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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A

PROPOSED POVERTY REDUCTION SUPPORT CREDIT

IN THE AMOUNT OF

SDR 6.8 MILLION

(US$ 10 MILLION EQUIVALENT)

TO THE

REPUBLIC OF MOLDOVA

September 20, 2006

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

CURRENCY EQUIVALENTS
(Exchange Rate Effective August 31, 2006)
Currency Unit = Leu
US$1 = 13.3 Lei

FISCAL YEAR
January 1 to December 31

WEIGHTS AND MEASURES
Metric System

ACRONYMS AND ABBREVIATIONS

AER	Annual Evaluation Report
BEEPS	Business Environment and Enterprise Performance Survey
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CIS	Commonwealth of Independent States
COA	Court of Accounts
CPAR	Country Procurement Assessment Report
CPIA	Country Performance Indicator Assessment
CRS	Control and Revision Service
DFID	UK Donor
EBRD	European Bank for Reconstruction and Development
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
FSAP	Financial Sector Advisory Program
FSU	Former Soviet Union
GDP	Gross Domestic Product
HIF	Health Investment Fund
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Finance Institutions
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
JSAN	Joint Staff Advisory Note
LDP	Letter of Development Policy
MDGs	Millennium Development Goals
MOE	Ministry of Economy
MOF	Ministry of Finance
MOU	Memorandum of Understanding
MTEF	Medium-Term Expenditure Framework
NBM	National Bank of Moldova
NGO	Non-Government Organization
NPV	Net Present Value
O&M	Operations and Maintenance
PAD	Project Appraisal Document
PAR	Poverty Assessment Report
PEFA	Public Expenditure and Financial Accountability Assessment
PEMR	Public Economic Management Report
PER	Public Expenditure Review
PFM	Public Financial Management
PFR	Public Financial Review
PIP	Public Investment Program
PPF	Project Preparation Facility
PPG	Public and Publicly Guaranteed
PRGF	Poverty Reduction Growth Facility
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
QAG	Quality Assurance Group
RISP	Rural Investment and Services Project
SAC	Structural Adjustment Credit
SCAs	Savings and Credit Association
SDR	Special Drawing Rights
SIDA	Sweden Donor
SME	Small and Medium Enterprise
SOE	State-owned Enterprise
TA	Technical Assistance
TTFSE	Trade and Transportation Facility for Southeast Europe
UNDP	United Nations Development Program
VAT	Value-Added Tax
WTO	World Trade Organization

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REPUBLIC OF MOLDOVA

PROPOSED POVERTY REDUCTION SUPPORT CREDIT

CREDIT SUMMARY

Borrower: Republic of Moldova

Amount: SDR 6.8 million (US$10 million equivalent)

Terms: Standard IDA Terms, with 40 years maturity, including a 10-year grace period

Objectives: The proposed Poverty Reduction Support Credit (PRSC) for the Republic of Moldova follows an intensification of the Government's reform efforts over the past several years and is intended to bolster and deepen those efforts. More specifically, the proposed credit aims to enhance the Government's ability to accelerate economic growth and improve the efficiency of its social programs and public administration – key elements in poverty reduction. To this end, the proposed PRSC will support selective areas of the Government's reform agenda, as outlined in the Poverty Reduction Strategy Paper (PRSP) and the European Union (EU)-Moldova action plan, thereby complementing and reinforcing other Bank Group programs in Moldova, the International Monetary Fund (IMF)-supported Poverty Reduction Growth Facility (PRGF) and other donor activities. Closely aligned with the Country Assistance Strategy (CAS), the PRSC will support the EGPRSP objectives of:

Improving the Investment Climate. Moldova is entering a new phase in its economic development where consumption driven growth – based on the export of labor and inflow of remittances – can no longer be expected to sustain current growth rates over the medium-term. Sustaining and accelerating future growth and poverty reduction in Moldova will depend on increases in domestic productivity which, in turn, will depend on the extent to which firms and farms address current low levels of investment and innovation. The Government's agenda focuses on further improving the investment climate for private sector development. These efforts will also directly contribute to Government efforts to improve governance and reduce corruption. Key to Moldova's efforts to accelerate economic growth and poverty reduction will be improving the performance of the agriculture sector. Similarly, reducing destabilizing economic impacts of external energy price shocks will require improvements in energy efficiency.

