1. Country and Sector Background

In the recent years Moldova has been on a steady path of recovery from the economic decline of the 1990s. Since the year 2000, the economy registered a cumulative growth of more than 30 percent, which helped reduce poverty rates from 71 percent in 1999 to 48 percent in 2003. The Government has maintained prudent fiscal and tight monetary policies, which in effect brought inflation down to single digits. The Government has implemented a number of important policy reforms to promote economic growth and reduce poverty. The legal and regulatory framework for private investments was improved with the adoption of the Law on Insolvency, Title V of the Fiscal Code (Tax Administration), the Law on Financial Institutions and a new Civil Code. Moldova joined the World Trade Organization (WTO) in 2001, and aims to integrate with the European Union (EU).

However, the growth performance of the recent years largely reflects a combination of economic recovery from the collapse of the 1990s, when the economy shrunk by more than 60 percent, and the growth of consumption, fueled by an inflow of remittances, estimated at approximately 27 percent of GDP in 2004. Gross fixed capital formation remained at low levels, averaging less than 17 percent of GDP during 2000-2004 period. Low level of investment, in turn, hampers much needed improvements in productivity in the real sector, and makes the diversification of exports, particularly to non-CIS markets, difficult. Healthy economic growth cannot be sustained without increased competitiveness and productivity in the real sector.1

I. Business Environment. The unfavorable business environment is one of the main constraints to improvement in productivity and competitiveness of Moldovan enterprises. Moldova still has one of the highest regulatory compliance costs in the region. The cumbersome certification, licensing, inspections, and customs regulations continue to discourage foreign investment, and

1 For more analysis see CEM 2005
limit the ability of local firms to invest and compete internationally. Moreover, the multitude of laws, regulations, and procedures makes the regulatory environment opaque, breeding opportunity for duplication, contradiction, and eventually corruption.

To address these constraints, since 2001 the government has exerted efforts to improve the business environment, in particular, by simplifying business registration and licensing procedures, decreasing the number of licensed activities, consolidating them in the Chamber of State Registration and the Chamber of Licensing respectively. Reforms of the Investment Law providing equal treatment to foreign investors and of customs procedures followed the WTO accession in 2001.

In 2004, the Government took a more systemic approach to reforming the business environment with adoption of a “Concept for Regulatory Reform”, which set the framework for implementation of regulatory reform and defined its priorities, including reform of business inspections, simplification of business licenses, authorizations, permits, statistics reporting and reduction of costs and range of paid services offered by supervisory and control bodies. It was followed by the adoption of a radical Law on Optimization of the Normative Framework for the Regulation of Business Activities, the so-called Guillotine Law. The guillotine approach mandates a rapid review of a large number of regulations and elimination of those that are no longer needed, without lengthy and costly legal actions. A high-level National Committee for the Regulation of Entrepreneurial Activity, assisted by the National Working Group, was created and tasked with its implementation. The entire process is to be completed by August 2005, when the “guillotine falls” and a registry of normative acts that have passed the guillotine filter is established, all unregistered regulations lose their legal effect.

The Government is committed to consolidate, expand and institutionalize the advances made within the framework of the “guillotine” exercise. In particular, the Government sees the necessity of strengthening the capacities to promote and implement the inter-ministerial reform program and introducing a regulatory impact assessment (RIA) in the legislative process. RIA will improve the transparency and quality of new regulations at the early stage of their development, and avoid the necessity of going through another broad scale regulatory review process in future. The commitment of the government is highly opportune, as the guillotine has created the necessary momentum for regulatory reform to be deepened. The following areas are essential at this point: (i) developing framework law on the principles of state regulations of economic activity; (ii) building institutional capacities for regulatory reform planning and implementation; (iii) further streamlining business entry and operations, particularly post-registration procedures in the issuing of permits, licenses and similar documents; (iv) reducing the number of state controls and inspections of business activities to diminish regulatory risks; and (v) decreasing the burden of paid regulatory services rendered by public authorities by setting tariffs for these services at the level of costs incurred, and providing free services that do not imply additional expenses.

