costs of being detected) to an iterated process in which migrants will have the option to work abroad when there is demand for their labor.

**Table 2.2. Summary of Bilateral Labor Agreements Among Select European and Central Asian Countries**

Country	CEEC	CIS	EU15 + Switzerland and Norway	Total
<i>Moldova</i>	0	3	1	4
<b>CEECs</b>				
Czech Rep	4	2	5	11
Hungary	3	0	8	11
Poland	2	3	9	14
Slovak Rep	3	2	5	10
Turkey	0	0	6	6
<b>CIS</b>				
Armenia	0	2	0	2
Azerbaijan	1	2	0	3
Belarus	3	6	0	9
Georgia	1	1	0	2
Kazakhstan	0	4	0	4
Kyrgyz Rep	1	2	0	3
Russia	2	7	0	9
Tajikistan	0	2	0	2
Ukraine	6	3	2	11

Numbers in cells represent the number of countries (among the CEECs, CIS EU15, Switzerland, and Norway that have signed bilateral labor agreements with the countries listed in each row

Source: World Bank, International Organization for Migration, International Labor Organization, and national authorities

## REMITTANCES IN MOLDOVA

### Stylized Facts

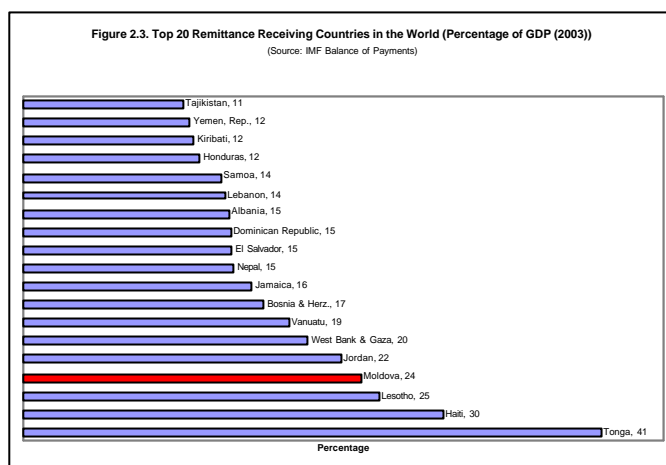
2.16 The level of recorded migrants' remittances has increased enormously since the late 1990s. Balance of payment statistics indicate that they have grown 269 percent from 2000 to 2004, though there may be some distinctions in how remittances were measured over this time period.<sup>23</sup> As Figure 2.3 indicates, Moldova's level of remittances, as a

*Remittances to Moldova have grown enormously and the country is one of the largest recipients of remittances in the world (as a share of GDP)*

<sup>22</sup> The commitment to negotiate bilateral agreements that establish quotas for Moldovan migrants is illustrated in the Migration Department's creation of the Directorate for Labor Migration and Foreign Relations. Part of the Directorate's portfolio includes negotiating these bilateral agreements.

<sup>23</sup> International remittances are notoriously difficult to measure accurately. One problem in recording remittances is that unknown (though, it is suspected large) amounts are sent through 'informal' channels (such as being hand carried by migrants themselves or transfer agents such as bus or train drivers) which—often by design—are difficult for the Government to measure. Moreover, there is no consensus on how to measure those remittances transmitted through official wire channels and recorded in the Balance of Payments. For example, Bryan Roberts (2004) defines remittances as "monetary funds sent by individuals working abroad to recipients in the country they came from". His definition includes transfers from both those temporarily working

share of GDP, was the fourth largest in the world in 2003 at about 24 percent (US\$484 million) and this rose to 26 percent in 2004. Yet even this figure may dramatically understate the true volume of remittances. Large quantities of remittances—perhaps about 50 percent -- are sent through informal channels and are not well recorded in balance of payments estimates.<sup>24</sup> An



extrapolative exercise computed from the results of a micro-survey of Moldovan families permits an alternative remittances estimate that may capture more of the informal flows than the balance of payments. These estimates put the 2003 figure near US\$650 million or over 30 percent of GDP.

2.17 Some caution should be taken in interpreting the high rates of remittances growth in the last several years. Though much of this growth reflects the high levels of out migration that occurred after the 1998 Russian financial crisis, some portion may be explained by the National Bank’s improved capacity for monitoring remittances flows. Beginning in 1999, the National Bank introduced a standardized form that commercial banks must submit to record international remittances. As Figure 2.4 shows, the implementation of this method corresponds with a spike in official recorded remittances levels.

*Remittances transmission costs are relatively high.*

2.18 Moldovan migrants remit large amounts of the income that they earn abroad, yet they pay relatively high transmission costs. Over 80 percent of migrants remit funds and over 70 percent of these remit over half of their earnings. The majority of the funds

abroad and those who have permanently emigrated and became legal residents of another country. Yet remittances are also often defined as sum of credit entries for compensation of employees (remittances sent by seasonal migrants and border workers), workers’ remittances (remittances sent by migrants who live more than one year in the host country), and migrants’ transfers in the balance of payment statistics (Ratha 2003). Though the latter definition does not count personal expenditures and taxes paid by seasonal workers as well as include money carried through borders by physical traders, remittances from whom may be of considerable number in some East European countries, it is widely accepted as a good proxy for remittances estimate using balance of payment statistics and, unless otherwise noted is the definition employed here. See Robert, Bryan (2004) *Remittances in Armenia: Size, Impacts, and Measures to Enhance their Contribution to Development*, submitted to USAID, 1 October. Ratha, Dilip (2003) “Global Development Finance Report,” World Bank.

<sup>24</sup> The Moldovan National Bank’s procedures for recording migrants’ remittances in the Balance of Payments does record some remittances forwarded through informal channels. In addition to the standard practice of obtaining remittances transfer data from banks, the Central Bank monitors foreign exchange transactions made at bureaus de change and in the purchase of goods in which foreign currencies are often used (e.g., automobiles). In this way, the Bank is able to pick up some of the funds that move into the country from abroad but are not sent through formal channels.

remitted through formal channels are sent through Western Union, which has dominated the transmission market. In 2000, nearly 70 percent of formal remittances were sent through Western Union.<sup>25</sup> Though this total has fallen to 50 percent as a number of lower-cost competitors (such as Anelik Money Transfer) have entered the market, it still transacts about 50 percent of wire transfers. As Table 2.3 indicates, these transfers are being made at relatively high costs when compared with other services on the market.<sup>26</sup> Bear in mind that as transfer costs are regressive; these affect poorer migrants most as they tend to send smaller sums of remittances to their families.

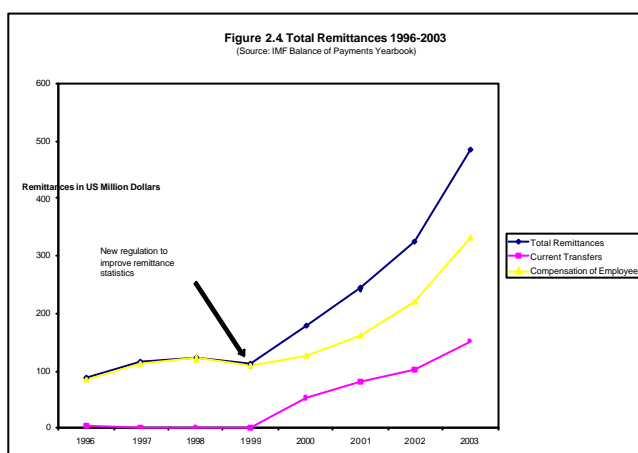
**Table 2.3. Transfer Fee Charges as a Percentage of a Typical Remittance Amount**

	USD 200	USD 500
Western Union	11	8
MoneyGram	10	6
Anelik Money Transfers	3	3
Strada Italia	6.25	2.5
Ruskaya Pochta	1	1
Bank account transfer (SWIFT)	15	6

(Source: Sander, C., D. Nistor, A. Bat, V. Petrov, V. Seymour (2005) *Migrant Remittances and the Financial Market in Moldova*, prepared for USAID (BASIS/CRSP), February.

2.19 Some capacity limitations exist on the distribution of remittances sent through formal channels in rural parts of Moldova. Only banks and post offices are permitted to offer remittance transfer through the SWIFT network or money transfer systems. Yet not all bank offices are able to offer clients these services and often remittances can only be collected at raional centers.

For example, only 30 percent of Banca de Economii, Moldova's largest bank, offer these services. Distributing remittances through automated teller machines (ATMs) is impossible for the majority of rural Moldova given the lower regional coverage of these services and Moldovan lack of knowledge on how to use ATMs. Post offices are located widely throughout Moldova yet, at present, only post offices in Chisinau and the raional centers can handle remittances and, unlike banks and money transfer services, they can only distribute remittances in lei.



<sup>25</sup> National Bank of Moldova reported in Sander, C., D. Nistor, A. Bat, V. Petrov, V. Seymour (2005) *Migrant Remittances and the Financial Market in Moldova*, prepared for USAID (BASIS/CRSP), February.

<sup>26</sup> The table reports the transfer fees that migrants would pay to send US\$200 and US\$500 back to Moldova. The actual average transfer sum sent by migrants is US\$267 according to CBS-AXA *Moldova Remittance Study*, p. 24.

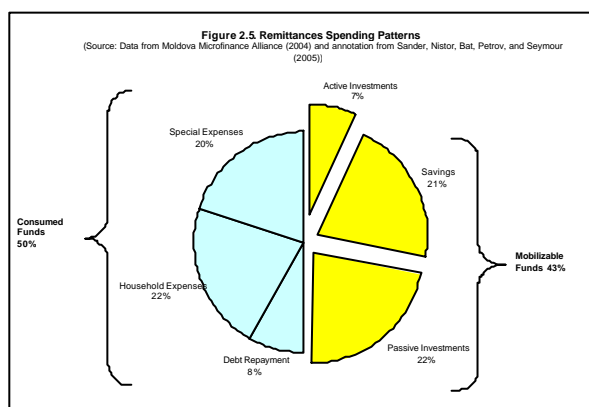
## Economic Impact

*Remittances have driven economic growth over the last six years by expanding household consumption*

2.20 Remittances have been a key driver of macroeconomic growth in the last six years or so. Between 2000 and 2003, per capita GDP grew 13.5 percent on average. The vast majority of this growth was generated from consumption rather than investment. Gross national disposable income per capita expanded by 18 percent from 2000 to 2003 and is nearly perfectly correlated with increasing levels of consumption.<sup>27</sup> These trends could be worrying to the degree that remittances are highly concentrated on consumption than investment in the long term. Cross-country research has found that the short-term stimulus provided by remittances will not produce sustainable growth if increased investment does not follow. Countries can face a situation similar to the natural resource “Dutch disease” in which the inflow of remittances causes a real appreciation, or postpones depreciation, of the exchange rate, restricting export performance and hence possibly limiting output and employment.<sup>28</sup>

*The perception that remittances mostly fund consumption does not capture the full picture.*

2.21 Looking at the household spending patterns from remittances, however, such fears are only partly warranted in Moldova. Remittances appear to fund a fairly wide mix of expenditures (Figure 2.5). It is generally argued that remittances go mostly to household consumption in Moldova and that while this consumption is necessary to combat poverty, it generally does not benefit the economy as a whole.<sup>29</sup> Indeed, about 60 percent of remittances fund consumption of one sort or another.<sup>30</sup> In this context, remittances have been extremely important in reducing poverty in the poorest households. About 40 percent of migrants’ households reported that remittances constitute at least 65 percent of their income while another 25 percent of households indicated that they fund between 35 and 65 percent of income. Yet, those sampled suggested that there is great variation in this consumption. While about 22 percent funded basic household needs, 8 percent serviced debt (much of which was likely generated to fund migration as about 25 percent of migrants funded their trips abroad through loans), and 20 percent funded “special consumption.” The latter includes a mix of one-off household expenditures (e.g., furniture purchases)



<sup>27</sup> International Monetary Fund (2005) *Republic of Moldova: Select Issues*, Washington.

<sup>28</sup> Lucas, R.E.B. (2005) *International Migration and Economic Development*, Stockholm: Expert Group on Development Issues, Swedish Ministry for Foreign Affairs.

<sup>29</sup> Some empirical work has found that remittances can exercise a deleterious effect on macroeconomic growth if they are spent mostly on consumption. Though there are a number of empirical problems with this work, it does suggest the need to pay attention to household spending patterns. See Chami, R., C. Fullenkamp, S. Jahjah (2003) “Are Immigrant Remittance Flows a Source of Capital for Development?” *IMF Working Paper*, WP/03/189.

<sup>30</sup> This information is from Ghencea, B. and I. Gudumac (2004) *Labor Migration and Remittances in the Republic of Moldova*, Moldova Microfinance Alliance and Soros Foundation.



and human capital spending on university fees and medical treatment.<sup>31</sup> The more unsettling side of the expenditure allocation is that only about 7 percent of remittances were invested directly into businesses and perhaps as little as 5 percent (of the 21 percent reported as ‘saved’) were saved in a bank account. Another 22 percent financed “passive investments” in procuring housing or an apartment, purchasing or leasing cars, or funded social investments such as weddings, funerals, etc. What this does suggest, however, is that about 43 percent of remittances funds are available—after basic needs and some human capital have been funded—to be mobilized into further business investment or into the formal financial system for intermediation.

2.22 A key constraint on increasing the savings seems to lie in Moldovans’ lack of trust in the banking system. A recent survey found that over 30 percent of Moldovans have difficulty trusting the banks and only 12 percent of respondents reported that they had a bank account in Moldova.<sup>32</sup> The banking crises of the early 1990s and after the 1998 Russian financial crisis left many Moldovans without any savings. For those seeking to save in the formal financial sector, there is a narrow range of savings instruments offered by commercial banks, which dominate the industry. The longest term on savings deposits is 3.5 years and such products are not currently offered by all banks and have not yet generated much interest.<sup>33</sup>

2.23 Moreover, as Chapter 3 will discuss, the incentive to place remittances in business investment, particularly in small and medium-sized enterprises are limited by the high level of bureaucracy and unpredictability that surrounds the investment climate. Migration does not provide human capital development that makes Moldovans more willing to take the risks necessary to practice entrepreneurship in the face of existing government constraints and continued uncertainty about the business investment environment. After migration, Moldovans are about 6 percent less likely to want to start or invest in domestic business than before leaving the country as migrants.

2.24 Some sense of expediency should accompany efforts to reform the business environment and public service delivery. Remittance-fueled economic growth is may not be sustainable over the longer term as there is reason to believe that the rate of remittances growth and their absolute levels tend to decline with time. The propensity to send remittances home is greater in the initial phase of the migrant’s life abroad, when links with the family and the country of origin are stronger and when the migration project is still temporary. The propensity to remit declines as migration becomes more stable, and family members are reunited or a family is established in the destination country. However, this point should not be overstated as only 6.4 percent of interviewed migrants, at the time in Moldova, intend to move permanently abroad while the vast majority prefers temporary migration and it seems unlikely that current migration rates will diminish in the near term.

*Remittances-fueled economic growth may not be sustainable as remittance rates may decline with time*

<sup>31</sup> Ghencea, B. and I. Gudumac (2004) *Labor Migration and Remittances in the Republic of Moldova*, Moldova Microfinance Alliance and Soros Foundation.

<sup>32</sup> International Organization for Migration, Food Security Program of the European Commission, and the International Monetary Fund (forthcoming) *Moldova Remittance Study*.

<sup>33</sup> C. Sander, D. Nistor, A. Bat, V. Petrov, and V. Seymour (2005) *Migrant Remittances and the Financial Market in Moldova*, prepared for USAID (BASIS/CRSP), February, p. 31.

## **POLICIES TO FACILITATE MIGRATION'S CONTRIBUTION TO GROWTH**

2.25 The Government has a role to play in creating the economic and political incentives that encourage migration and remittances' contribution to sustainable and pro-poor growth. Clearly, migration has had a number of very positive effects on the Moldovan economy: working abroad has increased many households' income and thus alleviated poverty and driven broader, economic growth by increasing national disposable income levels. Yet, migration has had a number of negative effects: some evidence suggests that some essential skills may be disappearing from the workforce and high remittance levels can complicate the setting of macroeconomic policy and detract from sustainable growth. It is thus important to ensure that policy is aligned with those incentives that permit migration and attendant remittances to allow households to build human and financial capital and invest in the Moldovan economy.

2.26 First, international experience does not clearly indicate that there is an optimal set of best practices for managing migration that can be directly adopted by the Moldovan Government. The impact of policies appears to be very country-specific and policies that endeavor to 'channel' remittances into investment and savings have had mixed success in other countries. In Morocco, the majority state-owned Groupe Banques Populaires has successfully offered Moroccan emigrants cost-effective methods of sending remittances home through the banking system at almost no cost. The bank has offered investment products specifically to migrants with the result that emigrants or former emigrants have significantly higher savings and investment rates than non-emigrants. Yet the success of state organized programs in the Philippines and Turkey have faced mixed success. The Philippines, previously one of the largest recipients of remittances in the world, has faced mixed success in creating both directorial and market-based incentives for attracting remittances into investments while Turkey's extensive efforts to attract remittances into the business investment through the State Industrial and Workers' Investment Bank was generally considered a failure. A great more study is required to understand what circumstance these "migration-centered" policies have succeeded before policy advice can be derived from their example.

2.27 It is clear that for remittances, like other income, to be used more productively two conditions must be fulfilled. First, earnings of households from all sources need to be sufficient to meet basic needs. The survey results above suggest that many households may have significant quantities of funds above and beyond what is necessary for basic consumption. Also, as many household begin to accumulate more remittance capital and exceed basic requirements, a large pool of funds will be available for human capital and business investment and savings. Yet the second requirement is that policies must favor savings and investment so that at the margin some income can be saved or invested. Within Moldova, some limitations to creating the incentives for attracting remittances lie with a lack of confidence in the financial sector and overly restrictive business/investment environment.

2.28 The Government may have a role in encouraging banks to expand their product offerings and perhaps create new savings and investment instruments to attract remittances. In particular, encouraging the expansion of foreign currency products may increase the incentives for drawing savings from "under the mattress" and into the banking system for intermediation. The Government has discussed the possibility of issuing a foreign currency bond to attract remittances. Issuing this bond could perhaps

spark greater interest in and knowledge of such products among Moldovans though the implications of issuing such a bond have not yet been fully studied.

2.29 In the last year, the Moldovan Government has signaled its desire to implement policies that do seek to create new incentives for households to allocate remittances in savings and investment vehicles. One such program seeks to provide preferential opportunities for those investing remittances in rural-based areas. Though the details of how the “Moldovan Village” program will create these incentives is not yet clear, this program is designed to stimulate development in rural areas that have fallen into poverty since transition as 63 percent of rural residents were classified as poor.<sup>34</sup> The Government needs to be clearer in linking this program with remittance income and in laying out a time table for implementation.

2.30 An alternative strategy for increasing the quantity of savings from remittances might be to adopt policies that encourage migrants to transfer funds through formal channels. As indicated above, large quantities of remittances are sent through informal channels. More migrants would be able to access the formal financial system if they were able to work abroad legally. As a result, the expansion of bilateral agreements to cover more Moldovans working abroad could facilitate greater access to foreign banking accounts. The incentives for substituting formal transmission channels for these informal flows might be created by reduced costs. At present, only banking institutions and post offices are permitted to provide remittances transfer services. Introducing greater competition in this marketplace by permitting non-banking financial institutions or foreign exchange bureaus to handle remittances might lower the costs of these transactions.

2.31 Beyond attracting remittances, improving the investment climate will improve the payoffs to migration more generally (see Chapter 3). The human capital development that many migrants might experience abroad will benefit Moldova more effectively if the business environment encourages entrepreneurship and innovation and the financial sector is able to provide seed capital to business start ups. Similarly, the incentives for migrants to create international trade and investment linkages while abroad will be greater if the costs of creating these are not prohibitive.

2.32 Remittances could also contribute to more and higher quality human capital development with sustained improvements in public service delivery (see Chapter 5). The household budget allocation data suggested that remittances are being spent on education and health care. Yet, they represent a small part of this expenditure. As Chapter 5 will suggest, part of the limitations on furthering human capital spending relate to supply-side problems in service delivery.

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<sup>34</sup> International Monetary Fund (2005) *Republic of Moldova: Select Issues*, Washington.

## **CHAPTER 3. ENHANCING DIVERSIFICATION AND COMPETITIVENESS**

### **INTRODUCTION**

3.1 The catalog of the various barriers contained in the Investment Climate Assessment (ICA), drawing on the Business Environment and Enterprise Performance Surveys (BEEPS) and Cost of Doing Business (CODB) surveys, suggests that the business environment in Moldova is very difficult and is a major impediment to private sector led growth. Because Moldova is a small economy and hence a price taker, a poor business environment operates very much like a tax. It reduces the net price to the producers making them less competitive internationally.