Improving the Efficiency and Management of Public Resources. Better governance and public institutions are central to growth and poverty reduction. The EGPRSP is conscious of the constraint imposed by the insufficient functional and institutional adaptation of the public administration to the requirements set by the transition from a centrally planned economy to a market economy. The EGPRSP recognizes that establishing a modern and efficient public administration is necessary in order to achieve the country's longer-term development outcomes. Increased public investment spending, particularly in public infrastructure, will be needed in order to support Moldova's private-sector led growth. This will require enhancing the strategic allocation of public resources by improving the (Medium-Term Expenditure Framework (MTEF) process, public procurement practices and including better public investment management. Reforms in a number of key sectoral areas can also improve the efficiency of public resource use, yielding increased fiscal space for more public investment spending without crowding out the private sector.

Strengthening Pension and Social Assistance Systems. While the recent slowdown in poverty reduction highlights the need to improve the quality of growth in Moldova, it also points to the need to strengthen existing social safety nets. The Government's program to improve delivery of utility, infrastructure and social services is reflected in the EGPRSP. The PRSC would strengthen the effectiveness and future fiscal viability of the pay-as-you-go pension program by supporting efforts to complete the 1999 pension reform, including efforts to unify the pension system for all types of pensioners. Improving targeting efficiency of social assistance programs and gaining efficiency in program administration will be a necessary element of Moldova's poverty reduction efforts.

Benefits: Benefits are: (i) improved business environment and investment climate, which directly contributes to changing the quality of growth and poverty reduction in Moldova by stimulating a stronger domestic supply response, particularly in the key agriculture sector; (ii) a more professional civil service combined with increased transparency and accountability of public finances with improved public expenditure management and strategic allocation of resources - through better medium-term budget planning, as well as strengthened procurement functions - enabling an increase in current low levels of public sector investment, particularly in rapidly deteriorating public infrastructure; (iii) strengthening existing social safety nets for vulnerable groups by completing the 1999 pension reform and improving the targeting efficiency of social assistance programs.

Risks: Primary risks to the proposed operation include: (i) public financial management and procurement systems have been strengthened but fiduciary risks remain non-negligible; (ii) low implementation capacity at the central and decentralized level. Dovetailing the PRSC with other Bank Group operations and donor activities that provide detailed support to capacity building helps mitigate this risk; (iii) Destabilizing external shocks, such as the volatility of energy prices and ban on Moldova exports of wine by Russia, could seriously affect public finances and delay implementation of poverty reduction measures in the PRSP. The PRSC's support to prudent fiscal policy and medium-term budget planning, combined with an IMF PRGF program, mitigate these risks.

Schedule of Disbursements: The proposed credit, SDR 6.8 million (US$10 million equivalent) will be disbursed in total upon effectiveness of the credit.

Poverty Category: This is a poverty focused operation.

Rate of Return: N/A

Project ID Number: MD-PE-P099166

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REPUBLIC OF MOLDOVA
POVERTY REDUCTION SUPPORT OPERATION

PROGRAM CONCEPT DOCUMENT

I. INTRODUCTION

1. This program document proposes a single-tranche First Poverty Reduction Support Credit (PRSC-1) to the Republic of Moldova for SDR 6.8 million (US$10 million equivalent) on standard International Development Association (IDA) terms of 40 years maturity including 10 years grace. The proposed operation is an integral part of the Bank's strategy to support the implementation of Moldova's Economic Growth and Poverty Reduction Strategy (EGPRSP) and EU-Moldova Action Plan. The move to supporting poverty reduction through programmatic lending is consistent with Moldova's level of institutional, economic and political development and acknowledges the country's strong and sustained performance in recent years. PRSC-1 is the first in a series of three single tranche operations that would facilitate the implementation of cross cutting reforms aimed at improving the living conditions of the Moldovan population.