The results of the recent Investment Climate Assessment suggest that the regulatory burden in Moldova is high by regional standards. Also, the 2004 Cost of Doing Business survey (CODB) confirms that the average share of time spent by top managers in order to meet all mandatory requirements has been fluctuating around 18.5 percent since 2002.
II. Standardization and Quality. Regulatory reforms provide necessary but not sufficient conditions for more competitive enterprise sector in Moldova. Global markets have become increasingly stringent in terms of product quality and performance; and conformity with international standards such as ISO 9000 has become a de facto requirement for market access. Upgrading the framework for measurements, standards, testing and quality (MSTQ) is a necessary first step in gaining access to the foreign markets and boosting competitiveness.

Moldova inherited its MSTQ infrastructure from the old Soviet Union system. While the main MSTQ institutions exist in Moldova, the entire system is based on central economy principles and operates out-dated equipment and standards, inadequate for market economy practices in international/European markets. With the WTO accession in 2001 Moldova started the process of reforming the MSTQ system in accordance with WTO commitments, including the transition to a system based on voluntary standards. In practice, however, the process has been slow and the old system is still in use. For example, foreign origin certifications (even from EU) require re-certification in Moldova which, while being unnecessary and in many cases impossible to perform given out-dated systems, also opens field for corruption. On the institutional level, the separation of functions and responsibilities in the areas of standardization, national measurements standards, verification and accreditation between the existing institutions is not explicit, leading to conflict of interest. As a result, the national MSTQ system is not fully recognized by the corresponding European organizations, which causes serious problems for the compatibility of Moldovan goods (some of which are excellent candidates for international markets) with the requirements of international trade, thus hampering the international competitiveness of the enterprise sector. The results of the initial demand survey identified key sectors and areas in need for new standards as well as testing and certification needs which will serve as a starting point for the transformation of the MSTQ system.

WTO membership and the EU/Moldova Action Plan, which underlines European integration as the main objective of EU-Moldova cooperation, placed strong accent on the necessity of upgrading the MSTQ system. The Government started developing a three-fold strategy, including: (i) upgrading existing MSTQ institutions to international levels (including obtaining relevant international recognition), (ii) improving existing services and introducing new MSTQ services (all based on demand from Moldovan producers), and (iii) promoting use of MSTQ services by enterprises to improve quality and conformity with international standards. Significant improvements in the legal MSTQ framework have taken place, with a number of important laws adopted (see Annex 1). At the same time more regulatory regime adjustments are required. However, improvements in the legal framework per se are not sufficient to have a fully functional system. Reorganization of the MSTQ institutional framework and new investments in equipment and human resources are vital. At the same time, it is important that the upgrade of the MSTQ infrastructure is accompanied by measures that promote the demand for MSTQ services.

More specifically, the government would need to undertake measures to: (i) improve the methodological basis and procedures for the assurance of products conformity and accreditation according to international and European criteria and practices; (ii) de-monopolize the conformity assurance procedure; (iii) promote the voluntary application of standards by developing technical
regulations, in accordance with international/European standards; (iv) create conditions for the introduction of ISO 9000 quality and ISO 14000 environment management systems; (v) improve the accreditation and products conformity assurance system to promote integration of Moldova’s products into the international markets; (vi) facilitate enterprises’ access to external technical expertise for upgrading quality of their products and services, and obtaining ISO and HACCP certifications.

III. Access to Finance. Poor access to finance is mentioned by The Economic Growth and Poverty Reduction Strategy Paper of the Government of Moldova (EGPRSP) among the main impediments to small and medium enterprises (SMEs) growth. While the overall soundness of the financial sector in Moldova is perceived as adequate, it remains shallow with inadequate product diversification. Lending to SMEs, especially long-term investment lending is scarce. According to the recent investment climate assessment, cost of financing remains among the key constrains to the development of the enterprise sector, particularly small enterprises. This is particularly worrisome since SMEs constitute over 90 percent of the total number of enterprises in Moldova, and are the main contributors to new job creation. The reasons for the current situation include maturity mismatch in the financial system (while the banking system is liquid, with capital adequacy of about 13%), too few financial products offered by financial institutions (for example, leasing and factoring are not developed), and – what is particularly relevant for SMEs - problems related to the lack or quality of collateral. For SMEs lack of collateral is reinforced by the absence of a unified system of information on enterprises’ payment practices and credit history as it makes harder to satisfy collateral requirements of commercial banks.