3.2 Despite the negative implications of a poor business environment, aggregate enterprise production and profitability in Moldova have grown in recent years. Industrial output has increased, underpinned by higher capacity utilization. Investment activity has increased somewhat though it is still quite low. Enterprise performance, however, is not yet well understood. Which firms have experienced higher sales and higher profitability and which firms have engaged in higher investment activity? What are their key characteristics? How are these characteristics related to the business environment?

3.3 This chapter provides an overview of the business environment, presents some stylized facts on enterprise performance, and assesses the dimensions of the business environment that are binding constraints to firm performance. The rest of the chapter is organized as follows: Section 2 provides an overview of the business environment. This section will review findings from recent investment climate assessments and assess Moldova's relative ranking compared to other countries. It will also report on recent government efforts to improve the business climate. Section 3 documents some stylized facts on the enterprise sector in Moldova. This section will report stylized facts in enterprise investment, employment, productivity and profitability. It will explore whether performance differs between, for example, private and public firms, between foreign and local firms, and exporting and non-exporting firms. Based on this analysis, the section will identify the underlying constraints to better enterprise performance. Section 4 summarizes the key binding constraints to growth. This section will also offer some policy recommendations.

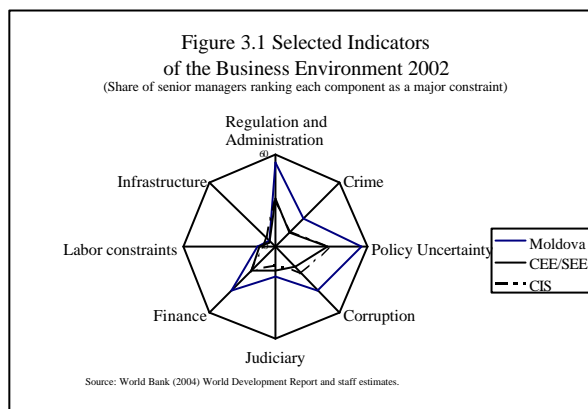
### **OVERVIEW OF THE BUSINESS ENVIRONMENT**

*The business environment in Moldova is perceived to be difficult.*

3.4 The business environment has many dimensions. In general, it is related to the risks, costs, and barriers to competition facing firms. As typically measured, it is related to the regulatory and administrative burden, policy uncertainty, crime, corruption and the quality of the judiciary. Defined more broadly, it also encompasses measures of the quality of infrastructure, access to finance, and labor/skills constraints.

3.5 By some measures, based on 2002 data, Moldova's business environment is perceived to be one of the most difficult in the region.<sup>35</sup> Composite investment climate indicators relating to the multiple dimensions of the business environment suggest that Moldova ranks relatively low in the region. In addition, the latest Corruption Perception Index from Transparency International, a measure of how foreign business perceive governance problems across countries, suggests that Moldova is still widely perceived to have one of the more corrupt countries worldwide, ranking 114th out of a sample of 145 countries and may explain why Moldova has had difficulty attracting foreign direct investment.

3.6 Some indicators suggest a more mixed picture, but Moldova is still a relatively poor performer. For example, under regulatory and administrative constraints, management time dealing with officials is seen as less of a constraint compared to other countries in the region. Indicators from the CODB surveys also suggest a more nuanced ranking. Compared to other countries in the region, the costs of starting a new business (measured in days and number of procedures involved) is lower in Moldova, the costs of property registration and the number of procedures related to contract enforcement are relatively larger. As for perceptions of regulatory, finance, infrastructure, and human capital constraints, Moldova generally ranks high in regulatory and tax administration constraints but ranks lower with respect to infrastructure constraints, relative to other countries in the region. Financial sector constraints, however, are considered to be a major problem.



3.7 The Government has made efforts to improve the business environment over the last few years, in particular, by easing the regulatory and administrative burden. In response to complaints from the business community about the poor business and regulatory environment, the Government, led by the Ministry of Economy, has recently initiated a reform program. As stated by the authorities, the reform program aims at substantially reducing the burden of administrative regulation and the costs of obtaining licenses, authorizations, permits, and other costs related to paid services offered by supervisory and control bodies. In designing the reform, the Ministry applies a systemic approach, covering all phases of a company's life cycle, from the registration of a new business through the closure of a failing business.

3.8 Government efforts appear to be appreciated by the private sector but are still not widely known. There is also some skepticism concerning the sustainability of such reform efforts and whether these efforts can be effectively coordinated between the relevant agencies and between the central and local government. Nonetheless, these

*The government has exerted effort to ease the regulatory and administrative burden.*

<sup>35</sup> The last year for which cross-country business environment indicators are available (2002) may not reflect recent improvements in the business environment following important reforms in this area, as described in this section.

reform programs hold promise for real improvements in the administrative and regulatory framework.

### **Registration Procedure**

3.9 In the fall of 2001, the Chamber of State Registration of the Information Technology Department initiated the reform of registration procedures. Procedures were concentrated in a single office and the number of required documents needed to register a business was reduced from between seven and thirteen to five. The following year, the Chamber launched “one-stop shops” and introduced a single identification code for legal entities, unifying the registration number, the fiscal code and the statistical code of enterprises. One-stop shops have since been opened in all ten former *judets*, complete with on-line connections to the central agency. Under the new system, the Chamber of Registration requests the necessary documents (to confirm the applicants’ identity and verify outstanding indebtedness, criminal record, etc.) directly from the relevant institutions. The registering entity can also receive notary services and order stamps without leaving the Chamber.

3.10 Though the official cost of registration has increased along with the concentration of procedures in the Chamber, the Government claims that total cost (sum of both formal and informal costs) has been reduced, due to the elimination of the need for intermediary services. The law stipulates that the decision on the registration or on the rejection of the application is to be taken within 15 days from the date of submission. According to the Chamber of Registration, the registration procedures may take anywhere from 3 to 15 days. In July 2004, the registration fees paid by enterprises with foreign capital and those with local capital were made uniform by eliminating the extra tax paid by enterprises with foreign capital.

### **Licensing and Permits**

3.11 Before 2001, licensing was regulated by an organic law, which stipulated only general licensing conditions, and by almost 200 normative acts defining specific requirements, issued by ministries, departments, and other government agencies. With the enforcement of the *Law on Licensing of Certain Types of Activities* in 2002, the licensing authority was transferred to a single institution, the Chamber of Licensing, and most of the ministerial regulations lost their validity. Licensing became more transparent with the publication in 2002 of all conditions in a single document, Order No. 38 of the Chamber of Licensing. The new law has also reduced the number of licensed activities from 106 to 49 and generally increased the period for which the licenses are valid from 2.6 years to 5 years. The examination period decreased from 30 to 18 days. In addition, the notary authorization of copies of required documents was rendered unnecessary.

3.12 In 2004, authorities attempted to identify and analyze all existing regulatory acts in this area. It found a significant number of acts and many more likely remain undisclosed by central and local agencies with very little incentive to disclose the existence of these acts to the Ministry. In response, the Government, led by the Ministry, initiated the “guillotine” approach (see Box 3.1), which envisages the cancellation in six months from the date of the law enforcement of all normative acts that have not been registered in a special registry of regulatory acts kept by the Ministry of Economy.

### **Box 3.1 The Guillotine Law**

The *Law on Revision and Optimization of the Normative Framework for the Regulation of Business Activities*, effective February 7, 2005, defines the principles and actions needed for the revision of the normative framework with the objective to eliminate regulations that do not correspond to primary legislation or are “not market oriented,” as well as to ensure stability and quality of the regulatory framework in order to avoid creating impediments for business activities.

The revision and optimization of the regulatory framework is based on the following principles: (i) transparency and stability; (ii) assumption that the businessman respects the legislation; (iii) noninterference in the activity of the enterprise; (iv) financing of central and local public agencies from the budget; (v) delimitation of regulation, control and inspection functions of state agencies from those of rendering conformity assessment and other paid services; (vi) prohibition of charging other taxes and establishing and requiring documents for issuing licenses, authorizations and permits other than those established by Parliament or Government acts.

All regulatory acts will be considered from the point of view of their legality and correspondence to the above-mentioned principles. After the revision, the normative acts will be registered in the register of official acts regulating business activities, kept by the Ministry of Economy (MoE).

The revision of the normative acts will proceed in three stages. First, each institution of public administration will consider its regulations according to the established criteria and submit to the MoE the list of documents to be maintained with the appropriate argumentation provided within a month’s time.

A special National Commission and a Working Group have been created to “filter” the lists during the next two stages. Both the Commission and the Working Group include representatives of public and private sectors. After consultations with the authors and the business community (the draft document will be also published on the Government’s web page), the final version of the Register will be developed by the Working Group and considered by the Commission, after which it will be submitted to the Government for approval. The entire process is to be completed within six months (between February and August 2005), after which the “guillotine” will “fall” on all regulations that have not been included in the Registry.

### **Bankruptcy Proceedings**

*The functions of the Council of Creditors have been delegated to line ministries.*

3.13 The *Law on Enterprise Restructuring* enables insolvent enterprises to restructure their debts by applying to the Council of Creditors. Council membership consists of representatives of state and commercial creditors appointed by the Government and Parliament. Upon application, the Council investigates the financial conditions of the enterprise to confirm insolvency. If the Council decides that the enterprise qualifies for restructuring, an “isolation period,” not exceeding 12 months commences, during which time the enterprise is shielded from creditors. The isolation period terminates if the company fails to fulfill its obligations, which includes the obligation to make all current payments for taxes, salaries, utilities, and other payments specified by a memorandum. The Council is authorized to temporarily suspend the company’s obligations to repay state debts and negotiate the restructuring or partial cancellation of such debts.

3.14 The past performance of the Council of Creditors has not been satisfactory. A review of previous performance indicates that in a number of cases, the Council failed to demand full compliance with conditions and obligations stipulated in a memorandum governing the isolation period. The Council has periodically granted exemptions,

allowing companies to keep working under isolation conditions, despite continued accumulation of payments and tax arrears and failure to demonstrate restructuring efforts. Second, the current arrangement is hampered by the lack of sound restructuring plans. Previously, enterprises received free technical assistance in designing and implementing restructuring plans from the Agency of Enterprise Restructuring and Assistance (ARIA). These days, enterprises in distress develop restructuring plans on their own. Given these firms' limited technical skills and experience, it is not surprising that the results have been dismal. Third, there is typically no provision for a change in management of distressed companies, although in principle changes in management can be negotiated.

3.15 The composition of the Council of Creditors has changed several times since its creation. Initially, the Council included representatives of both state (Ministry of Finance) and private creditors (commercial banks), and was supported in its day-to-day activities by a Secretariat. Starting in 2002, Council membership was limited to government officials led by the Prime Minister. Recently the Government dissolved the Secretariat and transferred its functions to line ministries. A working group has been created to evaluate the financial situation of insolvent enterprises, analyze their restructuring plans, and submit proposals to the Council.

### Foreign and Local Investments

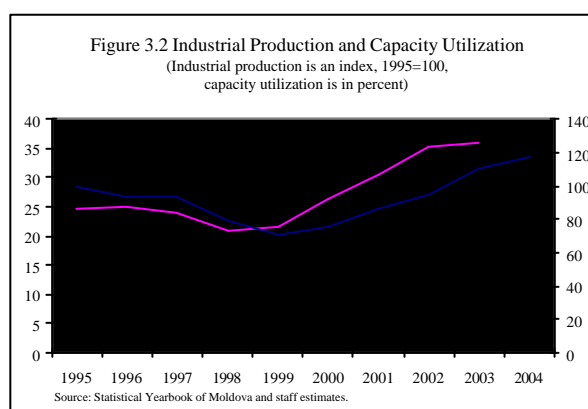
*The law on investment was amended to allow for equal treatment of local and foreign investors and ensures unlimited profit repatriation.*

3.16 Over the last year, efforts have been made to improve the legal framework for foreign businesses. The new *Law on Investments in the Entrepreneurial Activity* was approved in March 2004, replacing the old *Law on Foreign Investments*. The new law applies the principle of national treatment, unifying the treatment of foreign and local investors. It also provides for guarantees against expropriation and ensuring unlimited profit repatriation. Although under the previous law foreign investors enjoyed specific privileges, the new law is expected to generate more stability and transparency in the regulation of foreign investment activities.

## STYLIZED FACTS ON ENTERPRISE PERFORMANCE

### Overview of Aggregate Enterprise Performance

3.17 The industrial production index rose by 46 percent between 2000 and 2004, recovering from the gradual decline in output through the late 1990s. Within the industrial sector, the manufacturing industry experienced especially large increases in the volume of production, including food processing, textiles, and wine manufacturing. In the energy and utilities sector, production levels remained more or less unchanged. Meanwhile, the volume of service output has also picked up, outstripping in fact the increase in industrial production, while agricultural production has remained flat. Within the agricultural sector, there is a clear divergence in performance between corporate farms, which have experienced steadily declining output,





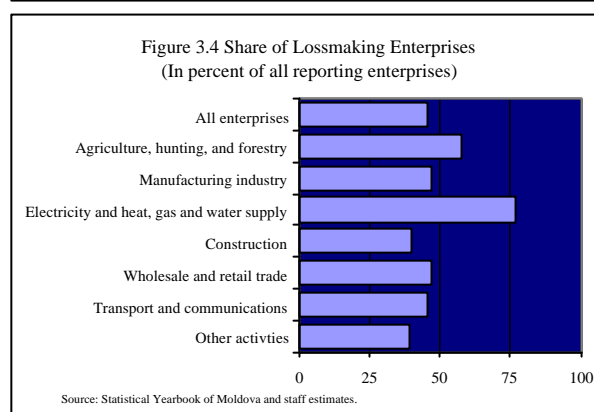
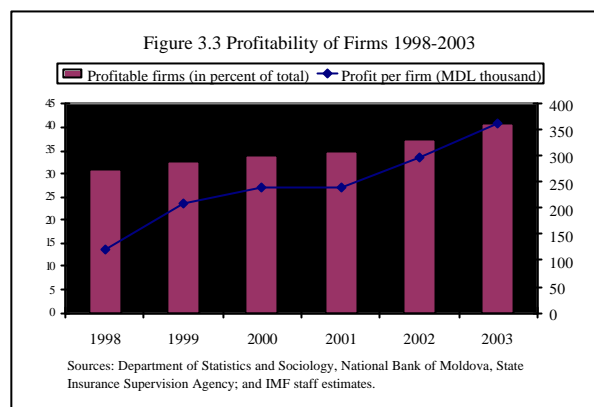
and household farms, which have experienced increases in output (see Chapter 4 for details).<sup>36</sup>

*Industrial production has risen, underpinned by rising capacity utilization.*

3.18 Rising industrial production, in turn, has coincided with rising capacity utilization. Following the recession in the early transition period, most sectors experienced declining capacity utilization through the late 1990s, when average utilization rates reached a low of 22 percent. Since 1999, such rates have picked up, on average, by about 14 percentage points to 36 percent average capacity utilization rate by 2003, with sharp increases in a number of sectors including wine manufacturing, sausage processing, and others.

*Enterprises have experienced rising profitability.*

3.19 Along with rising output and rising capacity utilization, enterprises have experienced rising profitability.<sup>37</sup> Between 2000 and 2003, the share of profit-making firms grew across all sectors—except in the agriculture sector—with particularly rapid increases in the construction sector.<sup>38</sup> In particular, over this period, the share of profit-making firms grew by about 7 percentage points (increasing from 33 to 40 percent of all reporting enterprises) across all sectors and while growing by over 16 percentage points in the construction sector. In terms of profits per worker for continuing firms, data from the



<sup>36</sup> Summary data presented in this section are mostly drawn from two sources, as indicated in the charts. Data on industrial production, capacity utilization, and enterprise profits and losses are drawn from the *Statistical Yearbook of Moldova*. Firm-level data on sales, investment, employment, profits, and others, are drawn from the data from the Annual Structural Survey of Enterprises over the period 2000 to 2003. The dataset covers a broader sample of enterprises (up to 8,693 firms), of which the large enterprises (average employment >50, up to 1,753 firms for each year) are tracked over time while the smaller enterprises are covered by an annual random sample.

<sup>37</sup> Profitability should be understood as an accounting concept, i.e., firms declaring profits for the year, and not as an economic concept.

<sup>38</sup> This is based on summary data reported in the *Statistical Yearbook*. Using the firm-level information from the Annual Structural Survey of Enterprises, we also calculate that the bulk of profits in absolute terms are concentrated in the retail sector. The share of profitable firms (using the panel data sample of large firms) grew from 31 percent in 2000 to 42 percent in 2003. The share of profitable firms is highest in the wholesale and retail sectors while transport and communication, electricity and heat, gas and water supply have the lowest shares of profitable firms

Annual Structural Survey of Enterprises suggest that the construction sector has experienced rapid increases in profitability, along with the manufacturing, wholesale and retail trade sectors.

*Job creation rates have increased*

3.20 Job creation rates have increased. Like other transition economies, job creation, defined as the sum of employment gains in a sample of continuing firms (i.e., large firms active in two consecutive periods), in percent of total employment at the beginning of the year, has been historically dominated by high job destruction rates among continuing firms in Moldova.<sup>39</sup> In 2001, for example, the job destruction rate was over 11 percent while job creation was merely 6.5 percent. In recent years, however, the gap between job destruction and job creation has narrowed and since 2003, net employment growth among the sample of continuing firms has been positive. Job creation has been concentrated in the private sector, among foreign-owned and relatively smaller firms, and firms in the manufacturing, retail, and energy sectors.

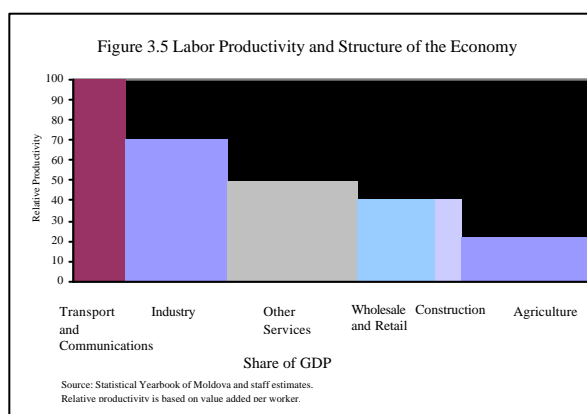
*Investment activity has risen among large firms...*

3.21 Among large enterprises investment activity has increased along with rising profitability and employment. Between 2000 and 2003, the share of investing firms grew by about 22 percentage points among large enterprises (firms with more than 50 employees) while remaining flat among smaller enterprises. Investment activities in the manufacturing, transportation and communication, wholesale and retail trade sectors represent over 70 percent of total investments. The rest are distributed among the agricultural, energy, and other sectors. Investment activity is largely undertaken by private enterprises. Among publicly -owned enterprises, the largest share of investment activity is in transportation. For the rest, it is in manufacturing.

*...but investment is still low*

3.22 However, the level of investment activity remains low. Among large enterprises where the increase in investment activity has been sharp, about half are still not investing. For the enterprise sector as a whole, only about 11 percent are investing.

3.23 In addition, there remains a large number of loss-making firms and some signs of slowing industrial production. Across sectors, on average, close to half of all reporting enterprises are considered loss making.<sup>40</sup> In the electricity and heat, gas and water supply sectors, close to 80 percent of reporting firms declared losses in 2003. Recent reports also suggest that a large share of small and medium-size enterprises



<sup>39</sup> See Rutkowski (2004).

<sup>40</sup> Again, this needs to be understood in an accounting sense, i.e., firms declaring losses for the year. Caution also is warranted in interpreting these numbers as there are incentives for firms to underreport profits.

posted net losses in 2004.<sup>41</sup> Meanwhile, the growth of industrial production has slowed from 15.6 percent in 2003 to 6 percent in 2004, in large part due to slower growth in the food processing sector which accounts for close to half of industrial output. Industrial output growth is projected to decline further to 5 percent in 2005.

3.24 Not surprisingly, the economy is still dominated by relatively less productive sectors. For example, most sectors are characterized by a level of productivity that is at best lower than half the productivity of the most productive sector (transportation and communications sector). The agriculture sector, which has a level of productivity that is only about a fifth of that of the transportation and communications sector nonetheless accounts for close to a fourth of total economic activity. In contrast, the most productive sector represents only about a tenth of all economic activity.