2. The first EGPRSP Annual Evaluation Report, circulated to the Board in April 2006, raised the concern that overall poverty reduction in Moldova has stalled in recent years despite continued strong growth performance. Indeed, the Bank's recent Poverty Assessment update shows that poverty in rural areas has actually increased. The Government is aware that to address these stagnant poverty trends the quality of economic growth needs to be changed. To accelerate economic growth and poverty reduction, the three pillars of the PRSC will support the Government's efforts to: i) improve the investment climate so as to stimulate a greater domestic supply response; ii) increase the efficiency and management of the public sector resources to create fiscal space for increased public investment spending; and, iii) strengthen social protection systems to better protect the poor and vulnerable groups.

3. Bilateral and multilateral donor assistance will continue to play an important role in supporting the implementation of the EGPRSP and EU-Action Plan, given that the country's own resources fall short of the levels required for achieving the objectives spelled out in the strategy. The PRSC is an important step to further the principles of harmonization, providing a framework for policy dialogue and decisions linked to progress in the implementations of the critical areas of the EGPRSP. In support of the EGPRSP, the PRSC has created the momentum for a significant group of donors to align their budgetary support under a common framework. The PRSC will be supported by co-financing from other multilateral and bilateral donors, including the United Kingdom (DFID), Sweden (SIDA) and the Dutch Government with close coordination with the EU in the context of the new European Neighborhood Policy initiative.

II. COUNTRY CONTEXT

A. RECENT ECONOMIC DEVELOPMENTS

4. ***Gross Domestic Product (GDP) Growth, Inflation and Exchange Rate.*** Since 2000, Moldova's strong growth performance has reversed a decade of economic decline and rising poverty. The economy has grown by nearly 40 percent since 2000 with average real growth of around 7 percent per annum. In 2005, the economy grew at 7.1 percent but developments in the first part of 2006 point to some weakening (see next section). The major source of growth in Moldova has been domestic household consumption and construction fueled by massive inflows of workers' remittances – officially recorded at nearly 30 percent of GDP in 2005. While growing slowly as a share of GDP, private domestic investment has averaged only 17 percent of GDP since the beginning of recovery. Similarly, public domestic investment has remained very low (less than 2 percent of GDP) with the result that public infrastructure, particularly roads, has continued to deteriorate with negative implications for growth. During the recent recovery, the increase in domestic output has relied more on increased capacity utilization rather than significant additions to capacity. While remittance inflows are likely to continue to support strong consumption growth in the short run, over the medium-term the EGPRSP notes that Moldova will need to generate a stronger and more robust domestic supply response. Indeed, as the opportunities reaped from labor shedding and increased capacity utilization are exhausted, future gains in productivity will require increasing domestic investment and innovation.

Table 1. Moldova: Macroeconomic Framework, 2001–2008

	Actual				Estimated	Projected		
	2001	2002	2003	2004	2005	2006	2007	2008
Real GDP growth (%)	6.1	7.8	6.6	7.4	7.1	4.0	5.0	5.0
CPI Inflation (average, %)	9.8	5.3	11.7	12.5	11.9	10.4	8.2	7.5
Exchange rate (average, MDL/$)	12.9	13.6	13.9	12.3	12.6	..	..	..
Real effective exchange rate, %	-1.2	-6.1	-5.4	12.8	-1.3	-1.4	-4.4	1.2
Revenues and grants, % of GDP	29.2	29.6	34.0	35.4	39.5	39.3	39.5	39.3
Expenditures and net lending, % of GDP	29.4	31.5	33.3	34.6	37.9	39.7	40.0	39.8
Primary balance (cash), % of GDP	3.8	0.7	2.3	2.7	3.0	0.9	0.7	0.4
Overall balance (cash), % of GDP	-0.4	-1.4	0.2	0.8	1.7	-0.5	-0.5	-0.5
Current account balance, % of GDP	-2.5	-4.6	-7.1	-2.0	-7.3	-8.5	-6.8	-6.2
Exports G&S growth (percent)	14.7	19.1	20.9	27.4	13.3	6.9	15.7	11.0
Imports G&S growth (percent)	12.0	18.9	33.5	22.8	29.1	17.8	12.1	10.0
Gross official reserves (months of imports)	2.1	1.9	1.7	2.1	2.2	2.1	2.4	2.6
Total External debt/GDP, %	105.1	100.8	88.7	63.8	54.7	53.2	53.1	49.6
of which, public and publicly guaranteed (PPG)	77.0	61.1	52.5	35.3	28.2	24.8	23.1	21.6
External Arrears (millions $US)	17.5	42.9	86.1	50.6	56.3	0.0	0.0	0.0
PPG Debt service to exports of GNFS, %	17.2	14.3	12.5	9.3	6.9	5.6	4.7	4.1
NPV of PPG Debt service to revenues, %	224.3	174.8	115.8	80.2	61.8	45.9	40.4	34.0

Sources: Moldovan authorities (MTEF), IMF Article IV Staff Report, April 2006 and World Bank Staff estimates.
Fiscal accounts in the table are for those of the general government.