Enhancement of access to finance is viewed by the Government of Moldova among the main avenues for reducing impediments to SMEs growth. In this respect the Government would need to strengthen lending infrastructure and develop credit risk mitigation mechanisms. Several measures can be undertaken in this respect, including (i) development of adequate legal framework for establishment of a credit information system that enables credit institutions to make better informed lending decisions, while allowing SMEs to accumulate credit history and business reputation they can use as non-financial loan security; (ii) support for emerging loan-guarantee mechanisms in order to address the important issue of lack of adequate collateral. In addition, it is also important to disseminate cash-flow based lending methodologies and SME tailored standardized products that would enable banks to decrease costs of lending and to deal with SME clients in a profitable manner.

Already there are some positive developments on which better access to finance can be built. Increasing demand for micro loans has been accompanied by an expansion of microcredit services, with the emerging commercial microfinance institutions. The operation of the USAID Loan Portfolio Guarantee Scheme has been successful. Several leasing companies were established in response to growing demand, and drafting of the amendments to the leasing legislation has been completed. Also, a number of banks have started to offer services and products appropriate to SME needs. However, the scope and volumes of these initiatives are far from satisfactory.

2. Objectives
The project’s overall objective is to assist Moldova in enhancing competitiveness of enterprises through improvements in the business environment and making adequate standards, testing and quality improvement services available to enterprises. The project expected outcomes are:

(i) more efficient and streamlined regulatory regimes (especially licensing and inspections) and reduced regulatory compliance costs of enterprises to increase their competitiveness;
(ii) strengthened Government institutional capacity for carrying forward the business environment reform agenda through the introduction of regulatory impact analysis methodology;
(iii) upgraded national MSTQ system and improved and more accessible MSTQ services for enterprises;
(iv) strengthened supply and quality of local consulting services to enterprises in the area of international certification, quality improvement, and product modernization; and
(v) improved access of private small and medium enterprises to investment finance.

Primary beneficiary of the project would be the business sector, especially SMEs. The Department of Standardization and Metrology (DSM), the Institute for National Standardization and Metrology (INSM), the Accreditation Center (AC), and other institutions of the MSTQ infrastructure are also expected to be major beneficiaries. Agencies that will be selected to administer matching grants and credit guarantee components will also benefit from the technical assistance and know-how to manage these activities.

3. Rationale for Bank Involvement

The Competitiveness Enhancement Project (CEP) will help the Government to continue the earlier started regulatory reform and to commence modernization of the national standards and quality system, all together, leading to improved competitiveness of Moldovan economy in international markets and its attractiveness for FDI. The Bank can continue to play an important role of a reform facilitator and coordinator of the reform efforts in accordance with the international best practices. The project timing is highly opportune, as it can build on the political momentum of the European choice of the Moldovan leadership and, at the same time, address growing non-tariff barriers for some Moldovan products (food, wine, etc). The CEP builds on the experiences of the two Private Sector Development (PSD) Projects which created constituency for broader reforms of business environment and access to technical assistance, training, and investment finance. In addition, the project builds on the findings of the recently completed Investment Climate Assessment (ICA), the Financial Sector Assessment Program (FSAP), the Country Economic Memorandum, the Trade Development Study as well as on the experience of other Bank financed technology and business environment projects implemented in Turkey, Tunisia, Brazil and Indonesia.

4. Description

The project will be implemented over a four years period and will be financed through IDA Credit. The Japanese Government has also approved a Policy and Human Resources Development Grant (PHRD) that will co-finance technical assistance activities that will be supported under the project. The project consists of the following components:
(i) Business Environment Improvement (US$2.15 million). This component will contribute to the overall government effort in the area of improving business environment and provide strategic input, including continuous support for developing regulatory reform strategy, building institutional capacity for deregulation, and introducing Regulatory Impact Assessment (RIA) in the legislative process of Moldova. It will build on the experience of the so-called “guillotine” law implementation and ensure sustainability of its outcomes. Main responsible agency for this component will be the Ministry of Economy.