*To sustain enterprise growth and overcome Soviet era capital stock, new investments, new technology, and new production methods are critical.*

3.25 The large increase in output, underpinned by increasing capacity utilization, is not sustainable. Like other transition economies, Moldova inherited a Soviet era capital stock and production processes that are, by Western standards, obsolete. The low level of investment suggests that the capital stock has not been sufficiently upgraded. Therefore, while rising capacity utilization is a positive development, further increases in utilization using existing factors of production will be difficult to attain. To sustain enterprise growth, there is a need to raise the level of productivity, in part by increasing the level of investment, restructuring, acquiring new technology and introducing new production methods.

### **Enterprise Performance by Firm Characteristics**

3.26 This section reports on enterprise performance, analyzed along selected dimensions of firm characteristics.<sup>42</sup> It draws from two sources of empirical information.<sup>43</sup> First, the major findings on enterprise performance are summarized from a large volume of cross-country empirical studies involving Moldova's production performance in recent years. These studies relate measures of firm performance (typically sales growth, employment growth, and productivity growth) with known covariates of firm performance: competitive pressure, access to finance, quality of infrastructure, regulatory burden measured in days and number of requirements or subjective perception, governance/corruption and other firm characteristics such as private ownership, foreign ownership, age, size, etc. Second, major results are presented from an analysis of over 8,000 enterprises in Moldova surveyed over the period 2000 to 2003. The analysis

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<sup>41</sup> Recent reports based on data from the Trade Department suggest that 43 percent of small and medium-sized enterprises posted losses in 2004. Most of these loss-making enterprises are in the agricultural sector.

<sup>42</sup> For simplicity, the summary data on enterprise performance illustrated below to support the stylized facts are based on unconditional averages. The stylized facts, however, are based on both unconditional as well as conditional averages, that is, the average performance of enterprises characterized along one dimension, holding other characteristics constant. The latter provides stronger empirical support for the stylized facts.

<sup>43</sup> Each source has its own relative merit. Cross-country studies allow more variation and are able to relate constraints common to firms within each country (and would thus be insignificant in a country-specific study) to measures of firm performance. The Moldova-specific study is panel data (allowing for firm heterogeneity), covers a broader, more representative sample of firms, and uses actual measures of constraints rather than subjective perceptions of constraint, as has been typical in recent cross-country studies.

undertaken for this study includes panel regressions relating enterprise performance with a vector of firm characteristics.

### Competitive Pressure

*Competitive pressure and hard budget constraints are good for enterprise performance*

3.27 Firms facing greater competitive pressure—driven by domestic competitors, foreign competitors, or both—generally perform better and innovate more. Cross-country studies suggest that

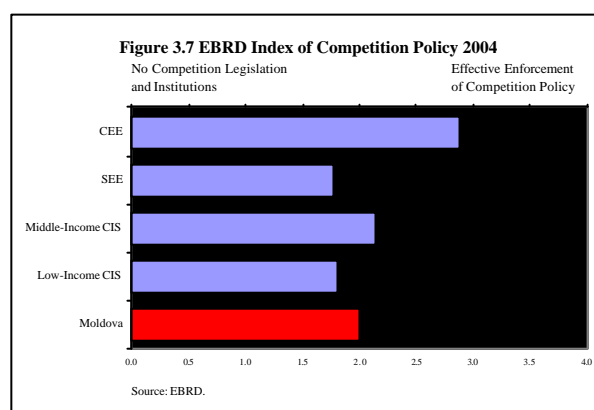
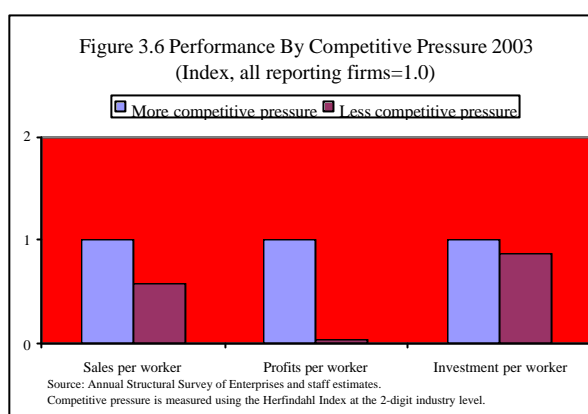
some degree of market power is beneficial to a firm, but competitive pressure by and large drives better performance. Monopolies, on the other hand, innovate less and have experienced weaker growth than firms facing a “minimum of rivalry.” A growing volume of cross-country evidence supports this hypothesis. Among Moldovan firms, the empirical evidence suggests that competitive pressure faced by enterprises, as measured by concentration indices in major industries (i.e., lower concentration represents greater competitive pressure), is associated with higher sales, profitability, and investment activity.

3.28 A number of factors inhibit the emergence of greater competition among enterprises. For example, a difficult regulatory and administrative environment limits the free entry and exit of firms, thus effectively constraining competition. The dearth of foreign-owned corporations also eases the competitive pressure faced by local firms.

3.29 Among state-owned enterprises, many loss-making firms have survived because of preferential tax treatments, rather than subjecting these firms to harder budget constraints. For example, the Executive recently approved an initiative of the Ministry of Agriculture and Food Industry, which seeks preferential fiscal conditions (freezing and gradual payment of debt) for seven tobacco processing plants until 2012. A draft law developed by the Ministry of Agriculture and Food Industry and endorsed by the Government calls for a write-off of debts to the state budget (as of January 1, 2004) owed by 30 agricultural entities (September 20, 2004).

*...but many loss-making enterprises have survived through preferential tax treatments.*

3.30 In general, there has been little restructuring activity to promote corporate governance in Moldova. The European Bank for Reconstruction and Development (EBRD) Index of Restructuring, a measure of progress in cutting tax credits and production subsidies and the introduction of effective bankruptcy procedures and hard budget constraints to promote sound corporate governance, indicates that Moldova is lagging behind countries in the region.

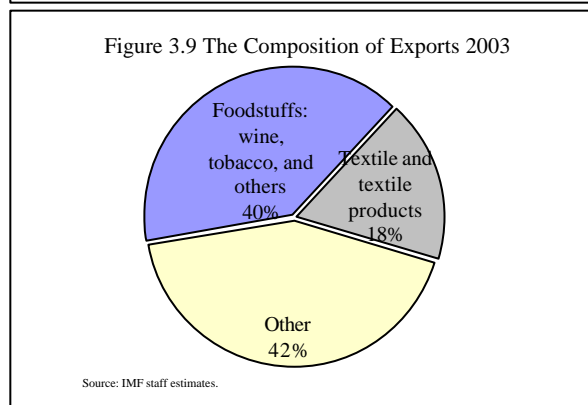
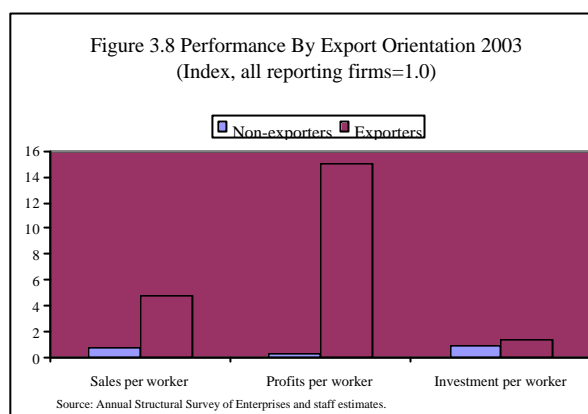


3.31 With respect to competition policy, Moldova is doing better than other transition economies. The EBRD Index of Competition Policy, an assessment of whether legislations and institutions are in place and whether competition policy is effectively enforced, indicates that Moldova is more advanced than many transition economies. However, it is still lagging behind others, such as the CEE countries. The EGPRS rightly recognizes that a number of institutions need to be put in place, such as the creation of a National Competition Agency, to form a more coherent and coordinated policy against abuse of market power.

### Export Orientation

*Export orientation is consistently and positively related to enterprise performance.*

3.32 Export orientation is consistently and positively related to enterprise performance. Market size in a relatively small economy such as Moldova is in large part boosted by access to world markets. As their market expands by exports, firms are then able to exploit economies of scale. They are also exposed to new technologies and innovations in the means of production. In addition, they face steeper competition thus forcing them, in the process, to be more efficient.<sup>44</sup> Indeed, export orientation among enterprises in Moldova is found to be consistently associated with higher sales and profits per worker and also with a higher probability of profitability and investment activity.<sup>45</sup> Cross-country studies also confirm that innovation and restructuring are driven by exporters and foreign-owned corporations or by greater openness to trade.



*...but exporting firms account for a small fraction of enterprises.*

3.33 The share of exporting firms is a small fraction of all enterprises. This is insensitive to the threshold share of exports in net sales used to define export orientation.

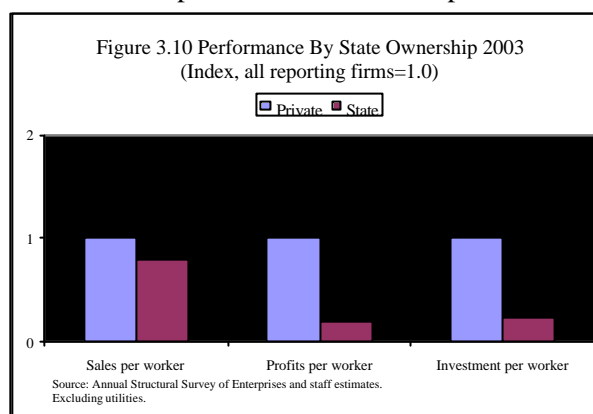
<sup>44</sup> There is some debate as to whether the better performance of exporters compared to their non-exporting counterparts may be driven in part by self-selection, that is, efficient firms self-select themselves into becoming exporters, rather than by learning from the experience of exporting. Notwithstanding self-selection, however, there is still significant evidence of the beneficial impact of exporting as documented in empirical studies that have attempted to account for selectivity.

<sup>45</sup> It is also related to higher firm growth (measured in terms of employment growth), but not with sales or productivity growth. For reasons discussed in the technical annex, however, our preferred measure of firm growth is employment growth, with presumably fewer measurement errors.

As an illustration, we define export orientation based on total exports of a firm accounting for at least 25 percent of its total sales. By this measure, export-oriented firms represent only about 5 percent of all enterprises and 13 percent of employment, but owing to their higher relative productivity and profitability, they account for 19 percent of total sales as well as of investments, and 25 percent of total enterprise profits.

3.34 In addition, there is limited export diversification. Moldovan exports are dominated by a few products and have become increasingly more concentrated over the last few years. Wine and tobacco constitute a significant share of exports, after falling as a share of total from close to 60 percent in 1997 down to about 40 percent in 2003. Textiles, underpinned by financing from German, Italian and Turkish investments capitalizing on low wage cost, have risen as a share of total exports over this same period. Limited export diversification reflects the underlying concentration of enterprise activity in a few key sectors.

3.35 A number of factors are known to impede the emergence of a vibrant exporting sector. While tariffs in EU markets constitute an important barrier to the export of traditional agricultural products, the recent *Trade Diagnostic Study* also suggests that a number of impediments in the home market may themselves limit the ability of enterprises to export. These include the regulatory and administrative costs associated with customs procedures and clearance of exports, the difficulties of obtaining access to working capital, and the slow pace in adopting a modern standards system. The poor condition of transport infrastructure and logistic services are also constraining trade.



### State Ownership

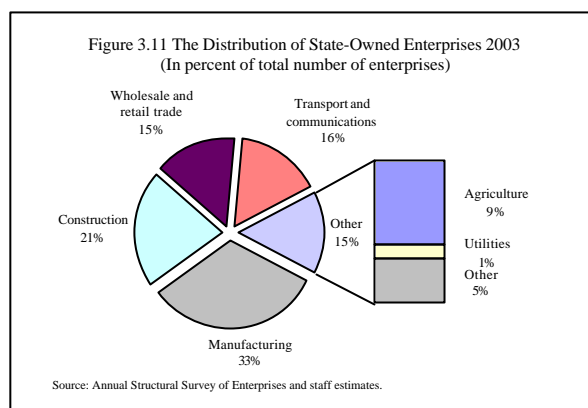
*State ownership is negatively related to performance*

3.36 State ownership is negatively related to firm performance<sup>46</sup>. Government-owned firms may have different objectives, face different incentives, and may be subject to softer budget constraints compared to other firms. Cross-country studies of transition economies provide strong evidence that private ownership is associated with better performance. Among Moldovan enterprises, private ownership is also associated with better performance. State-owned enterprises have lower profits per worker and invest less than their private sector counterparts. Excluding the utilities sector—where state-owned utilities account for most of sales but are less profitable than private firms—public enterprises also have lower sales per worker.

<sup>46</sup> State ownership is defined as at least 25 percent share of ownership. Under Moldovan company law, the ownership of at least 25 percent of total capital grants shareholders the right to block certain decisions (Sandu and Bouton, 2005).

*In some sectors, public firms still account for a large share of economic activity*

3.37 State-owned enterprises still account for a large share of economic activity in selected sectors, though they are few in absolute numbers. Such enterprises are a small fraction of the total number of enterprises (only about 1 to 4 percent of all enterprises, depending on the sector). A number of public enterprises are in wholesale and retail trade, construction, and manufacturing. But though they are few in absolute terms, they account for a disproportionately large share of economic activity in selected industries. For example, they represent over 40 percent of total sales in the utilities sector and 10 percent of total sales in manufacturing. They also employ about 14 percent and 11 percent of workers in the manufacturing and construction sectors, respectively.



*Reviving the privatization program will be critical but does not guarantee restructuring*

3.38 Given the poorer performance of state-owned enterprises, privatization will be critical for sustaining growth. While there are public finance arguments for sustaining public ownership in sectors with market failures such as the utilities sector, it is less clear why wholesale and retail firms or manufacturing firms should continue to be state-owned.<sup>47</sup> Loss-making state-owned enterprises buoyed by tax arrears are also a drain on public resources and deter the creation of a competitive market environment. The literature suggests that privatization is associated with greater restructuring and can thus introduce hard budget constraints, bring in new human capital and management techniques, foster new investment, and promote better enterprise performance.

3.39 In Moldova, however, privatization has effectively stalled. Over the last four years, only 59 enterprises out of the 482 enterprises listed in the 2001 privatization program have been sold. In addition, 27 enterprises have been removed from the program.<sup>48</sup> Reviving the privatization program will be critical but it does not guarantee restructuring or better performance. The experience with voucher privatization in transition economies, for example, has generally been disappointing.<sup>49</sup> A productivity-enhancing reform program has to create the right incentives for subsequent restructuring and management reforms. For example, a study of Moldova from the mid-1990s suggests that the privatization method matters for the speed of restructuring. In particular, restructuring is more rapid in enterprises bought out by their managers compared to voucher-privatized enterprises, suggesting that restructuring is undermined by ownership

<sup>47</sup> There are also opportunities for greater private sector participation, even in sectors typically in government control. In the utilities and infrastructure sectors, for example, there are opportunities for public-private partnerships, to introduce corporate governance, harder budget constraints, and private sector management practices into state-owned enterprises.

<sup>48</sup> See Sandu and Bouton (2005).

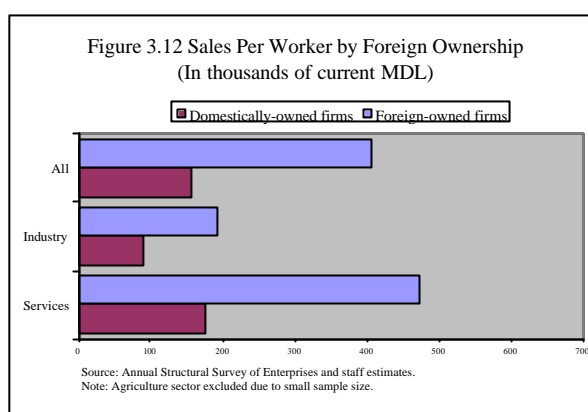
<sup>49</sup> In a number of countries voucher privatization led to “insiders” (managers or workers) or privatization investment funds owning controlling stakes in privatized firms. In the process, this impeded the restructuring necessary for better performance. See for example Birdsall and Nellis (2003).

perceived as a windfall gain. Evidence from manufacturing enterprises in Moldova suggests that in firms where managers have engaged in retraining, sales increased substantially and more restructuring was initiated.<sup>50</sup>

### Foreign Ownership

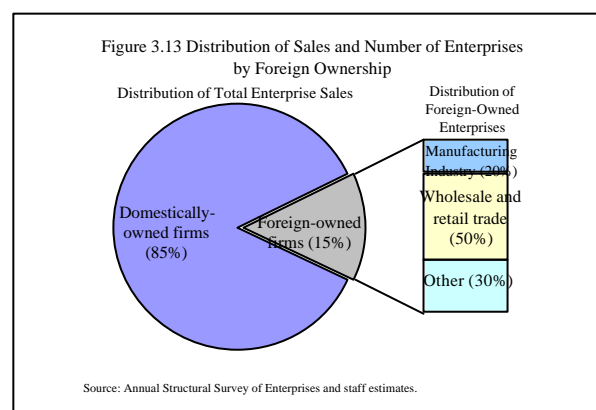
*Foreign ownership is positively related to performance, but...*

3.40 Foreign ownership is positively related to performance.<sup>51</sup> Foreign direct investment is expected to perform a dual function in sustaining enterprise growth. First, it supplements the level of financing for investment. Second, foreign ownership facilitates the transfer of new technology, production methods, and market expertise from firms abroad to their local counterparts. For the economy as a whole, there are also spillover benefits from the presence of foreign-owned enterprises.



3.41 The analysis of Moldovan enterprise data supports the cross-country evidence that foreign ownership is generally associated with better performance, measured in terms of sales per worker and profits per worker. For example, in 2003, for the enterprise sector as a whole, sales per worker among foreign-owned firms (a proxy for productivity) were more than twice those of

domestically-owned firms.<sup>52</sup> Across sectors, foreign-owned firms consistently had sharply higher sales per worker than domestic firms particularly in retail, transport and communications, and utilities. Measures of firm growth are also consistently positively associated with this form of ownership. Furthermore, foreign ownership is associated with higher probability of investment activity.



*...foreign-owned enterprises account for a small share of total economic activity*

3.42 However, foreign owned enterprises represent a small share of total enterprises activity. In 2003, foreign-owned firms represented about 3 percent of all enterprises and 5 percent of total employment while accounting for a disproportionate but still relatively small share of total sales (15 percent) and total investment activity (23 percent). Foreign-owned firms are mostly found in the wholesale and retail trade and manufacturing sectors.

<sup>50</sup> See Djankov (1999c).

<sup>51</sup> Foreign ownership is defined as ownership of at least 25 percent of total enterprise capital.

<sup>52</sup> One exception is agriculture where the sample size is too small to measure accurately (only 1 percent of foreign-owned firms in the sample are in agriculture). The figure suggests that foreign-owned agricultural enterprises have lower sales per worker than their domestic counterparts. The figure, however, is based on a very small sample of foreign-owned enterprises (11).



*...and foreign direct investment in Moldova is among the lowest in the region.*

*Foreign direct investments in Moldova is perceived to be associated with high risks.*

3.43 Foreign direct investment (FDI) in Moldova has been historically low by regional standards. Between 1999 and 2003, cumulative FDI per capita was among the lowest in the region, averaging only US\$22 per capita. In contrast, Romania received US\$56 per capita while the Czech and Slovak Republics attracted inflows 14 to 22 times as large. A number of studies suggest that the volume of foreign investment inflows across countries is affected by corruption, the quality of governance, and the regulatory environment. That is, corruption functions like a “tax” on foreign investment, effectively raising the risks and decreasing the returns associated with such investment.<sup>53</sup> Some firms may benefit from private rent-seeking opportunities in countries where governance is poor, but corruption is also associated at the aggregate level with weaker economy-wide firm performance.<sup>54</sup> The relatively low ranking of Moldova with respect to the perception of corruption, or the quality of the business environment may explain why Moldova has had difficulty attracting foreign direct investment.

3.44 The empirical evidence also suggests that where governance is weak, foreign direct investment inflows are not only lower in terms of volume but they also tend to be of lower quality. Where the protection of property rights is weak, attracting foreign investments in technology-intensive sectors (where high fixed costs have heavy reliance on intellectual property rights) also becomes particularly difficult. When they do invest, foreign investors undertake projects related to distribution and not local production.<sup>55</sup>

3.45 Corruption is not the lone determinant of FDI location. A large literature has emerged in recent years on the determinants of foreign direct investment, broadly classified according to the motive for investment. For “market-seeking” FDI, the purpose of which is to serve local consumers, the size of the local market is important. “Resource-seeking investment” is typically export-oriented. As such, factor costs along with trade openness and access to world markets are consistent determinants of export-oriented FDI. Among CIS countries, including Moldova, the quality of infrastructure also matters for FDI flows.<sup>56</sup> Finally, there is some evidence that FDI flows are also a function of the corporate tax rates and selected characteristics of corporate tax laws, including their complexity and predictability.<sup>57</sup>

3.46 It is not clear, however, that Moldova should be actively engaged in recruiting firms by offering generous tax holidays and subsidies. Such packages may ultimately incur costs that outweigh their benefits. Instead, policies that improve the investment climate more generally offer benefits for foreign and local firms alike, without introducing new distortions.<sup>58</sup> Ongoing efforts to streamline the regulatory requirement and level the playing field between local and foreign firms then seem to be steps in the right direction.