This component would include institution building activities for the National Committee for Regulation of Entrepreneurial Activity, the Working Group, relevant departments of the MOE and other entities involved in the regulatory reform implementation, management, monitoring, and impact assessment. It will also support technical assistance with review of the regulations and drafting relevant legal documents, setting up regulatory registries and information systems. To build support and understanding among stakeholders in the business and government sectors, the project will also finance public awareness workshops and seminars, public consultation activities, and study tours of key staff to selected countries where such reforms were implemented.

(ii) Modernization of MSTQ System (US$9.21 million). This component addresses product quality obstacles faced by enterprises in competing in domestic and international markets related to poor MSTQ infrastructure and services. The objective of the MSTQ Component is to strengthen capacity of the MSTQ system to provide internationally acceptable (especially, EU-compatible) MSTQ services. This objective will be achieved through assistance to the Government in (i) revising and strengthening relevant MSTQ regulations and implementing institutional reorganization reform; (ii) building capacity in metrology area by upgrading most urgently needed by the industry laboratories in INSM and strengthening their institutional capacity; (iii) upgrading standards system through adoption and translation of most frequently used standards, strengthening institutional capacity of INSM in this area, and revising relevant regulations in line with international best practices; (iv) strengthening accreditation and certification capacity of Accreditation Center; and (v) improving number and quality of testing services provided by conformity assessment bodies (laboratories and certification and inspection bodies) to enterprises. The main beneficiaries under this component will be Department of Standards and Metrology and its Institute for Standards and Metrology, Accreditation Center, and selected conformity assessment bodies.

The project will finance equipment (laboratory and information technology) and technical assistance and training for INSM, AC and selected testing laboratories. Translation of standards and technical documents will also be included into the project. Special attention will be paid to the institutional building activities of the MSTQ institutions to ensure sustainability of the reform including reaping full benefit from upgraded facilities. Staff would receive specialized training in operating new equipment and software, performing tests, assessments, implementation of ISO 9001:2000, and other activities. An emphasis will be made on building skills among younger specialists and strengthening management and industry outreach.
(iii) Facilitation of enterprise access to MSTQ services (US$1.71 million). This component will help promoting the use of MSTQ services by enterprises, especially SMEs through the use of the Matching Grants Scheme (MGS). It will aim to strengthen the competitiveness of Moldovan companies, both to increase exports and secure their domestic market position, by improving quality of their products and services. The scheme will provide financial support on a matching basis to enterprises willing to use external technical assistance for upgrading quality of their products and services initially by obtaining international certifications, such as ISO and HACCP, and, once the scheme is well established, by undertaking feasibility studies and upgrading technological processes. The project will provide the grant facility and will support technical assistance, training and some administration costs of the administrator. The scheme will be administered by an entity that will be selected on a competitive basis by the MOE. [Moldovan Export Promotion Organization (MEPO) that has an extensive experience with the previous matching grant scheme financed by TACIS, Chamber of Commerce, and other relevant organizations will participate in this tender].

(iv) Facilitation of access to finance (US$0.43 million). This component will improve access to finance of private enterprises (mostly SMEs) in Moldova by setting up regulatory framework and developing expertise for better tracking credit histories and creating capabilities for credit risk guarantees industry and its regulation. It will build on improved financial standing and overall liquidity of Moldovan commercial banks, by providing appropriate instruments to commercial banks to lend to SMEs thus increasing their loan portfolios and the share of lending to SMEs. Given that the main obstacles at the moment include poor collateral on the part of the borrowers and inefficient credit information system, the project will help the government in: (i) creating conducive environment for establishment of a credit bureau, and (ii) building relevant capacity in administering credit guarantee schemes in Moldova as well as promoting among Moldovan financial sector SME tailored financial products and services.

(v) Project Management (US$0.50 million). The project would finance costs of project management, monitoring, financial management, audits and other activities related to overall project management, monitoring and coordination.

The project will also include a US$0.50 million contingency fund.