<sup>53</sup> See Wei (2000).

<sup>54</sup> See, for example, Hellman and others (2003) and Fries and others (2003).

<sup>55</sup> See Javorcik (2004).

<sup>56</sup> See Campos and Kinoshita (2003).

<sup>57</sup> See for example Edmiston and others (2003).

<sup>58</sup> See Dreimeier (2001).

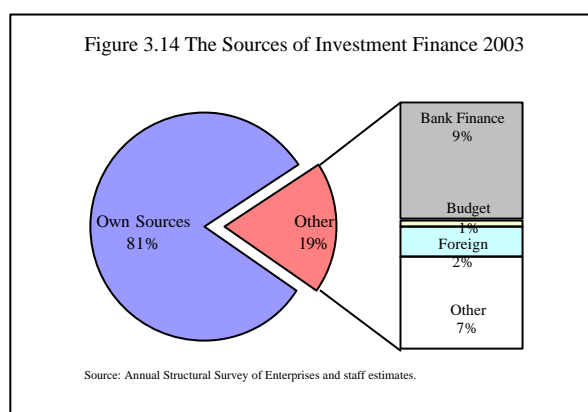
## Access to Financing

*Access to credit leverages firm performance...*

3.47 Access to credit or finance is associated with better performance. In transition economies, access to finance is critical for facilitating long-term physical restructuring and innovation. Cross-country studies confirm that providing access to financing is essential for restructuring and better performance and in Moldova, access to bank finance (and long-term bank finance) is one of the stronger and more consistent predictors of performance among reporting firms.<sup>59</sup> In particular, the association between access to finance, on the one hand, with the probability of investment and profitability, on the other hand, is particularly robust.

*...but many enterprises, particularly the smaller firms, are credit-constrained and face high-borrowing costs*

3.48 Enterprises in Moldova face constrained access to financing. To finance their investment activity, enterprises could potentially draw from commercial bank for credit. However, there is limited access to bank financing, especially among small firms.<sup>60</sup> In 2003, bank-financed investment represented only about 9 percent of financing sources while own-sources (or internal finance)



account for over 80 percent of financing. While own-sources certainly include reinvested profits, this may not be sufficient to finance critical investment activities in an economic environment still characterized by limited profitability, especially among smaller firms. Most small firms in Moldova reportedly resort to “informal finance” (or borrowing from friends and family). Cross-country data confirm that the degree of reliance in Moldova on internal finance or own-sources is among the highest in the world, second only to Armenia (90 percent), and far above the world average (about 58 percent). Across sectors in Moldova, the structure of financing varies somewhat. Data from 2003 suggests that enterprises in the manufacturing and utilities sectors are able to secure relatively more bank finance than those in other sectors. The construction sector is the most dependent on own-sources of finance.

*Loans provided by commercial banks are largely short-term credits*

3.49 There is a lack of medium- and long-term credit. Loans provided by commercial banks are largely short-term credits. Long-term loans have become virtually non-existent, although the share of medium-term loans has grown in recent years.

3.50 Bank financing is associated with large borrowing costs. The (nominal) lending rates offered by commercial banks are relatively high compared to other countries in the region and compared to advanced economies. Compared to CIS countries, enterprises in

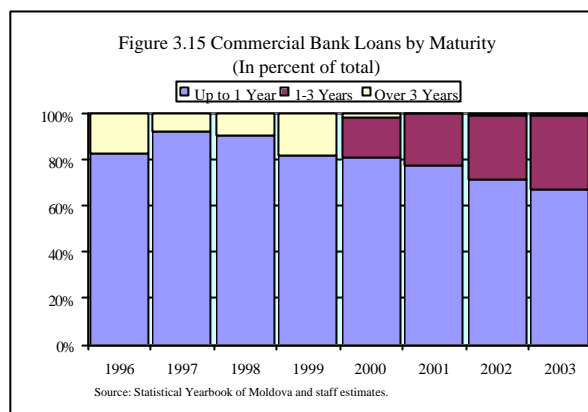
<sup>59</sup> Bevan and others (1999) review the literature on enterprise performance, drawing from both the literature on established market economies and transition economies. They examine the evidence on the effects of ownership, competition, and access to finance on firm performance and find a strong, robust influence of finance on performance.

<sup>60</sup> Firm size is found to be an important determinant of whether firms can have access to specific types of finance (Beck and others 2002).

Moldova face lower borrowing costs. However, Moldova's relative advantage has fallen over time as CIS lending rates have converged toward Moldova's lending interest rate. Interest rate spreads, a measure of banking efficiency, are also highly relative to other countries in the region. And Moldova's relative efficiency compared to other CIS countries in the region has narrowed over time.

*State ownership may in part adversely affect the efficient functioning of banks*

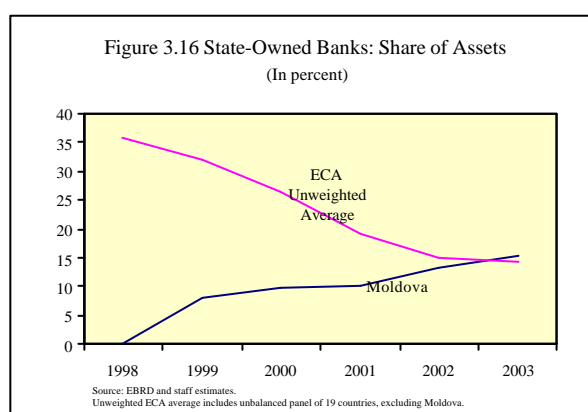
3.51 State ownership may in part adversely affect the efficient functioning of banks. The *Financial System Stability Assessment* suggests that state-owned banks' efficient functioning is more vulnerable to government pressure.<sup>61</sup> Despite these problems, the government share of activities in Moldova's financial sector has been growing, in contrast to the general decline in government activity in this sector among transition economies. This growth in government share of assets has been underpinned in part by the concentration of state-owned enterprise borrowers in the state-owned bank and an exceptional increase in the bank's loan book.<sup>62</sup>



3.52 Measures to reduce informational constraints on credit history may be useful. Banks in Moldova have limited capacity to assess creditworthiness of firms. A large body of research suggests that such an inability to distinguish credit-worthy firms from other firms leads to the inefficient allocation of credit. Cross-country research suggests further that mechanisms for reducing informational constraints, such as the registry of credit history and payment performance, may facilitate greater bank financing, especially among small and medium-sized firms.<sup>63</sup> However, in the context of the transition process, enterprises may find that past performance may be an inadequate measure of future profitability.

*Higher foreign bank participation may also ease credit constraints.*

3.53 Cross-country experiences suggest that greater bank competition may foster higher access to finance. Across countries, bank concentration is associated with greater financing obstacles and the decreasing likelihood of receiving bank finance. This is mitigated by higher foreign bank participation, higher levels of financial development (as measured by financial depth), and fewer



<sup>61</sup> IMF and World Bank (2005).

<sup>62</sup> The study recommends that the state-owned bank be privatized.

<sup>63</sup> See Love and Mylenko (2003).

restrictions on bank activity. In the case of Moldova, where the banking sector is characterized by significant concentration (5 banks account for most total assets) and low degree of sophistication, attracting more foreign banks may be desirable, to exert competitive pressure on the domestic banks and introduce new financial instruments to the local market. There is some evidence suggesting that foreign banks may be reluctant to locate in Moldova in part because the market is small and few foreign-owned companies exist. This further underscores the need to expand access to overseas markets and attract more foreign companies.

3.54 In exploring policy options for increasing access to finance, financial prudence is warranted. Easing restrictions on bank activity should be tempered by policies required for maintaining financial and macroeconomic stability, especially given the history of the fragile confidence in the banking system.

3.55 Again, policies to improve the investment climate more generally are steps in the right direction. For example, a transparent and efficient court system is likely to protect creditor rights and facilitate loan recovery which, in turn, allows banks to reduce lending interest rates and extend credit to more customers. Cross-country evidence indeed suggests that the quality of judicial and legal systems and the protection of property rights are negatively related to lending spreads.

## CONCLUSIONS AND POLICY RECOMMENDATIONS

### Key Binding Constraints to Firm Performance

3.56 Over the last few years, industrial output has increased and the share of profitable firms has risen. These gains seem to have been driven in large part by increasing capacity utilization. It is not clear how these gains could be sustained without measures to improve productivity, such as by encouraging restructuring and innovation and by increasing investment activity. The preceding section discusses key firm characteristics associated with better performance. While these characteristics were discussed separately, there are clear inter-linkages between them and several underlying, mutually reinforcing constraints tie them together.

3.57 Not surprisingly, these underlying constraints correspond to selected dimensions of the business environment, broadly defined. And, as is clear from cross-country studies, the quality of the business environment, broadly defined and incorporating its many dimensions, is positively related to enterprise performance and higher investment activity.<sup>64</sup> But the preceding discussion drawing from experience of Moldovan firms over

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<sup>64</sup>Such studies have typically used composite indices—consolidating several components of the business environment into a single country-level measure rather than estimating the independent effect of each component—to account for the strong correlation between these components (e.g., the burden associated with selected components of the business environment, such as licensing, are typically high in countries where the burden associated with other components, such as registration or bribery, are high). These composite indices are based on either a formal, first-stage principal components analysis (e.g., Bastos and Nasir, 2004) or an ad hoc weighted average of selected indicators (e.g., Fries, Lysenko, and Polanec, 2003) summarizing the business environment.

the last few years also highlights the role of specific dimensions of the business environment in constraining economic activity in Moldova. They are as follows:

- ? *A difficult regulatory and administrative environment.* An overly burdensome regulatory and administrative framework constrains the free entry and exit of firms. Constrained entry, in turn, limits the competitive pressure faced by existing firms, effectively reducing the incentive to invest, innovate, and perform more efficiently. Constrained exit procedures, meanwhile, unnecessarily prolong the life of loss-making firms, reducing the incentive to restructure and innovate, and creating a drain on the budget in the process. In the traded goods sector, regulatory and administrative requirements in customs clearance limit the ability of firms to export and gain access to world markets. Along with corruption and quality of institutions, a restrictive regulatory environment also deters the inflow of foreign investment, thus limiting the entry of high-performing, foreign-owned corporations as well as of foreign banks.
- ? *Constrained access to finance.* In the transition period, physical restructuring in order to raise the productivity of firms requires the availability of long-term credits. In Moldova, however, there is an acute shortage of long-term financing. Smaller firms are particularly constrained in their access to bank borrowing. Among exporting firms, the costs of financial services are aggravated by restrictions on foreign exchange borrowing, effectively doubling the interest rates they face.
- ? *Infrastructure and management constraints.* There is some evidence that the quality of transportation infrastructure may constrain the performance of selected firms, such as those in the export sector. Cross-country evidence on FDI flows also suggests that quality of infrastructure matters for attracting investment, especially among CIS countries including Moldova. With respect to labor constraints, there is some evidence that effective restructuring activity depends on management personnel receiving appropriate training.

3.58 In addition to these constraints that correspond to typical dimensions of the business environment, two other constraints exacerbate the obstacles to sustained, private-sector led growth.

- ? *Limited access to world markets.* In a small economy such as Moldova, market size is ultimately a function of openness and access to world markets. Such access, however, is limited by a number of domestic factors, including the current systems of standards and conformity assessment (metrology, standardization, and testing quality, or MSTQ), the costs of customs regulation and procedures, among other factors.<sup>65</sup> With increased access to overseas markets, returns on domestic investments increase, as firms produce not just for domestic consumption but for markets abroad. FDI flows are, ultimately, positively related to a country's openness and access to world markets.

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<sup>65</sup> There is also evidence that export activity is furthered constrained by underdeveloped distribution channels, especially in sectors producing non-traditional exports of goods and services such as those in information technology.

- ? *A stalled privatization program.* There are public finance considerations for keeping certain public enterprises in government hands. It is less clear why enterprises in the manufacturing and wholesale and retail sectors, less productive than their private counterparts, should remain state-owned. Together with complementary policies, privatization can lead to the restructuring of loss-making firms, attract new investment and technology, and facilitate the introduction of new management and production methods. In the banking sector, privatization of the state-owned bank can lead to its more efficient functioning.

### ***Policy Recommendations***

#### **3.59 Sustain efforts to reform the regulatory and administrative environment.**

Recent reform efforts are, in general, steps in the right direction.

- ? First, easing the regulatory burden decreases the “tax wedge” created by an unfavorable business environment, raises the returns to investment, and facilitates the entry and exit of firms.
- ? Second, efforts aimed at leveling the playing field between domestic and foreign investors and removing unnecessary restrictions on foreign profit repatriation are important for attracting more foreign investment, providing access to new technology, and fostering competition.
- ? Third, initiatives to review the functions of the Council of Creditors are also welcome but need to be carefully reconsidered. The evidence suggests that measures that subject loss-making firms to softer budget constraints, through tax holidays, for example, may ultimately be counterproductive. Just as lowering barriers to business entry is essential, measures to facilitate the exit of unsound firms would also allow the development of a more viable enterprise sector.

**3.60 Design a more comprehensive communication campaign to disseminate information on regulatory reform efforts.** Reform is as much about altering perception as it is about altering practice. Establishing a credible and meaningful dialogue between the private sector and the Government is also complicated by past experiences. In a number of recent business forums, the business community expressed skepticism about the Government’s ability to follow-through on these reforms.

**3.61 Ensure real ownership of reforms by all agencies with regulatory mandate.** The implementation of these reforms depend on multiple public agencies, some of which do not seem keen on easing the regulatory burden or on giving up the extra revenues they receive and the authority they exercise under the current system.

**3.62** Other dimensions of the business environment critical to enterprise performance in Moldova will need to be addressed:

**3.63 Implement measures to increase access to finance and efficiency of the banking sector.** Measures to reduce the cost of borrowing and for reducing credit information asymmetries are critical for increasing access to finance.

- ? Create a system for unified credit information and exchange service, to facilitate creditworthy enterprises' access to financial resources.
- ? Allow the entry of more foreign banks into the banking system, to exert more pressure on a highly concentrated system and introduce new financial services to the market.
- ? Following the EGPRSP, facilitate the access of smaller enterprises to finance through the sustained development of micro-credit organizations to increase the availability of micro credit at affordable interest rates. Following the FSAP, encourage cash-flow based lending, as an alternative to collateral-based lending, and develop other products tailored to the needs of smaller firms.
- ? Develop a strategy for privatizing the state-owned bank, as indicated in the *Financial System Stability Assessment*.

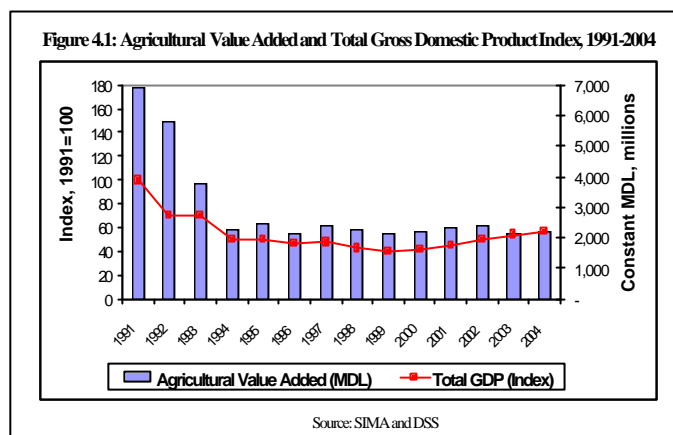
3.64 **Revive the privatization program while creating the right incentives for restructuring, innovation, and efficient management.** The privatization program appears to have stalled in recent years, resulting in reversals and cancellations in some cases. Moldova has been unable to attract strategic investors who could potentially bring in new technology, more efficient management practices, and more advanced production methods. As emphasized in the EGPRSP, central to private sector development is the renewed effort in privatizing and restructuring state-owned enterprises. A renewed privatization program, however, needs to be carried out carefully to create the right incentives for restructuring and innovation.

## CHAPTER 4. UNLEASHING THE POTENTIAL OF THE AGRICULTURAL SECTOR

### INTRODUCTION

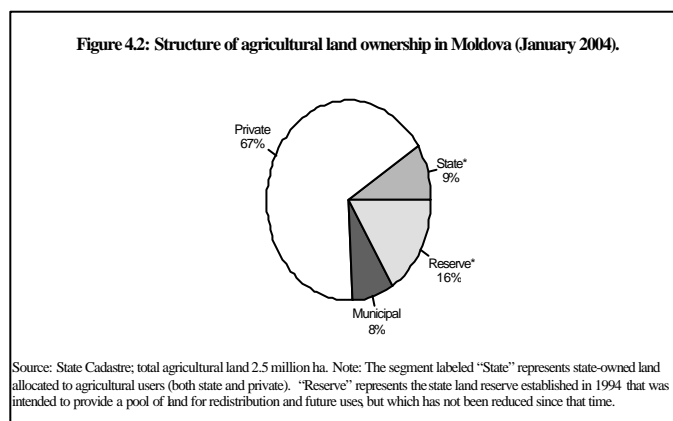
*Growth of the agricultural sector is essential for Moldova's economic development.*

4.1 Agriculture is the largest real sector of the Moldovan economy, accounting for 19.2 percent of GDP (30 percent if agro-processing is included), and generating the majority of Moldova's exports (59 percent). It is also very important in terms of employment (43 percent of the total), incomes and poverty reduction, especially in rural areas, with rural poverty accounting for 68 percent of the total and rural households deriving 73 percent of their income from agriculture.<sup>66</sup> Due to its importance, growth of the agricultural sector is essential to sustaining and accelerating growth of the Moldovan economy in general. Faster growth in the agricultural sector, by raising incomes and employment opportunities in rural areas, will increase purchasing power and demand for products of other economic sectors.



*The good news is that the agricultural sector is no longer in decline.*

4.2 Like all other sectors of the economy, agriculture suffered during the transition, with agricultural value added shrinking by more than 50 percent (see Figure 4.1). Moldova carried out its farm restructuring later than most other transition economies, not starting in earnest until 1998, which prolonged the contraction of the sector. But reform has now mostly been successfully completed, resulting in a highly equitable distribution of agricultural land and a new class of landed independent farmers. As of January 2003, two-thirds of agricultural land had been formally classified in private ownership (see Figure 4.2). This reform, combined with macro-economic stabilization and a boost to domestic demand from remittances, resulted in an arrest in the decline of



<sup>66</sup> World Bank, *Recession, Recovery and Poverty in Moldova*, (2004).

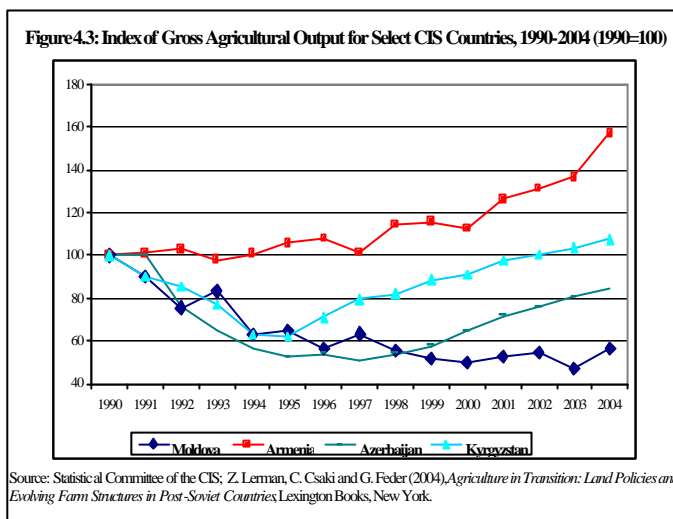


the agricultural sector and the beginning of a recovery. The sector grew gradually from 2000 to 2002, before the drought of 2003 set it back again.

*The bad news is that the agricultural sector continues to underperform.*

4.3 While the industrial sector has experienced a strong rebound since 2000, the agricultural sector continues to lag behind. Due to a poor business environment characterized by underdeveloped and imperfect markets and policy uncertainty, producer prices are low and Moldova has not been able to benefit as much from farm restructuring

as other CIS countries with similar agricultural sectors (see Figure 4.3). Although late implementation of land reform and farm restructuring has delayed its recovery compared to other countries, Moldova is better situated than it would have been without reform because, as we shall see, the new independent farms are more efficient than older farms. But to generate sustained growth in the agricultural sector, the

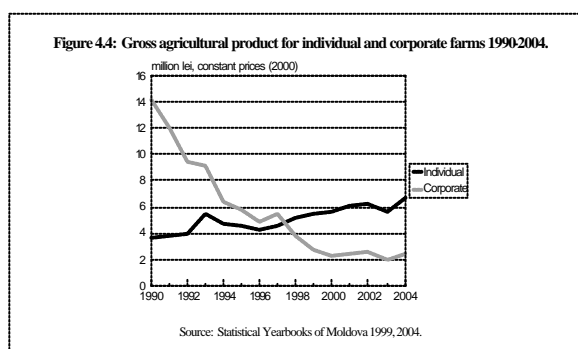


Government should build on these reforms by creating the necessary incentives for market-oriented production by independent farmers, and providing the support they need to take advantage of new opportunities. By improving market opportunities and increasing prices received by farmers, farm incomes will be increased, farmers will be able to invest and pay more for hired labor, and there will be less incentive to emigrate.

#### EXPLOITING AGRICULTURE'S NEW OPPORTUNITIES

*Farm restructuring created tremendous opportunities that have yet to be exploited.*

4.4 The new farm structure resulting from restructuring is small, independent, labor-intensive, high-value, and more efficient and productive. Private ownership, however, does not necessarily mean individual use of land. A dual structure has been created with about half of the private land in 300,000 smaller, individual farms averaging 1.9 hectares. The other half of the privately owned land is managed by about 1,500 large-scale corporate farms that average around 650 hectares, with joint, not individual, cultivation of land.<sup>67</sup> These corporate farms are typically managed by "leaders" from the former collectives who encourage land share recipients to lease out their shares. They are often run in a similar fashion to the former collectives, but are about one-third the size. Today,



<sup>67</sup> These include joint stock societies and agricultural production cooperatives, though the vast majority are limited liability companies (78 percent).

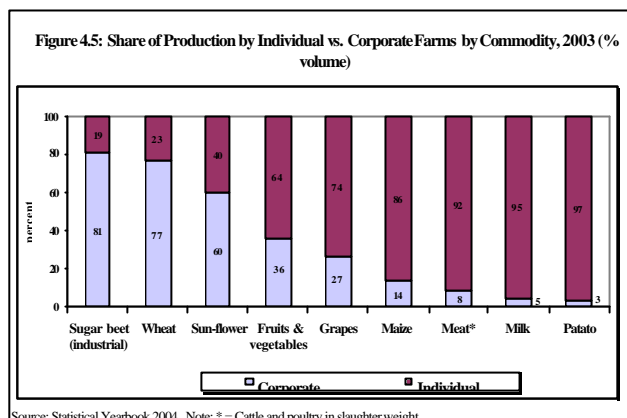
using only half of agricultural land, the individual farms produce about 75 percent of the value of agricultural output (see Figure 4.4).

*Individual farms produce more through more efficient utilization of the primary inputs to agricultural production in Moldova: land and labor.*

4.5 In general, individual farms tend to have higher land productivity (yields), while corporate farms tend to have higher labor productivity. This is because individual farms focus more on labor-intensive products such as milk, meat, fruits and vegetables, which are also high-value (see Figure 4.5). Meanwhile, corporate farms produce extensive crops

like sugar beets, wheat, and sunflowers that require less labor, but more land and machinery. In order to derive a more comprehensive and accurate measure of efficiency, in contrast to partial productivity measures like yields or labor productivity, we have estimated total factor productivity (TFP) for Moldovan agriculture (see Figure 4.6).<sup>68</sup> The results show

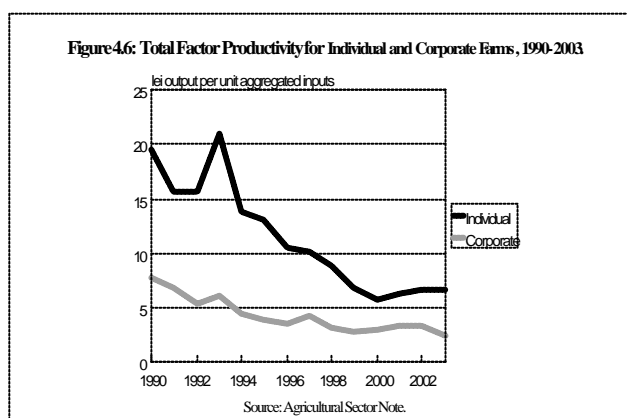
that small individual farms attain consistently higher TFPs than large corporate farms (although TFP for both types has generally decreased over time). The TFP calculations thus eliminate the ambiguity between the partial productivities of land and labor for large and small farms and conclusively show that small farms use their resources more productively than large farms. The analysis also reveals decreasing returns to scale in Moldovan agriculture. In other words, as farms grow larger, their costs per unit of production increase (although this will vary somewhat by commodity).



4.6 With the end of the market distortions caused by heavy input subsidies and guaranteed output prices that were prevalent during the Soviet period, Moldova's true comparative advantages in agricultural production are becoming evident again. The Domestic Resource Cost Ratio (DRC) ratio is a standard indicator of international competitiveness that measures

the relative efficiency of domestic production by comparing the opportunity costs of using domestic primary factors – land, labor and capital – to the value added they

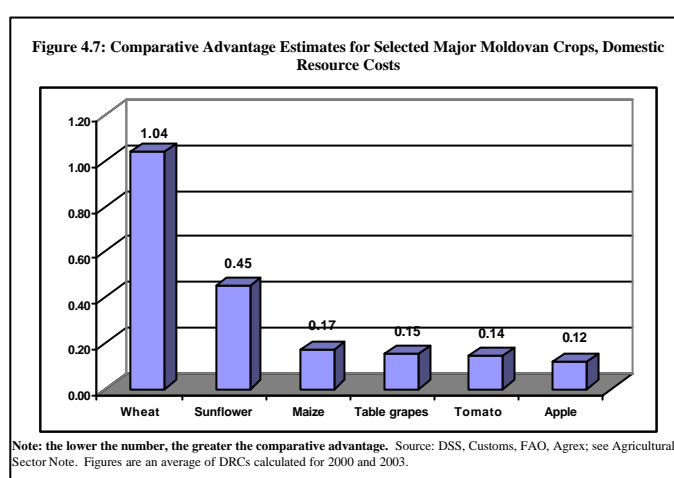
*The new farm structure is well suited to Moldova's re-emerging comparative advantages.*



<sup>68</sup> TFP is calculated as the ratio of the value of output to the aggregated cost of input use. In the absence of market prices for valuing the cost of inputs (such as the price of land), TFP is usually determined by estimating a production function and then using the estimated input coefficients as the weights to calculate the value of the bundle of inputs. The ratio of the observed output to the estimated bundle of inputs is the TFP. See the Agricultural Sector Note for more details.

generate.<sup>69</sup> The DRCs were calculated to assess the competitiveness of Moldovan agricultural production for six main commodities: wheat, maize, sunflower, tomatoes, apples, and table grapes. These products were chosen due to their relative importance in both gross agricultural output and exports (all of them are net exports, depending on the year).<sup>70</sup> The results are presented in Figure 4.7, where the lower the DRC, the lower the relative cost of production, and the greater the international comparative advantage. The analysis demonstrates that Moldova is fortunate to have the greatest comparative advantage in the production of high-value crops like tomatoes, apples, and table grapes (as well as the staple maize). As noted above, these crops are more labor-intensive and are more likely to be cultivated by small independent farms. Moldova has less of a comparative advantage in the production of crops like sunflowers and especially wheat, which are more likely to be cultivated by large corporate farms.

4.7 Agricultural producers are receiving low prices for their outputs relative to international prices. The effects on the same six commodities as above are reflected in Figure 4.8, which compares the prices received by Moldovan farmers to international prices, after accounting for transportation, handling and other costs.<sup>71</sup> Positive figures indicate that farmers



receive high prices for their products relative to international prices, while negative figures indicate that farmers receive low prices. The results show that on average for these six commodities farmers received a significant 29 percent less on their sales than they should have based on world market prices over the period 2000 to 2004. This is even true for crops such as maize, tomatoes, and table grapes in which Moldova has the greatest comparative advantage. Further, the situation has not been improving over time, and for crops like wheat and tomatoes, it has worsened considerably. The situation of low farmgate prices creates disincentives for agricultural production.

<sup>69</sup> Details can be found in the Moldova Agricultural Sector Note.

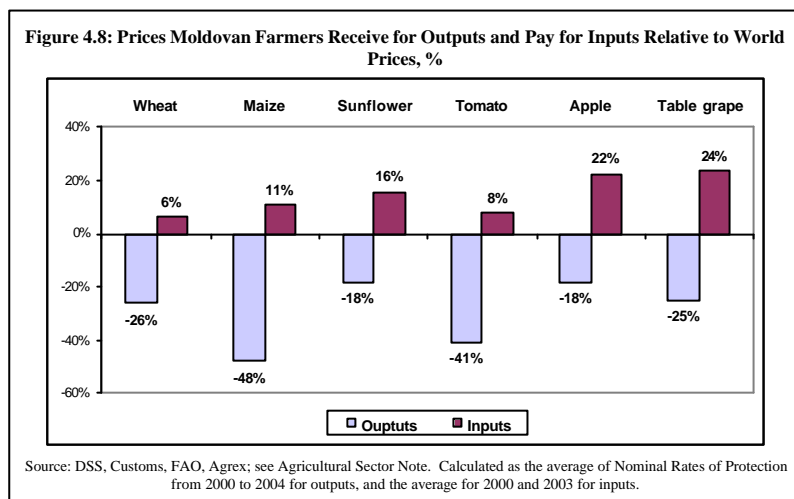
<sup>70</sup> It should be noted that livestock products have been left out of this analysis due to the lack of available data on livestock production and prices. The Moldovan livestock sector is generally considered to be in a poorer state than the crop sector, and anecdotal evidence suggests that it could not compete in export markets, primarily due to the lower feed costs in neighboring countries like Ukraine. Moldova has serious problems with finding export markets for its livestock products, and for the first time in 2002 it became a net importer. However, this does not mean that it could not compete in the domestic market.

<sup>71</sup> This indicator is also known as the Nominal Rate of Protection (NRP), which measures market distortions based on the ratio of the domestic price actually received by farmers (market or private price) to the economic (or social) international parity price of a commodity, both taken at the same point in the marketing chain (usually farmgate) after accounting for transaction costs. For more information see the Agricultural Sector Note. For an overview, see: [http://www.fao.org/documents/show\\_cdr.asp?url\\_file=/docrep/003/x7352e/x7352e03.htm](http://www.fao.org/documents/show_cdr.asp?url_file=/docrep/003/x7352e/x7352e03.htm)

*Farmers are being discouraged by low prices for their products relative to international prices.*

4.8 As agricultural output decreased over time in Moldova, input use declined even more. For example, average application of chemical fertilizers to cropland dropped from 294 kg/hectare in 1985 to only 20 kg/hectare in 2002,<sup>72</sup> a decrease of over 90 percent (by comparison, consumption in the EU-15 ranges from about 60-250kg/hectare, and has been gradually decreasing). This is largely due to the concomitant reduction in agricultural incomes and collapse of former distribution channels, but our analysis shows that high input prices also play a part. To illustrate, we have calculated the prices paid by farmers for their tradable inputs relative to international prices for production of the same six commodities, and these results also appear in Figure 4.8. They demonstrate that Moldovan farmers pay on average 15 percent more for the tradable inputs used in the production of these crops than comparable international prices (after adjusting for transaction costs). The effect is to reduce the ability of farmers to use purchased inputs, which has a negative impact on yields and production, and this effect is strongest for high-value commodities like apples and table grapes in which Moldova has a strong comparative advantage, and which small farmers tend to produce. To summarize, Moldovan farmers pay more for their inputs and receive less for their outputs than they would if there were no market imperfections.

*Input markets are also problematic for farmers, but less so than output markets.*



*The new small farms are being squeezed by distorted markets.*

4.9 The new independent farmers have the potential to become much more productive and commercially oriented. But they receive low prices for their outputs, and pay high prices for and have very little access to inputs or support services. The information collected on the domestic market and international prices for agricultural inputs and outputs can be used to measure the combined effect of agricultural policies and the economic efficiency of the system. By measuring the divergences between private (i.e., financial) and social (i.e., economic) values for tradable inputs, domestic resources and outputs, the magnitude of the transfers to or from farmers can be calculated.<sup>73</sup> The results provided in Table 4.1 show that Moldovan production of the six major commodities is on average both privately and socially profitable, at 800 and 1,563 lei per ton, respectively. Private profitability indicates the degree to which production of a commodity can compete at current market prices, and is important for policy-makers concerned with growth-enhancing investments, because new investments must be privately profitable if agricultural producers are to expand their activities.<sup>74</sup> Table grapes

<sup>72</sup> Trends in Trade with Major Agricultural Inputs in Moldova, PFAP, 2004.

<sup>73</sup> See Monke, Eric A. and Pearson, Scott R. (1989), *The Policy Analysis Matrix for Agricultural Development*, <http://www.stanford.edu/group/FRI/indonesia/courses/manuals/pam/pam-book/>.

<sup>74</sup> Pearson, S., C. Gotsch., and S. Bahri, (2003), *Applications of the Policy Analysis Matrix to Indonesian Agriculture*.

and apples have the highest level of private profitability, at 1,547 and 1,337 lei/ton respectively, while maize, sunflowers and tomatoes are profitable in the range of 600-850 lei/ton (though for maize and sunflower profits appear more irregular and unstable).

Wheat is the least profitable crop, both privately and socially (wheat's profitability is negative on average due to the terrible 2003 season, but otherwise it is normally marginally profitable). The social

**Table 4.1: Private Profits, Social Profits, and Transfers from Farmers for Six Production Systems (MDL/ton)**

Crop	Private Profits	Social Profits	Transfers from Farmers
Wheat	-110	-31	-78
Maize	600	2356	-1756
Sunflower	604	884	-280
Tomato	823	2187	-1364
Apple	1337	1704	-367
Table grape	1547	2276	-729
<b>Average</b>	<b>800</b>	<b>1563</b>	<b>-762</b>

Source: DSS, Customs, FAO, Agrex; average of 2000 and 2003 figures; see Agricultural Sector Note.

profitability of production is significantly greater than private profitability for all the analyzed crops (including wheat). The higher social profits indicate that as a result of policy distortions and market imperfections, there are significant economic transfers from farmers to others in the marketing chain, including traders, processors and consumers in output markets, and suppliers in input markets. These transfers range from 78 to 1,756 lei/ton on average, depending on the crop, and are highest for maize and tomatoes, in which Moldova should have a comparative advantage. In addition to depressing farmer incomes, the fact that private profits are lower than they could be has two important negative impacts on agricultural development: (i) it lowers the demand for investment by farmers; and (2) it lowers the supply of credit from banks.

*This creates a vicious circle.*

4.10 Negative price distortions reduce agricultural incomes, which leads to insufficient working capital and a lack of new investments, which in turn leads to declining productivity and poor quality produce, which reduces incomes further. The evidence for this can be seen in the poor performance of agricultural firms. The profitability of agricultural firms is the lowest of all sectors, with profits per worker just over 1 percent of the national average.<sup>75</sup> Given these low returns it is perhaps not surprising that, as illustrated in the previous chapter on enterprise performance, the agricultural sector received only 5 percent of total investment in 2003, which is one-fourth of its contribution to GDP.

#### **IMPROVE AGRICULTURAL MARKETS TO BENEFIT FROM THE NEW FARM STRUCTURE**

*The priority is not to produce more, but to fix the market.*

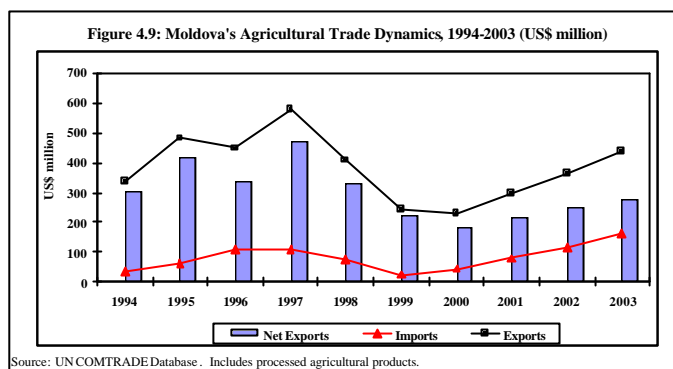
4.11 Based on the evidence thus far, it is clear that increasing production is not the immediate priority. Given current market conditions, increased production would only depress agricultural prices further. Rather, the priority should be to address the policies and market imperfections that reduce farmers' terms of trade. By improving markets, the new independent farms will receive the price signals they need to increase investment and production of those high-value crops in which Moldova holds a comparative advantage.

*Exports of high-value agricultural products show the most potential.*

4.12 Prior to the breakup of the Soviet Union and collapse of markets, Moldova was a significant net exporter of agricultural products. Due to the small size of Moldova's domestic market, the export market continues to hold the most potential for growth in the

<sup>75</sup> Source: Elaboration of the Annual Structural Survey of Enterprises.

future. Moldova's agricultural exports bottomed-out in 2000, and have been growing steadily ever since (see Figure 4.9). Although imports have also grown due to rising demand, exports have grown faster, resulting in positive and increasing net exports. In fact, agriculture accounted for over half of Moldova's total exports in 2003, which demonstrates its potential as a driver of export-led growth. Nevertheless, agricultural exports have still not recovered their levels before the Russian financial crisis of 1998, so there remains considerable room for improvement.



Currently, the biggest export by far is alcoholic beverages, while other major exports include fresh and processed fruits and vegetables, vegetable oils, meat, and in most years cereals. The growing agricultural imports (\$126 million in 2003), meanwhile, provide opportunities for efficient import substitution (in other words by improving competitiveness—not by imposing import tariffs). Major imports include sugar, alcoholic beverages, tobacco, and in 2003 cereals.

4.13 Although there is considerable potential for Moldovan agriculture to exploit its comparative advantage and reap higher profits, there are a number of factors impeding its ability to realize this potential. These include:

- ✗ Policy interventions that restrict market opportunities and create uncertainty.
- ✗ Underdeveloped agricultural services and markets for outputs, inputs and credit.
- ✗ Lack of sustainable long-term linkages between the farmer and the processor that ensure a high quality and adequate quantity, and that meet the requirements of target export markets
- ✗ Lack of physical marketing infrastructure enabling farmers to get a fair price and add value to their farm products.
- ✗ Underdeveloped standards and certification system.
- ✗ High transportation and logistics costs.<sup>76</sup>
- ✗ Institutional weaknesses, such as lack of marketing groups and cooperatives that would increase farmers' negotiating power and open new opportunities for members.

*Interventions by Government hurt farmers and should be removed.*

4.14 While the Government does not appear to have sector-wide policies that discriminate against agriculture, there are instances of counter-productive government interventions in certain commodity sub-sectors, in particular export restrictions on wheat and sunflowers, such as the requirement that all export transactions be registered at the Universal Commodities Exchange (UCE). The specifics of these restrictions and their impacts are described in Box 4.1 for the case of oilseeds. The beneficiaries of these policies are existing processors who have now increased their market power in the

<sup>76</sup> See *The Republic of Moldova Trade Diagnostic Study*, L. Bouton et al. (2004), the World Bank.

**Box 4.1: Agricultural Export Restrictions—the Example of Oilseeds**

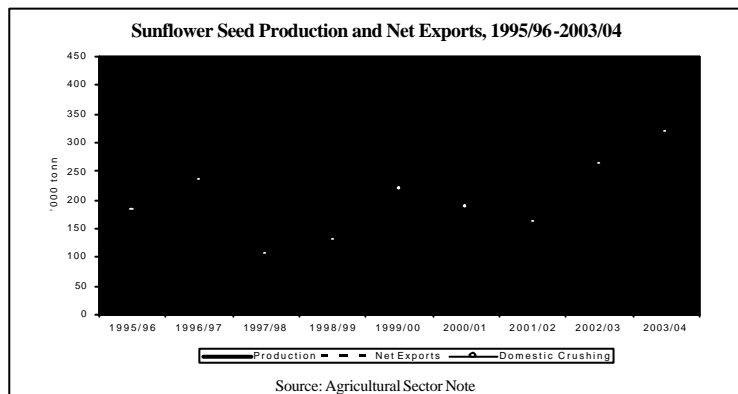
Domestic oilseed prices are below international levels due to the lack of free access to export markets. The non-transparent, unofficial measures effectively limiting exports of seed from 2001/02 to the present include:

- ? **Export Documentation and Certification:** Excessive requirements are non-transparent and time-consuming.
- ? **Customs Clearance:** Delays, stamps, and various red tape serve to block exports.
- ? **State Rail Facilities:** Commonly unavailable when requested, high charges levied, and delays frequent.