5. Financing
Source: ($m.)
BORROWER/RECIPIENT 0
INTERNATIONAL DEVELOPMENT ASSOCIATION 5
IDA Grant 5
JAPAN: MINISTRY OF FINANCE - PHRD GRANTS 4.5
Total 14.5

6. Implementation

The Borrower and Beneficiary (under PHRD and IDA Grants components) is the Ministry of Finance who will delegate overall project coordination and management to the Ministry of Economy. The project day-to-day management will be carried out by the Project Implementation Unit (PIU) that will be established in the MOF.
7. Sustainability

The objective of the CEP project is to aid the GoM in its effort of improving Moldova’s business environment and making it more conducive to enterprise creation and sustainable growth, and contributing to poverty reduction through economic growth and job creation. Project’s sustainability is strengthened by the benefits of a better business environment that the project is helping establish. In particular, SME growth boosted by a more favorable business environment will increase demand for MSTQ services and investment finance, implicitly enhancing the sustainability of investments in the MSTQ system upgrade and of the technology consulting sector, as well as of the credit bureau.

The project benefits from commitment and ownership on the part of the Ministry of Economy, the Ministry of Finance and the Prime Minister of Moldova. The objectives of the CEP are consistent with those outlined by the Government of Moldova in the EGPRSP. It further benefits from the fact that it is not being implemented in a vacuum. The project maps the findings of analytical work into policy actions and comes in support of government’s ongoing work, notably, the establishment of the Commission for Regulatory Reform (CRR) and the recent adoption of the Law regarding the Revision of the Normative Base for the Regulation of Entrepreneurial Activity, which outlines the modus operandi for the Guillotine. In addition, the comprehensive medium-term strategies that are being developed for the regulatory reform implementation and MSTQ system modernization go far beyond the project framework and can help the government in “pulling in “ other donors resources by laying out master plans for the reforms in these areas.

8. Lessons Learned from Past Operations in the Country/Sector

The project benefits from the previous experience of the World Bank in supporting private sector development in Moldova, as well as World Bank’s extensive experience in implementing industrial technology and regulatory reform projects around the world. By supporting government measures aimed at reaching medium term objectives of the EGPRSP and relying on active participation of the MoF, MoE, the Prime Minister and business community representatives, the project strongly echoes the principles of long-term holistic development and country ownership put forth in the Comprehensive Development Framework, as well as the lessons learned and outlined in the new CAS document, particularly the importance of allowing Governments to proceed with policies they own.

At the same time, the project builds on the international experience and lessons learned in the course of the regulatory reforms implementation. It acknowledges the importance of the institutional infrastructure for the regulatory reform successful implementation, and the necessity of local capacity building and improvement of the quality of legislation process for ensuring long-term sustainability of the reform’s results. It also addresses directly the regulatory constraints and the recommendations identified in the recent BEEPS and CODB surveys, as well as of the Investment Climate Assessment. In particular, it acts directly on the recommendations of the ICA by (i) supporting and strengthening a deregulation “champion” - the National Committee for Regulation of Entrepreneurial Activity; (ii) improving quality of the regulatory
process by introduction the regulatory impact assessment; and (iii) supporting measures for strengthening the quality and the demand for MSTQ services, as well as for the transition to a system of voluntary standards.

With regard to the MSTQ component, the project acknowledges that investment in MSTQ is a public-good, and that there are considerable positive externalities to the generation of new technologies – factors that justify the involvement of the public sector in this sphere.

The experience of the World Bank in the provision of matching grant schemes suggests that it is extremely important to find the correct proportion of the grant amount to the funds provided by enterprises. Too high a threshold may become prohibitive and prevent enterprises from applying. At the same time, a low threshold may result in funding undertakings that would have been financed even without a matching grant, or projects whose utility and positive externalities are low. These considerations were taken into account during project preparation.

The design of the project recognizes the importance of inbuilt synergies for project sustainability. Thus, while the MSTQ component addresses the supply side of the MSTQ system, the matching grants and access to finance components aim at increasing the demand for the above services in the private sector. At the same time, expansion of SMEs depends critically on both the business environment, as well as on the access to finance and to technology services, addressing these issues in a combined manner will have a total effect greater than the added effect of each individual component due to the existence of synergies among project components.

9. Safeguard Policies (including public consultation)

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10. List of Factual Technical Documents

11. Contact point
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* By supporting the proposed project, the Bank does not intend to prejudice the final determination of the parties' claims on the disputed areas
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