From July 2004, an official Governmental Decision added to these non-tariff barriers to exports. Though it does not officially include oilseeds, exporters have found them effectively subject to the same conditions. The following barriers were added to those above:

- ? **UCE Single Channel for Exports:** All exports must be registered with the Universal Commodities Exchange in Chisinau. Long delays related to logistical and documentation requirements occur.
- ? **UCE Fee:** The UCE receives a fee of 0.125 percent of each export trade transaction made.
- ? **Export Payment:** All UCE export payments are made via a commercial “clearing” bank. Delays in payment often occur at this stage.
- ? **State Rail Monopoly:** All exports must be made via the state rail network rather than by truck, making the problems mentioned above unavoidable.

The figure shows that these export restrictions have reduced net exports despite increased production, and increased domestic crushing volumes. This has had a significant negative impact on prices received by producers compared to international prices (producers have received on average 18 percent



less than international prices would indicate since 2000—see Figure 4.8). The estimated impact on margins for the Moldovan vegetable oil processor is illustrated in the table. It shows that

**Sunflower Seed Crushing Margins by Market, (US\$/ton of seed)**

	2002/03	2003/04	Average
<b>Moldova</b>	69	75	72
<b>Ukraine</b>	50	112	81
<b>EU</b>	10	25	14

Source: Agricultural Sector Note

margins in Moldova are several times higher than the EU average, and comparable to those in Ukraine, which has a 17 percent seed export

tax. Meanwhile, analysis also shows that crushing costs in Moldova are no higher than those in the EU. Therefore the one industrial oil processor in Moldova is effectively using its monopoly position to achieve economies of scale and influence policy in order to generate high profits relative to the more open EU market.

purchase of raw materials. Our analysis shows that this has had a significant negative impact on prices received by producers of these crops compared to international prices (refer to Figure 4.8). The effects are likely to be even more severe in 2005, as many farmers have been storing these crops in the hope that prices would rise, and they will

soon be forced to sell, depressing prices further. In addition to the direct negative impact on farmer incomes, wheat and oilseeds are high-profile commodities, and the policy changes add to the environment of uncertainty more generally and create negative signals to potential new investors. While the formation of the UCE is a positive step in terms of price transparency, its use should be made voluntary, and other official and unofficial barriers to export should be done away with (the Guillotine Law discussed in Chapter 3 is an important step in this direction).

*The Government should focus on improving markets.*

4.15 The Government should focus on improving market opportunities and the market environment for new, small farmers. Unlike for cereals and oilseeds, there are no official policies distorting prices for high-value crops like fruits, vegetables and dairy produced mainly by independent farmers. However, there are a number of market imperfections and inefficiencies that produce similar effects. In particular, the inability of Moldovan produce to meet international standards reduces output prices, and the lack of vertical coordination in market chains diminishes opportunities for independent farmers.

*The quality of Moldovan agricultural products needs improvement.*

4.16 Moldovan produce generally does not meet international standards, and cannot access high-value export markets or even domestic supermarkets. This does not mean the quality is necessarily “bad”, but just that it does not meet the specifications of buyers. The results are observed in the inability of Moldova to export significant quantities outside the CIS countries.

Table 4.2 reveals that Moldova is more dependent on

**Table 4.2: Trade Orientation of Selected CIS Countries, 1995 and 2002**

Country	Share of total exports to CIS countries		Share of agriculture and food exports to CIS countries		Share of agriculture and food in exports	
	1995	2002	1995	2002	1995	2002
Moldova	63	54	67	70	72	63
Azerbaijan	45	11	86	58	6	3
Kazakhstan	55	23	91	44	10	5

Source: Statistical Committee of the CIS (2003a); Sedik (2004)

agricultural exports to CIS countries than other comparator countries (in addition to being more dependent on agricultural exports in general), and that it was the only country whose share increased over time.<sup>77</sup> This is likely because standards are lower in CIS countries than, for example, EU countries, and because there are longer-standing market channels. But it also means that Moldovan exports receive lower prices than they could in higher-value markets, and this is being reflected in lower producer prices. Moldova’s current institutions and infrastructure for sanitary and phytosanitary measures very much reflect those of the former Soviet Union. One way to expand the export markets is by adapting the standardization and certification systems to EU standards, while at the same time streamlining the process. While harmonization with EU standards has begun, this is a major task that needs to be accelerated. Taking advantage of new export opportunities in Western Europe should be an important element of Moldova’s growth strategy. Improving standards will open not only more channels in the EU, but ensure continued access to traditional markets to the east—such as Russia and Ukraine—that are becoming more demanding as incomes rise, as well as improve access to domestic supermarkets, which are sure to expand as they have in every other country.

<sup>77</sup> The table also shows that Moldova is generally much more dependent on agricultural exports than the two oil exporters.



*Development of farmer-processor links is important for improved organization of markets.*

4.17 A recent study of agricultural markets across transition countries has found that vertical coordination (VC) in agrifood chains is an important and growing phenomenon.<sup>78</sup> Private contractual initiatives have emerged to overcome disruptions of supply and poor public institutions for governing exchange. Traders, agribusinesses and food companies contract with farms and provide inputs and assistance in return for guaranteed and quality supplies. This is more important for agriculture than for other sectors due to the large number of small suppliers (see below). VC has been shown to have important direct and indirect positive effects, including improved product quality and increased farm productivity, and often includes the smallest farmers. Thus far, contract support by agribusinesses in Moldova has been relatively well developed compared to other transition countries, offering advantages such as credit, physical inputs, transportation services and prompt payment for delivery.<sup>79</sup> This relationship should be further encouraged by ensuring a good business environment, especially for foreign investors. FDI has proven to be a major engine of VC, and also generates important horizontal spillover effects for local agribusinesses. Foreign investors also typically facilitate access to export markets.

*Market conditions can be improved through development of infrastructure and producer organizations.*

4.18 Poor marketing and storage infrastructure lead to over-saturation of the small domestic market during the harvest season, which depresses prices. Traders and processors use their monopsonistic position to impose low farmgate prices on farmers who have little negotiating power. Investment in collection points, cold storage, packing houses, wholesale markets and rural transportation infrastructure would increase both the temporal and spatial marketing options available for farmers to obtain higher prices. The Government should also encourage the development of producer organizations to facilitate joint marketing of outputs, which would improve the market power of small producers, as well as help to integrate them into vertically coordinated supply chains. The importance of the development of both producer organizations and market infrastructure in Moldova is illustrated by the example of the dairy sector. To reduce transaction costs, commercial dairies prefer to work with farmers that have at least ten cows. However, the vast majority (82 percent) of small farms in Moldova (which produce 95 percent of Moldova's milk) have only one cow.<sup>80</sup> For small farmers to participate in this market, it requires investment in milk collection points, which can be managed by processors or by associations of producers themselves.<sup>81</sup>

*Reduce input costs and increase productivity by facilitating access to improved seeds.*

4.19 Household farms report that seeds are their most important purchased physical input, although only one in ten households currently has access.<sup>82</sup> Access to seeds and seedlings is especially important for the high-value horticultural sector because the most advanced technology is often embodied in them, and enhancing quality begins at production. At present an important constraint to improved seed adoption by farmers is that the state institutes for plant breeding and variety selection largely control the market

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<sup>78</sup> Swinnen, J. (2004), *The Dynamics of Vertical Coordination in ECA Agrifood Chains: Implications for Policy and Bank Operations*, The World Bank.

<sup>79</sup> White, J. and M. Gorton (2004), *Vertical Coordination in ECA Agrifood Chains as an Engine of Private Sector Development: Implications for Policy and Bank Operations*, background report prepared for The World Bank.

<sup>80</sup> Source: Survey done in 28 communities from different zones of Moldova in November 2003, J. White and M. Gorton (2004), op. cit.

<sup>81</sup> An example of this is the Vita-Lact milk marketing association supported by the USAID-funded CNFA project.

<sup>82</sup> Jacoby (2004)

based on counterproductive procedures that impede the certification of imported seeds. This reduces access and increases costs for farmers. Moldova should be more easily able to take advantage of the existence of catalogs of certified seeds developed by the world's leading agricultural companies and research organizations. The Government should jumpstart technology improvement by radically simplifying and accelerating the seed certification process, and allowing importers to obtain expedited certification by presenting evidence of approval of new seed varieties in North America, the EU and certain other countries.

### AGRICULTURAL GROWTH REQUIRES INCREASED INVESTMENT

*Lack of access to credit is a frequent complaint in the agricultural sector.*

4.20 Access to investment and working capital is of key importance to private farmers. A World Bank survey of the enabling environment for farm households revealed that accessing credit was their second greatest challenge (access to irrigation was the first).<sup>83</sup> Results of the household budget survey show why, with virtually no farm households reporting receiving bank loans.<sup>84</sup> Small rural borrowers have certain characteristics that make them less attractive for commercial lending: transaction costs are high due to small transaction sizes, geographical dispersion, high risk, and lack of usable fixed assets for collateral. For farmers in particular, low producer prices result in low incomes, reducing their ability to invest and making them even more unattractive to lenders. Additional risks are manifest in weather and price variations and the perishable nature of commodities. As a result, as mentioned above, current investment in agriculture is quite low compared to its importance in the economy.

*With improved markets, increased investment will follow.*

4.21 By improving market conditions so that producer prices can increase to near their international parity levels (in other words, increasing private profits to the level of social profits), the incentive to invest will increase, and the flow of funds into agriculture should follow. One positive sign is the level of investment in food and beverage processing. In 2003, this sector benefited from 24 percent of total investment in the economy, which is more than twice its share of GDP and four times higher than the level in 2000.<sup>85</sup> Recalling the high margins garnered by oilseed processors, it is easy to see why. But ideally these profits would be the result of increased efficiency in markets and the processing sector, rather than at the expense of farmers.

*In the meantime, a project-based approach should continue to support grass-roots institutions.*

4.22 The approach of the World Bank-finance RISP project of promoting Savings and Credit Associations (SCAs), while simultaneously developing the capacity of the formal banking sector to process loan applications and to lend into the sector, is showing results. Approximately 90,000 small farmers and other rural borrowers are now part of a network of 512 SCAs. During 2005, lending to SCAs is expected to be about MDL 265 million, a 10 percent increase over 2004, and lending to the rural sector has increased from 25 percent of banking sector activities in 2000 to 37 percent in 2004 (although not all of this is for agriculture). These efforts should continue through strengthening of the SCA system and encouraging the increased involvement of the banking sector. Additional efforts should focus on alleviating current constraints by improving collateral and developing other financial instruments for sharing and reducing prices and quantity risks such as forward and futures markets. Moveable property such as machinery, equipment,

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<sup>83</sup> Dudwick et al., (2005), op. cit.

<sup>84</sup> Jacoby, (2004).

<sup>85</sup> Source: Annual Structural Survey of Enterprises .

livestock, inventories, accounts receivable, and warehouse receipts (for cereals, for example) should be made acceptable forms of collateral by:

- ✍ Improving the legal framework;
- ✍ Establishing registries;
- ✍ Making out-of-court settlement possible ;
- ✍ Helping banks to understand the process of securing collateral, including the disposal of secured property, specifically for the agricultural sector.

*More should be done to increase foreign investment in the sector.*

4.23 As discussed above, FDI has proven critical to developing vertically coordinated agricultural supply chains in transition economies, and also facilitates access to foreign markets. Unfortunately, the agricultural sector in Moldova has not proven to be very attractive for FDI. Although total investment in agro-processing has been increasing rapidly, FDI represented only 2.5 percent of the total in 2003.<sup>86</sup> During interviews with foreign agricultural investors in Moldova the reason became clear: the business environment. Investors complained of not only negative, but arbitrary and rapidly changing policies toward the sector, with little advance warning. The policy environment for the sector, particularly with regard to trade, should be stabilized, and gradually improved through open consultations with professional associations and current and potential investors.

#### **FACILITATE THE DEVELOPMENT OF EFFICIENT LAND MARKETS**

*The progress with land privatization has not been fully matched by progress with the individualization of agriculture.*

4.24 There are two dimensions to the farm structure problem: (a) the organizational form dimension – individual farms versus corporate farms; and (b) the size dimension – small farms versus large farms. In Moldova today there is a strong correlation (and association in the minds of policy-makers) between the two: individual farms are small, and corporate farms are large. However, this correlation is not necessary, and is often not the case in developed economies. In Moldova, 50 percent of agricultural land is still controlled by large-scale corporate farms. Relative to some neighboring countries, this is a big achievement, far surpassing the reform outcomes in Russia and Ukraine (where large corporate farms still control about 80 percent of agricultural land).<sup>87</sup> Yet this is not satisfactory compared to land-use patterns in market economies, where corporate farms control less than 2 percent of agricultural land. The large corporate farms in Moldova are a carryover from the Soviet era, when agricultural ideology was driven by expectations of economies of scale. Yet, as we have seen, Moldovan farms generally exhibit *diseconomies* of scale. This finding is not unusual, and is reinforced by similar findings for U.S. farms.<sup>88</sup> Therefore, two salient points should be borne in mind:

- ✍ **Market-based agriculture is agriculture of family or “individual” farms, not corporate farms:** in developed market economies, corporate farms are few in number and control a very small share of agricultural land.

<sup>86</sup> Source: Annual Structural Survey of Enterprises .

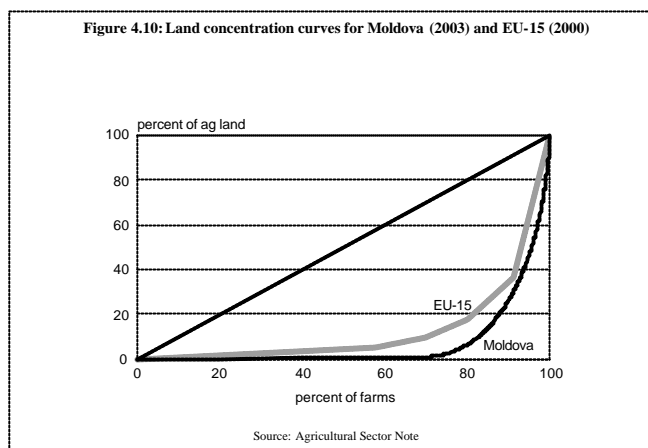
<sup>87</sup> This discussion is based on the Moldova Agricultural Sector Note.

<sup>88</sup> M. Ahearn, J. Yee, and W. Huffman, “The Effect of Contracting and Consolidation on Farm Productivity,” paper presented at the Economics of Contracting in Agriculture Workshop, Annapolis, MD (July 2002): “This suggests that on average a type of diseconomies of size is operating [in U.S. farms]” (p. 20).

✎ **Corporate farms in market agriculture are on average much smaller than corporate farms in Moldova:** they fall in the range of 100-300 hectares rather than the 1,000-3,000 hectares that is often the case in Moldova.

*Moldovan policymakers are strongly advised to study the successful experiences of similar agricultural economies.*

4.25 Policymakers should realize that all attempts to preserve large-scale corporate structures in former Soviet republics (whether as agricultural cooperatives or as new corporations with market-sounding names) have not produced positive results. The Russian and Ukrainian dream of “horizontal transformation”, making persistently inefficient



corporate farms suddenly efficient, has not worked. On the contrary, it is three small countries that resolutely abandoned the large-scale corporate structures and made a clean shift to small-scale individual agriculture—Armenia, Azerbaijan, and Kyrgyzstan—that demonstrate the most impressive recovery record among the CIS countries in recent years (refer to Figure 4.3). Moldova has more in common with these three small, densely populated countries than with Russia and Ukraine. Among EU countries, Moldovan agriculture has the most in common with that of Greece, Italy and Portugal, which all have average farm sizes below 10 hectares. The aggregated land concentration curve for all 15 countries of the EU combined (see Figure 4.10) shows that 10 percent of the largest farms control 64 percent of agricultural land, compared with 73 percent in Moldova. Further, in the EU-15 80 percent of the smallest farms control 18 percent of agricultural land compared with only 6 percent in Moldova. In other words, to have a farm structure more like that of the EU, Moldova needs to move to the left in Figure 4.10, which means more land in the hands of small farmers.

*Create an environment in which the most efficient farms can develop.*

4.26 Moldova should create a level playing field in which the most efficient farms are allowed to develop. In general, this is likely to mean that land would continue to flow from large corporate farms to small individual farms, which as we have seen are more efficient (although the optimal size will vary somewhat depending on the crop and local ratios of labor to land). This would bring Moldova’s farm structure in closer conformity with the pattern of land concentration in market economies. More importantly, it will increase incentives to invest in agriculture because individual farms do a better job of this than corporate—and especially cooperative—structures. At the same time this may correct, at least partially, one of the two manifestations of land fragmentation in Moldova: the average size of the very small individual farms will increase somewhat as they acquire more land at the expense of large corporate farms. This will not, however, affect the other dimension of land fragmentation, which involves fragmentation of land ownership (rather than farm size). There is insufficient data available to examine how fragmentation of small holdings into several (even smaller) parcels affects productivity in Moldova. It is generally believed that re-arrangement of small disjointed parcels into contiguous holdings is preferred by farmers and landowners. This sort of re-parceling of land—as opposed to consolidation—could be attempted through pilots with a very strong monitoring and evaluation component in order to test the impact and interest. It is

important to stress, however, that re-parceling should be carried out on a strictly voluntary basis in accordance with clear market principles. Any re-parceling programs should supplement market-driven consolidation through buying and leasing of land by private entrepreneurs, not replace it.

*Land markets should be developed to correct for land concentration and land fragmentation.*

4.27 Land sale transactions and land leasing have developed rapidly since 1999. Although no full statistical information is available, it seems that land sales and land leasing are having a significant effect on re-parceling already. The Government should make every possible effort to facilitate this process. Unfortunately, frequent talk of mandatory, “administrative” agricultural land consolidation has frightened investors in the sector, discouraged the development of land sales markets, and promoted leasing for short periods. Instead, by improving market opportunities for farmers, the profitability and viability of agriculture will be improved, and access to finance will be increased. This, along with re-assuring potential investors that their property rights will be respected, will increase the incentive for purchase and the long-term lease of agricultural land and investment in improvement of the land (including, for example, investment in appropriate irrigation infrastructure). In addition, immediate government action is recommended with the objective of facilitating ownership transfers and encouraging re-parceling as follows:

- ✍ Simplify the administrative procedures for transfer of ownership (paperwork, number of trips to regional cadastre office, etc.)
- ✍ Reduce transaction costs by reducing the minimum fee charged by notaries and allowing multiple parcels to be treated as one consolidated transaction.
- ✍ Improve the availability of market information on land transactions and prices.

*Stay the course of reform.*

4.28 The main recommendation is for Moldova to stay the course of its reforms and desist from experimenting with major reversals of strategy until the achievements made so far have had time to produce their full impact. It is important to build on the progress that has been made through agricultural land privatization. As demonstrated above, the new small farms are more productive and efficient than larger corporate structures, and if farm re-structuring had not taken place, the agricultural sector would be in even worse shape today. As markets and incentives improve, and investments increase, the growth promised by farm restructuring should become more and more apparent.

#### **IMPROVE AND INCREASE PUBLIC SUPPORT TO THE SECTOR AND ENSURE A LEVEL PLAYING FIELD**

*Public support is not well designed to address the new challenges facing the sector.*

4.29 The Ministry of Agriculture and Food Industry (MAFI) and related agencies under its supervision are the primary public institutions for delivering support to the agricultural sector. To be effective, sector spending should be based on a clearly specified strategy with priorities; a set of programs and policies that respond to these priorities; and allocations of financial and human resources that are consistent with the strategy, priorities, policies and programs. Currently, the agricultural sector in Moldova sorely lacks this framework. There is no effective mechanism for linking agricultural sector strategy and priorities to MAFI’s institutional organization and budget allocations. The annual budget appears to be prepared on the basis of political considerations and past expenditure patterns, irrespective of whether these patterns correspond to actual sector priorities in the present economic environment. In fact, the activities of MAFI have undergone little change since independence. Their development plans are mostly aimed at rehabilitating the industries that were dominant in Moldova during the Soviet era.

Instead, MAFI should pay increased attention to the elaboration of appropriate and affordable sector policies to enhance growth prospects for the new farm structure given current market realities.

*Agricultural expenditures are an important tool for government to promote growth*

4.30 There is ample international evidence of the strong positive impact agricultural expenditures have on pro-poor growth.<sup>89</sup> Despite this, government support to agriculture in Moldova is not commensurate with its importance. Total public expenditure in agriculture represented about MDL 236 million in 2004, including MDL 149 million (63 percent) for the delivery of services and MDL 87 million (37 percent) for farm subsidies. A substantial increase in subsidies is planned for 2005, mainly to support the development of vineyard plantations (though past experience suggests that this may not be fully implemented). Total public spending on agriculture is low in Moldova, both compared to its importance in the economy and compared to other countries (See Table 4.3). Agriculture accounted for about 2-4 percent of Moldova's total consolidated budget during the period 1998-2005 (although, as in other countries to varying extents, Moldovan agriculture has also benefited from debt cancellations, tax reductions and other quasi-fiscal activities). Typically, the share of total public spending allocated to agriculture is around 6-8 percent for developing countries, and 3-5 percent for developed industrialized countries (see Table 4.3).

**Table 4.3: Comparator Country Agricultural Public Expenditure Data (approximate figures)**

	Agriculture as share of GDP	Agriculture budget share	Agriculture spending as share of GDP
<b>Moldova</b>	<b>30%</b>	<b>3%</b>	<b>0.9%</b>
<b>Others</b>			
Armenia	35%	9%	1.2%
Azerbaijan	18%	6%	3.1%
Kyrgyzstan	47%	7%	1.8%
Nicaragua	30%	8%	3.5%
Turkey	12%	6%	1.1%

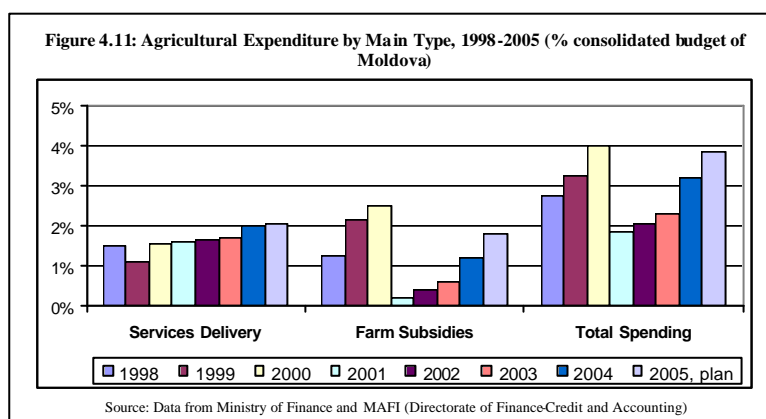
Source: World Bank PERs / country studies; Agricultural Sector Note

*The first priority is to re-align the allocation of scarce public agricultural resources.*

*Current support to the sector encourages production where productivity is lowest, and discourages production where productivity is highest.*

4.31 In the coming years, public finances in Moldova will remain extremely tight, with the MTEF indicating that public agricultural expenditures will remain below 1 percent of GDP. In this climate, growth

enhancement will have to come from reallocating expenditures within this constraint. Cross-country comparisons of public agricultural expenditures indicate that investment in public goods such as research and development, rural infrastructure, and education, along with creating a good policy and institutional environment, are the most important drivers



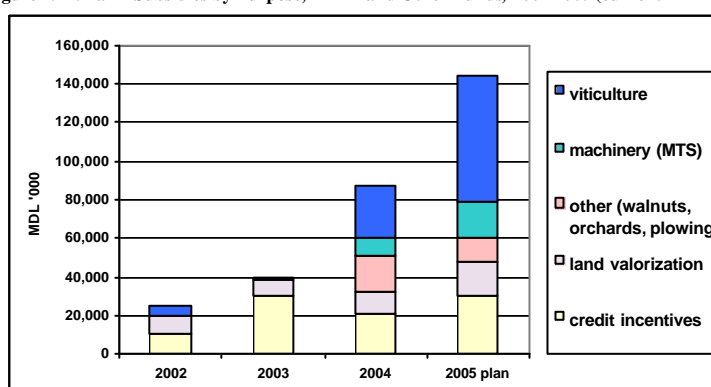
<sup>89</sup> See for example: Fan, S. and N. Rao (2003), *Public Spending in Developing Countries: Trends, Determination, and Impact*, EPTD Discussion Paper No. 99, IFPRI, Washington DC; and Byerlee, D. (2005), *Agriculture, Rural Development, and Pro-poor Growth*, draft report, The World Bank.

of growth.<sup>90</sup> In transition countries like Moldova, where a large share of farmers are relatively new to farming, farm advisory services are particularly important. In contrast, there is no evidence that subsidies for inputs such as fertilizer, irrigation operations, energy and pesticides promote long-term growth. In the case of Moldova, we have seen in the discussion of farm prices that subsidies have not been effective in improving agricultural terms of trade. Despite this evidence, investment in growth-enhancing public goods in Moldova is negligible. As Figure 4.11 illustrates, the bulk of the agricultural budget goes for current expenditures on services and subsidies, with the latter accounting for 59 percent of the increase in the total agricultural budget since 2001. Though services are generally a better investment, much of the services budget in Moldova is spent on activities of dubious value such as the anti-hail service, which employs 860 people (more than 10 times the staff of the central MAFI administration), and cost MDL 10.9 million in 2004. Meanwhile, only 5-8 percent of the services budget is allocated for research, with virtually nothing allocated for advisory services.<sup>91</sup> Furthermore, international experience suggests that agricultural services are most effective when decentralized due to varying needs across a country, but as the following chapter on governance will show, service delivery and budgets are instead highly centralized in Moldova. Outside MAFI's budget, special funds also distribute subsidies to farmers and have assumed growing importance (though the Government intends to integrate these funds into the national budget in future). In addition, the Government has continued to provide *ad hoc* extra-budgetary fiscal vacations for state-owned enterprises. For example, it was recently reported that seven tobacco plants would have MDL 120 million in debts frozen.<sup>92</sup> If correct, this would represent a sum nearly as large as the entire MAFI budget for 2004. Such fiscal vacations have recurred repeatedly over time, creating soft budget constraints that reduce the incentive for reform, and squandering precious public resources on items with little hope of enhancing growth prospects.

4.32 Starting in 2003, there was a shift toward targeting of subsidies to medium- and large-scale operators, with implementation mechanisms that tend to encourage consolidation of land. These

include interest free state credit for purchase of farm equipment by Machinery and Technological Stations (MTS) and substantial subsidies for the plantation of vineyards, with ambitious

Figure 4.12: Farm Subsidies by Purpose, MAFI and Other Funds, 2002-2005 (current MDL '000)



Source: Data from Ministry of Finance and MAFI (Directorate of Finance-Credit and Accounting); Note: "land valorization" is mainly for activities such as drainage and erosion control.

<sup>90</sup> Fan, S. and N. Rao (2003); Byerlee, D. (2005); op. cit.

<sup>91</sup> These are funded almost exclusively by external donors and MFIs, including the World Bank-financed RISP project, and are not integrated in the state budget.

<sup>92</sup> "Executive Accepts Fiscal Vacation for Seven Tobacco Plants", article in BASA-business, Chisinau, 12/2/04.

plans for expansion in 2005 (see Figure 4.12). Beneficiaries of the MTS subsidies are selected by government authorities based on eligibility criteria that are not clearly spelled out, including use on “contiguous plots ensuring efficient exploitation of agricultural machines.” They also represent the inefficient use of public resources that crowds out private suppliers of machinery services, and undermines the successful 2KR program. As for the vineyard subsidies, they can only be used for plots larger than 5 hectares, which puts them out of reach of most independent farmers. Thus in 2004 the average size of eligible applications was 31 hectares. In addition, Moldova-Vin, which managed the program, only had sufficient funds to pay for MDL 5 million of subsidies out of a total of MDL 83 million in eligible applications for 2004.

## CONCLUSION

*Invest in  
agriculture for  
growth.*

4.33 Given its importance in the economy, and based on experience from other countries, the agricultural sector has excellent potential—and may in fact be essential—for generating growth in the Moldovan economy. Farm restructuring and other reforms carried out during the 1990s have created a new class of small, independent farms that are much better placed to benefit from Moldova’s re-emergent agricultural comparative advantages given the current market realities, and are more efficient and productive than the large collective/corporate farms they replaced. The successes in re-structuring the sector should be built upon and continued where necessary, including by reducing discrimination against producers in output and input markets, improving the organization and infrastructure of agricultural markets, creating an improved and more stable investment climate, encouraging the development of efficient land markets and continuing to secure property rights, and allocating public resources based on a clear strategy and priorities. Improving policies and the allocation of public expenditures is much more effective and less costly than farm subsidies. In particular, public support should address the needs of the small farmer/entrepreneurs who hold the most potential for growth in agriculture. Once this has been achieved, the Government could consider increasing expenditures on agriculture to match its importance to the economy.



## CHAPTER 5. GOVERNANCE AND GROWTH

### GOOD GOVERNANCE FOR GROWTH

*Governance and institutions are central for growth and poverty reduction*

5.1 Perhaps the single most important step forward in development thinking over the past decade is the new consensus that better governance and institutions are central for growth and poverty reduction. Cross-country evidence convincingly demonstrates that investment and growth depend crucially on the quality of state institutions and control over corruption.<sup>93</sup> The evidence shows that corruption—which is both a symptom and a cause of bad governance—discourages private investment. The quality of state institutions has a significant impact on the delivery of public infrastructure and services. The harmful effects of corruption are especially severe on poor people, who are hardest hit by economic decline, most reliant on the provision of public services, and least capable of paying extra costs associated with bribery and corruption.

*Corruption and weak implementation of governance reforms have undermined state credibility*

5.2 Thus, good governance and an effective state are critical for any country's growth agenda in both the short and long term. An effective state must provide an attractive and stable investment climate, which includes short-term measures of property protection, medium-term guarantees of policy predictability, and long-term availability of a healthy, well-educated and skilled workforce. Ineffective use of public resources is a waste that transition economies cannot afford. Lack of efficiency and transparency increases the risks of corruption. It reduces the credibility of the Government in the eyes of citizens and investors alike. The quality of overall governance – defined as the exercise of public authority – influences growth rates and growth composition. Private investors, whether foreign or local, large or small, require an investment climate based on confidence in the rule of law and the overall effectiveness, predictability and transparency of the state. In Moldova, corruption, constant political and institutional changes, and weak implementation of adopted policies and programs have been the rule rather than the exception over the past 15 years.<sup>94</sup>

*Unconventional entry-points may be needed to further governance reform*

5.3 The challenge lies in uncovering effective mechanisms for *changing* institutions, including the prevailing administrative culture, particularly in countries where vested interests inside and outside of government have a stranglehold over policymaking, i.e., under conditions of *state capture* and *clientelism*. Where corruption is most severe, tackling governance reform is a struggle. In these settings, technocratic approaches to governance reform typically fail. Non-technocratic approaches emphasize the need to harness the demand for governance reform, explore unconventional entry points in particular sectors and at the sub-national level, and introduce greater transparency with

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<sup>93</sup> “There is by now a strong consensus among both academics and policymakers that good governance provides the fundamental basis for economic development.” Kaufmann, Kraay, Mastruzzi: “Governance Matters IV: New Data, New Challenges”, the World Bank, May 2005.

<sup>94</sup> The size of the informal economy is a reflection of the limited credibility of a ruling political-administrative system. In Moldova, estimates of the informal economy are in the range of 30-50 percent of gross national income. According to investment climate surveys, firms consider policy uncertainty a particularly critical constraint on private enterprises in Moldova.

respect to decisions most vulnerable to corruption. These are the approaches needed in Moldova today.

*Good governance, particularly effective public services, is needed for open and productive use of remittances*

5.4 Moldova is unique because of the high level of remittances, which reach wide sections of the population and are used primarily to sustain consumption. People's confidence in central and local governance is critical for the open and productive use of remittances, and hence for their contribution to growth. If confidence is high, the likelihood of remittances being used for long-term investments and being declared for taxation is higher. Among credibility-building measures available to governments the effective provision of public services is key. Governments must provide – or ensure the private provision of – high-quality public services in response to the demand of citizens and potential entrepreneurs, in order to promote an open and participatory economy and encourage investments and productive use of resources.

*What are the key challenges in governance? Has the reform agenda been appropriate?*

5.5 This chapter examines the governance and public services agenda of the Government of Moldova from two perspectives: (i) what are the key challenges in public sector governance facing Moldova? Has the Government's reform agenda addressed these? And has the agenda been implemented? (ii) can the delivery of public services by local governments be made more effective, so as to enhance growth in the short term (reducing waste and increasing credibility) and the long term (strengthening the labor force through health and education and improving infrastructure)?<sup>95</sup>

*Comprehensive reforms have not been successful. Entry-points are needed in public financial management, in public services delivered by local governments, and in engagement of citizens in local governance*

5.6 Several attempts have been made at comprehensive reform of public sector governance in Moldova. The next section outlines how comprehensive policies and reforms were designed, but never implemented. While the administrative culture has retained many centralizing features prior to independence, the administrative structure has been under constant change, making it difficult for the technical strengths of the pre-independence administration to manifest themselves. Successful administrative reform does, however, take place in public financial management, which provides an important entry-point to gradual public sector reform. The third section explores another potential entry-point to governance reform: improvements in public services delivered through local governments. Reforming public services requires critical changes at the central government level, including setting priorities and standards, establishing monitoring and accountability systems, and providing authority and resources; as well as sustained improvements of service delivery capacities at local government levels, in response to citizens' demands. The section examines the responsibilities, structures and resources of local governments to provide services in health, education and road maintenance. These sectors have been selected, because human development and infrastructure services are key to the creation of a credible government and an attractive environment for private investments. Finally, the last section suggests a way toward better governance for growth, emphasizing the need for more realistic and credibility-enhancing governance reforms and suggesting entry-points for reform in public financial management as a foundation for transparent decision-making by government; in performance-based accountability for

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<sup>95</sup> The importance of human capital and infrastructure to growth in Moldova has been outlined in the World Bank's health and education policy notes and trade study. In the context of the present chapter, the efficiency and effectiveness of the delivery of public services is of greater concern than their eventual outcomes. They are a signal to citizens and the private sector that the Government is serious about creating an attractive investment climate and a shared economy.

local public services delivery; and in reaching out to citizens as active participants in local governance.

## THE STATE OF GOVERNANCE IN MOLDOVA

### Governance Reforms

*Moldova completed the first generation of economic and governance reforms, but the first decade of transition brought poverty and political and institutional instability*

5.7 Moldova's first ten years of transition to a market economy were full of dramatic economic and political developments. Initial institutional constraints contributed to poor transition performance. The dissolution of the Soviet Union required the newly independent states to build from scratch the institutions of modern statehood and democracy. Like other CIS countries, Moldova started the transition period with a skilled, but passive public administration, which was used for the implementation of centrally laid out plans in selected sectors. The situation in Moldova was exacerbated by chronic political instability, with ten governments over the period. Still, Moldova was considered a leading reformer among the CIS countries during the early 1990s. Financial stabilization efforts were complemented by a series of first generation adjustment reforms, among which price and trade liberalization, mass privatization, and financial sector reforms contributed to successful stabilization of the economy. The real economy adjusted slowly, resulting in heavily indebted state-owned enterprises, poor performance of the emerging private sector, low agricultural productivity, and accumulation of high levels of arrears in the economy contributing to mounting external debt obligations. This led to unsustainable commitment deficits, sizeable arrears on pension and wages, and a dramatic decrease in living standards.

*Comprehensive governance reform strategies were developed around 2000*

5.8 The first concerted effort to develop a comprehensive governance reform strategy was undertaken in 2000. The strategy document aimed to reorient the role of the state away from universal caretaker inherited from the Soviet times and toward one consistent with the role of the state in a well-functioning market economy, yet also appropriate and affordable given government priorities and resource constraints. The strategy was never implemented, however, due to upcoming elections and the change in government in 2001. The 2003 Public Economic Management Review called for government attention to a series of deep institutional reforms: strengthening the center of government decision-making, particularly in the areas of strategic prioritization and budget formulation; undertaking cross-cutting reforms in civil service management and budget execution to improve operational efficiency and efficiency in resource utilization; and undertaking reforms in the social sectors.

### Corruption and Credibility as the Main Governance Challenges

*Corruption is a particularly critical challenge for Moldova*

5.9 By one measure, the quality of governance in Moldova compares well with other former Soviet Union republics, but lags behind the East and South-East European countries, particularly those that have recently joined the EU. This is a major challenge to the Government, whose vision contains close engagement with and eventual accession to the EU.<sup>96</sup> International, comparative governance indicators point to particular weaknesses in the control of corruption in Moldova. Figure 5.1 presents summary perceptions of

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<sup>96</sup> The 2002 BEEPs data, however, suggest that the quality of governance in Moldova is more in the middle of FSU countries than at the top. Indeed, preliminary results for the latest round of BEEPs suggest that Moldova fares quite badly, for example, on corruption in the judiciary.

Moldova's position in 2004 on six governance dimensions, relative to the average for the republics of the former Soviet Union. The key findings are: (i) Moldova's relative strength lies in 'voice and accountability' and 'rule of law', i.e., basic political, civil and human rights, where it is assessed to perform significantly better than other Former Soviet Union (FSU) countries. (ii) On the other four dimensions, the margins of assessment error are such that one cannot determine Moldova's positions relative to the FSUs. (iii) All FSUs, including Moldova, fare badly on 'control of corruption'.<sup>97</sup> (iv) There has been significant deterioration in governance performance in Moldova between 1996 and 2004 as regards 'rule of law' and 'control of corruption', whereas no clear trend emerges on the other four dimensions.

*The political and cultural transition is not complete. The skills and resources of the local political-administrative system have yet to be effectively utilized*

*The EGPRSP agenda for public sector governance reform is ambitious and comprehensive*

5.10 The comparative governance indicators fail, however, to capture some of the real governance challenges in Moldova. The political and administrative system has not completed the targeted transition from centralized, ad hoc decision-making and suffers from a consistent, and possibly widening, gap between stated political reform objectives and the reality of limited change in the political-administrative culture. These underlying governance challenges are not tied to the outcome of political elections, including the victories of the current government in 2001 and 2005. The poor quality of government, meaning the formulation, adoption and implementation of laws and regulations on public life, has been a constant feature since independence. The undeniable skills of the civil service and the emerging structures of local authority have yet to be fully used under a new, open and participatory political system. The institutional turmoil and the economic decline of the 1990s may have produced a desire in the citizenry for a return to the stability of pre-independence days. However, the gap between political promises and achieved results makes the Government vulnerable to another round of disappointed expectations. Hence, the Government faces an urgency to deliver on its promises of improved public services through local governments.

### **Governance Reform in the EGPRSP**

*The EGPRSP reform agenda may be too ambitious and comprehensive*

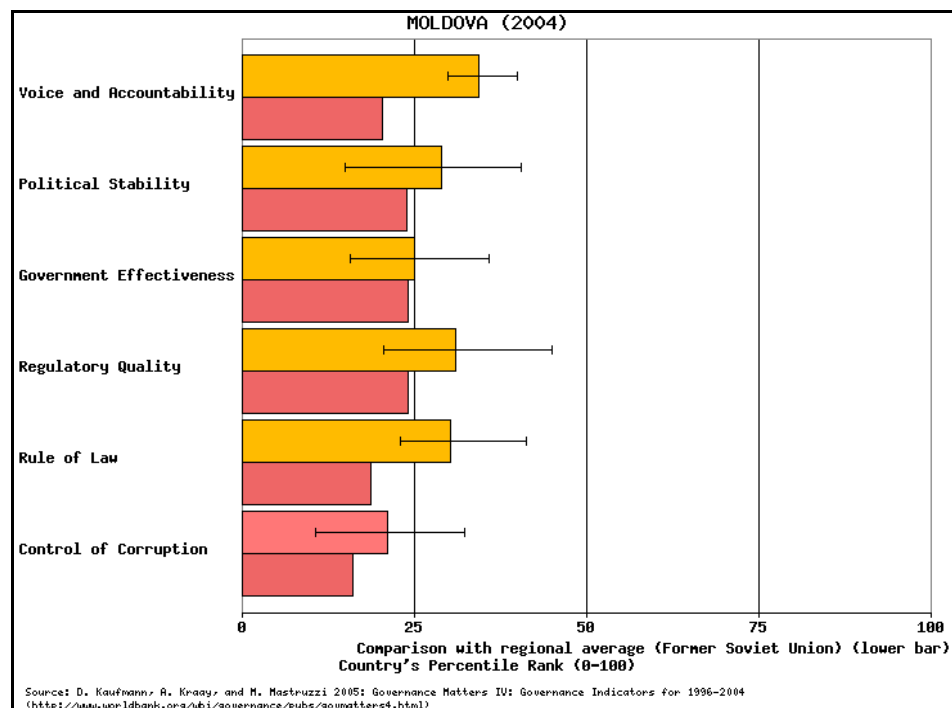
5.11 The EGPRSP is the first officially approved government program document of strategic nature that explicitly includes among its priorities a comprehensive public sector reform agenda. The EGPRSP, approved in June 2004, incorporates objectives, long-term strategy and medium-term priority actions for 2004-06 in the areas of public administration reform, public financial management, judicial system and fight against corruption. It is aimed at increasing the efficiency of the central administration apparatus, improving the government decision making process and its strategic orientation, developing institutional capacities and human resources management, and improving interaction between public administration and civil society. The list of medium-term priority actions is built around the development of a comprehensive strategic plan for reform implementation based on an in-depth, whole-government functional review using the experience of the new EU member states. The EGPRSP and the Government's related EU Action Plan include a commitment to "continue administrative reform and strengthening of local self government in line with European standards, notably those contained in the European Charter on Local Self Government, ... including with regard to

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<sup>97</sup> According to Transparency International's Corruption Perceptions Index 2004, Moldova ranked as #114 out of 146 countries; whereas the positions of relevant comparators were: Slovenia #31; Bulgaria #54; Belarus #74; Romania #87; Russia #90; Albania #108; Uzbekistan also #114; Kazakhstan, Kyrgyzstan and Ukraine all at #122; and Tajikistan #133.

management of the local budgets by local administrations and attribution of budgetary competence.”

**Figure 5.1: Governance in Moldova, 2004, compared with FSU averages**



5.12 While the EGPRSP and the EU Action Plan pursue the right objectives and are relevant for Moldova’s circumstances, the plans may be too ambitious and comprehensive to allow for effective implementation within the envisaged timeframe. An operational implementation mechanism is also missing, with no appropriately resourced unit within the Government authorized to lead the effort. With the exception of public financial management, little practical action has been observed in public administration reform in recent years, which questions the seriousness of intentions stipulated in this part of the EGPRSP and the depth of the commitment to meaningful change in the public administration. Alternative, selective, demand-based approaches to governance reform are needed as incentives to the Government and central state apparatuses to respond more constructively to reform needs and opportunities.

*A series of anti-corruption policies provides good strategies and measures, but they have not been implemented*

5.13 Following approval of the EGPRSP, which includes a broad list of measures to fight corruption, a comprehensive National Strategy for the Prevention and Control of Corruption and an Action Plan for its implementation were approved by Parliament in December 2004. The document focuses on key aspects of the institutional environment that need to be strengthened to enable an efficient fight against corruption, including stronger legislative framework based on international standards; adherence to the principles of rule of law; improving transparency of public sector operations; and creating incentives for civil society and the private sector to join the efforts against corruption. The implementation of this strategy remains uncertain. Moldova’s past track record in this area is not encouraging, as numerous strategic documents on this theme adopted at different levels of government have not been consistently and effectively implemented.

## **Progress on Public Financial Management**

*Public financial management has emerged as the public sector reform area with most commitment and achievement*

5.14 Of all the initiatives covered by the public sector governance strategies of recent years, strengthening public financial management has emerged as an area with serious commitment to reform, notably in the Ministry of Finance. In the area of budget formulation, important progress was made toward aggregate fiscal discipline and allocative efficiency through gradual introduction of the elements of medium-term planning into the budget process. Incorporating all elements of the national public budget into the MTEF and turning it into the actual framework for annual budget laws noticeably improved the comprehensiveness of budget formulation. The 2004 amendments to the organic Law on Budget System and Budget Process created the foundation for institutionalization of the MTEF as a regular phase of the annual budget cycle. In parallel, the transparency and discipline of budget execution were improved through strengthening the treasury system and extending its coverage to the local budgets (from 2000-01) and extra-budgetary resources (from 2003-05). Institutional capacities for debt management, cash management and commitment controls were improved within the Ministry of Finance.

## **DECENTRALIZATION AND PUBLIC SERVICES DELIVERY**

### **Decentralized Public Services as Entry-Points to Governance Reform**

*Governments can have different political objectives for decentralized service delivery*

5.15 Decentralization of public functions is neither good nor bad in itself. A government may decide to retain the delivery of most public services under central control, if its political priorities, for example, are to provide a standard package of services equitably across all rural and urban areas. In a relatively small country like Moldova, which is open to external influences particularly through the movement of people and their resources (including remittances), the Government could decide that equitable standards of living in all corners of the country are its primary development objective. However, such a centralized approach comes with significant costs, of which Moldovans have had decades of experience during Soviet times: Services are not adapted to local needs; effectiveness suffers as a consequence of long, bureaucratic command lines; service providers lack accountability to the intended users; and public services do not empower communities and serve as incentives for investments in the local economy. Conversely, full-scale decentralization may come with the politically unacceptable costs of inequities in public services and living standards and the risk of neglecting the most vulnerable citizens. Most countries therefore develop best with a mixture of central control and decentralized autonomy. Although the most appropriate mixture usually comes about through societal trial and error, rather than elaborate design, the lesson of history is that decentralization requires time and sustained commitment for capacity and accountability to be built and retained at all levels of society.

*Decentralization and the structure and responsibilities of local governments have been under constant change*

5.16 The role and authority of local governments and the territorial administrative organization of Moldova have remained the subject of continuous changes since independence. The most recent change took place in 2003, after a new version of the Law on Administrative Territorial Division was approved by Parliament, which basically reversed the decentralization reform of 1999. After the enactment of the March 2003 Law, the intermediary tier of local public administrations is again represented by 32 rayons, which replaced ten larger intermediary level self-governing judets introduced in 1999. The number of the lowest level administrative units was also expanded and

comprises at present 52 towns (cities) and 847 communes compared to 43 towns and 593 communes in the 1999 setup.

*Local governments have significant responsibilities and resources for human development services*

5.17 Delivery of key public services in Moldova, notably education, health, and rural infrastructure, is mostly the responsibility of the Government, divided between central and local levels. Local government is responsible for delivery of general education and rural infrastructure services, while public health institutions contracted by the National Health Insurance Company (NHIC) provide health services. Contrary to infrastructure, the level of spending on education and health is not low compared to other countries with similar income levels in the FSU. Improving public service delivery can serve as an entry point to improving the quality of governance that matters to income, growth and poverty over the long term. As a first step, the Government needs to address obstacles to improving efficiency of public service delivery as discussed below.

*The Government emphasizes leveling resources across local governments*

5.18 The existing legal framework in Moldova gives local governments the mandate and some resources to provide a range of public services. Local governments, at least at the rayon level, are better aware of their present and future entitlements. The Government has decided to level public budgets across rayons based on their population and the availability of local resources. This approach is in itself effective and equitable, but it reduces the incentive for local governments to perform better and to mobilize additional resources. The model adopted for leveling – norms set by line ministries and Ministry of Finance - reduces the flexibility of local governments to reallocate resources in accordance with local needs and priorities. The per capita-based resource allocation limits the direct accountability of the service providers to citizen demands and needs as emphasis is placed on meeting input norms, not on responding to direct demand. A more decentralized approach would require measurement of performance through feedback mechanisms from service beneficiaries, e.g., in the form of user surveys or citizens' score cards.

*Local government expenditures amount to some 10 percent of GDP. Local governments depend heavily on the state budget for their revenue*

5.19 Local governments spend approximately one-third of total public expenditure, accounting for over 10 percent of GDP, compared to overall government expenditure of 33 percent. About 40 percent of total local government expenditure goes to education. Local government budgets are funded by tax revenue (income, excise and VAT) shared with the central government; local tax revenue (land and real estate taxes), and equalizing budget transfers from the central government. The two main sources of revenue are taxes (70 percent) and transfers from the state budget (30 percent). The transfer to each rayon is calculated as the difference between the average expenditure per capita (estimated annually for each expenditure group) and the projected revenues per capita, multiplied by total population of the respective rayon.

*Local government services remain inadequate and of poor quality, partly due to weak capacity and accountability*

5.20 Major problems remain in terms of access to and quality of services and their outcomes. Inequities in access to health care and education have persisted or increased. The high cost of services engenders disparities in utilization of health care at all levels and even in compulsory education.<sup>98</sup> Insufficient resources for public services affect their quality and encourage informal payments in education and health. Lack of investment and limited repair and maintenance have caused rural infrastructure to deteriorate. Education and health outcomes are poor. Moldova's health indicators are the worst among countries in Central and Eastern European countries. The resources allocated to

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<sup>98</sup> World Bank: "Poverty Assessment – Recession, Recovery and Poverty in Moldova", 2004.

local governments are not commensurate with their numerous responsibilities.<sup>99</sup> Their autonomy and flexibility to raise additional revenue and reallocate expenditures in response to changing needs are limited. Furthermore, communities are not empowered to monitor public sector performance and service delivery.

### **Incomplete Decentralization and Sector Differences**

*There is a risk of reduced confidence in government, when decentralization is halfhearted*

5.21 Decentralization is incomplete in Moldova. Ad hoc bureaucratic controls and policy reversals prevent local governments from gaining experience and improving their performance, and there are structural gaps between the formal and political authorities on the one hand and the human and financial resources available to local governments on the other. In such cases, central and local governments lose credibility with citizens and economic actors, who feel the taxation and other regulatory powers of the authorities, but are not provided with social and infrastructure services in return.

*In education, per capita based allocations reach schools for salaries*

5.22 Decentralization is implemented very differently across sectors. In *education*, funds are allocated to rayons on the basis of norms established annually by the Ministries of Education and Finance. The rayon allocates funds among its own educational institutions and the local governments' educational institutions based on budget submissions by the latter. The flexibility of rayons, mayors and the school managers in using the resources is limited because the Budget Law requires that funds must first be allocated to salaries. No performance-oriented allocation principles are applied. The per-student funding ensures that funds reach the schools at all levels, but only for teachers' salaries.

*The health insurance scheme relies on contracts and professional management*

5.23 In *health* (which has received significantly increasing allocations in 2004-05), efficiency has been enhanced by the introduction of contracts and professional management. Under the health insurance scheme implemented in January 2004, the Ministry of Health enters into a contract with the NHIC, which, in turn, contracts the rayon health organizations. The latter manage resource flows to the rayon hospitals and to health care centers and family doctors, who serve as first reference points. This set-up operates financially independently of the rayon councils and the local governments, which have to mobilize additional resources for health buildings, maintenance, etc. A financing gap is found with respect to health equipment, which is covered neither by the health insurance company nor by the local government budgets.

*Road maintenance suffers from inadequate resources and weak institutions*

5.24 In *roads*, the institutional set-up of a road fund has not been completed, and stable funding sources are not provided, causing extensive inefficiencies. Rayons, responsible for regional roads, receive about 50 percent of the vehicle registration tax, which has amounted to less than 10 percent of the needs for road maintenance. The very limited funds are used either for emergency repairs or contracted to the state road administration company for a minimum of maintenance. The main problem here is not the form of decentralization to local governments, but the extreme under-funding and the lack of institutional autonomy for the road fund, which remains under the Ministry of Transport.

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<sup>99</sup> These include construction and maintenance of roads, streets, bridges, public places, street lights, pre-school, primary and secondary schools, gymnasiums, sports, cultural activities, medical centers, and social assistance, among others (Article 8 – Sharing competence for incurring public expenditures of the Law on Local Public Finance, Approved by Parliament on October 10, 2003).



## Limited Involvement of the Private Sector in Services Delivery

*There is limited state leveraging of private service providers*

5.25 The Government and local authorities can encourage and leverage private providers while providing assurance of quality services and equitable access. Non-state provision of critical public services is recognized as an often very effective, supplementary way of enhancing citizen satisfaction, because it increases people's choice and facilitates demand-fulfillment. In *education*, the role of the private sector is found mainly at the tertiary level<sup>100</sup> in big cities and high-income urban areas. In *health*, private provisioning of health care has yet to emerge. Currently, most health care facilities are publicly owned and funded. Private health practices are present in a few areas including dental clinics, pharmacies, and laboratories and are subject to government regulations. There are private outpatient clinics providing diagnostic services. In *roads*, the Government contracts out repair and maintenance functions to companies owned by both the public and private sectors. Contractors for road construction and rehabilitation are totally or partially privatized (joint stock companies). The Routine Maintenance Units, which are regional joint-stock companies with 20 percent private participation, operate mostly within their assigned districts and follow the instructions of the State Road Administration.

## Differences in Goal Achievement

*Efficiency, accountability, performance and participation in public services delivery vary across sectors*

5.26 In Moldova, there is significant variance among sectors with respect to the achievement of four objectives of decentralized service delivery: efficiency; accountability; performance, and citizens' voice and participation.

5.27 *Efficiency:* While the decentralization legislation is relatively clear, the revenue sharing, which dominates the inter-governmental fiscal relations, is unnecessarily complex and a disincentive to the resource mobilization efforts of local governments. In education, the model ensures that funds reach the schools at all levels, but only for teachers' salaries. In health, efficiency is strongly enhanced by the introduction of contracts and the professionalization of management. In roads, the institutional set-up of the road fund has not been completed, and stable funding sources are not provided, causing extensive inefficiencies.

5.28 *Accountability:* Resource allocation is per capita-based and hence relatively transparent, focusing on the accountability of the central government. However, the norm-based allocations in education and health reduce the direct accountability of the service providers to citizen demands and needs; emphasis is placed on meeting norms, not on responding to direct demand. In road maintenance, accountability is limited by the lack of funds.

5.29 *Performance:* The transparent but rigid resource allocation formula to the rayons interacts with the less transparent but potentially more flexible allocation within rayons, to produce what may be suboptimal resource allocation. However, actual performance is unknown because of the lack of outcome monitoring and the absence of feedback

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<sup>100</sup> In 2003, official figures reported by the Department of Statistics show that about 48 percent of universities, 22 percent of colleges and 11 percent of lyceum are private educational institutions. There is only one private school rendering secondary education and no private institutions render primary, secondary and vocational education services.

mechanisms from service beneficiaries, e.g., in the form of user surveys or citizens' score cards.

5.30 *Participation:* There is a significant gap between the service responsibilities assigned to the elected local governments and the resources that are made available to them, either through transfers from the central government or through the retention of local taxes and revenues. Furthermore, the transfers from the central government are tied to specific services, notably to the payment of salaries. Hence, the local governments bear the brunt of the de-legitimizing gap between responsibilities and services, which reduces government credibility with the citizenry. Within sectors, participation is limited to education, through the work of the parents associations. But even these are confined to providing supplementary resources to improve the environment of teaching. In health, the introduction of the family doctors and the limited services under the insurance scheme is perceived by many as reducing, rather than expanding, citizens' choice among service providers.<sup>101</sup>

## TOWARDS BETTER GOVERNANCE FOR GROWTH

*Moldova faces governance weaknesses in the regulation of the private sector; in the turmoil and lack of implementation of public sector reforms; and in the poor performance of public service delivery*

5.31 A country, which undergoes unavoidable transitions in society, and which is highly dependent on international economic relations, faces particular challenges in the establishment of governance arrangements and practices that can attract and retain investments. When remittances play such a key role as a potential source of investments, three aspects of public sector performance are particularly important. The first is related to the *state regulation* of investments, remittances and private sector development in general, which was discussed in earlier chapters. The second concerns the *predictability* of public sector governance, which determines the confidence that investors may have in stable market conditions. This chapter has demonstrated that Moldova suffers from excessive political-institutional change in the form of major reforms and early reversals that make it difficult for institutions at central and local levels of government to develop the required capacity to deliver. Furthermore, in key areas such as anti-corruption, the lack of implementation of well-crafted policies and strategies directly reduces confidence in government and undermines the investment climate. The third issue concerns the performance of *public service delivery* in areas (human development and infrastructure) of direct importance to potential investors, including to the recipients of remittances, who make daily decisions on whether to declare remittances and whether to use them for short-term consumption, long-term consumption (including housing and higher education), or investments. The analysis in this chapter has shown the increasing importance of local governments in public service delivery, but also the continuation of central interference and a gap between formal authorities and available resources of local governments. Decentralized public service delivery faces significant problems of efficiency, accountability, performance, and participation - problems that take different forms in different sectors. To strengthen governance for growth in Moldova, different avenues should be pursued.

<sup>101</sup> An in-depth analysis of "bottom-up governance of service delivery" in Moldova has found that the willingness of citizens to participate in the governance of public services, notably education, far exceeds what has been achieved so far. This represents a significant potential, which the Government should make full use of. See: "Changing the Way Our Services are Governed. Bottom-up Governance and Service Delivery in Moldova: Opportunities and Challenges for Effective Mechanisms of Participation", draft, the World Bank, 2005.

<p><i>Undertake only public sector governance reforms that are well-defined, realistic and sequenced</i></p>	<p><b>5.32 Undertake only public sector governance reforms that are well-defined, realistic and sequenced.</b> To strengthen the contribution of good governance to growth, and to prepare for possible EU accession, the Government must strengthen its credibility by adopting practical and feasible measures to make central and local governments responsive, enhance transparency and accountability, provide better public services, and reduce corruption. The Government should find ways of accelerating the implementation of a few of the many, highly ambitious reform measures contained in the EGPRSP, the anti-corruption action plan, and other public sector reforms. A continuation of the trend to declare but not implement comprehensive public sector governance reforms is likely to cause two interrelated problems: the good governance agenda is not advanced, and the Government's credibility is undermined. An important criterion for prioritizing among the many second generation governance reforms advocated by the Government should be the technical and political feasibility of reform measures and the minimization of disruptions to current administrative practices. An important step would be to remove inconsistencies in the decentralization of public service delivery, building on the strengths of different models of decentralized service delivery. Local governments need time and resources to implement the current local government acts. The shared revenue formula should be reviewed with the aim of enhancing the capacity of local governments to meet their service delivery responsibilities under current acts. Lessons of what works in Moldova should be learned from one sector and applied, as appropriate, in other decentralized service sectors. This applies particularly to the introduction of mechanisms providing feedback by citizens, business communities and local governments on the quality and relevance of public services.</p>
<p><i>Select and use entry-points to governance reforms that yield early and sustained benefits</i></p>	<p><b>5.33</b> Select and use entry-points to public sector governance reforms that yield early and sustained benefits to citizens by reducing corruption, leakage and waste of public resources. Three key entry-points are: (i) transparent public financial management facilitated by the medium-term expenditure framework; (ii) improved provision of economic and social services by local governments and/or the private sector; and (iii) further involvement of citizens in local governance, exploiting their commitment and willingness to engage actively in the local economy and politics.</p>
<p><i>Strengthen the MTEF as a transparent mechanism for public priority-setting</i></p>	<p>? <i>Strengthening the MTEF and related regular reporting as a tool for transparent decision-making by Government and a framework for public service prioritization.</i> This represents a continuation of current reform efforts. Of particular importance to the gradual improvement of public sector performance is the emerging use of the MTEF as an annual mechanism for analysis of service delivery needs and resources and flexible planning of service delivery standards that are affordable in Moldova. This should involve the Cabinet as well as the Ministries of Finance and Economy and the relevant line ministries.</p>
<p><i>Strengthen performance-based accountability for public services delivery through incentives</i></p>	<p>? <i>Strengthening performance-based accountability for public services delivery by providing incentives (rewards and sanctions in the form of more or less resources from higher levels of government) to the actual service providers.</i> In the short term, most services will continue to be provided by local government entities, but gradually, the Government should encourage and leverage private providers. This may require updated regulatory frameworks, and first and foremost a change in administrative culture, creating space for private service providers.</p>
<p><i>Create space for citizen demands and active participation in local governance</i></p>	<p>? <i>Consolidating the achievements made through decentralization by creating space for citizen demands and participation in local governance.</i> A starting-point should be</p>

broadening the decision-making authority of and participation in parent-teacher associations. Better civil society monitoring, e.g., through report card mechanisms, of public service providers serves the double purpose of holding local authorities accountable and creating joint responsibility for local developments. Citizens can be empowered to monitor the service providers' performance, exercise bottom-up pressures on service providers, and provide inputs to relevant decision makers to address quality and effectiveness of public goods and services. Improved citizen access to information on available resources and their intended and actual use increases accountability and transparency and reduces corruption from the bottom-up. These are essential components of credibility-enhancing governance reforms.