5. Agriculture is the largest real sector of the economy, accounting for nearly 20 percent of GDP (30 percent if agroprocessing is included), generating the majority of Moldova's exports (59 percent), and employing over 40 percent of the labor force. Like other sectors of the economy, agriculture suffered during the transition, with agricultural value added shrinking by more than 50 percent. Moldova carried out its farm restructuring later than most other transition economies, which prolonged the contraction of the sector. But with the launch of the National Land Program in 1997-1998, there was a marked acceleration in the creation of new peasant

farms and a coincident increase in agricultural production by the individual sector. [1] These reforms resulted in a gradual increase in sector output beginning in 2000. However, beginning in 2001, farm restructuring stalled and the sector was frozen in a semi-reformed state with approximately half of agricultural land used by 300,000 individual family farms, and the other half of the land still managed by 300-400 new corporate forms that are the heirs to the former collectives. The sector is also characterized by underdeveloped and imperfect markets and policy uncertainty, which cause low agricultural producer prices and lack of access to inputs. Thus, the sector has not been able to fully benefit from the land reform and farm restructuring efforts that have taken place. As a result, the agriculture sector has continued to underperform the industrial and services sectors in both absolute and relative terms. To generate sustained growth in the sector, the Government recognizes the need to build upon its earlier reform efforts by creating the incentives for continued farm restructuring, market-oriented production by individual family farms, and increased efficiency in the sector.

6. In recent years, monetary policy has strived to achieve a number of objectives, including maintaining a competitive exchange rate, keeping inflation low and accumulating a precautionary level of international reserves. The large inflow of remittances has contributed to appreciation pressure on the real and nominal exchange rate underscoring the need for more rapid improvement in domestic productivity. The National Bank of Moldova (NBM) has actively intervened in the foreign exchange market and has been rapidly accumulating foreign exchange reserves. To rein in the monetary impact of these interventions – and the inflationary pressures - the NBM sharply increased its sterilization efforts in 2005 and significantly slowed reserve money growth. Thus, despite the pick-up in energy prices in mid-2005, inflation dropped to 10 percent (y-o-y) at the end of 2005, after peaking at over 14 percent in April 2005. The macroeconomic framework supported by the IMF PRGF program envisages a gradual decline in inflation over the program's three year horizon.

7. **Fiscal Policy**. The Government has maintained a prudent fiscal stance, with the overall cash balance of the general government averaging only 0.2 percent of GDP since 2001, with a budget surplus of 1.7 percent of GDP recorded in 2005. Recovery-induced buoyancy in fiscal revenues has given Moldova the fiscal space to increase public expenditures. Since 2001, both expenditures and revenues have increased faster than GDP. There is a need to maintain fiscal discipline and for recognizing that the share of tax revenues and expenditures to GDP in Moldova already greatly exceed international norms for countries of similar income levels. To avoid crowding out private sector activity, the fiscal space needed to implement the EGPRSP, particularly increasing public investment in infrastructure, will require inter- and intra-sectoral reallocation of public expenditures and an increase in the efficiency of public spending rather than increasing the relative size of government.

8. The bulk of Moldova's fiscal revenues come from the taxation of consumption - primarily the value added tax (VAT). The VAT (with a rate of 20 percent) now supplies nearly 50 percent of total consolidated budget revenues with over 87 percent of that coming from the VAT collected on imports. Corporate and personal income taxes, on the other hand, each only contribute about 10 percent of fiscal revenues. To broaden the tax base and increase revenues coming from direct taxation, the Government has been reducing tax rates. Since 2001, the corporate tax rate has been reduced from 28 percent to 20 percent in 2004. Similarly, personal

[1] See Moldova Agricultural Policy Note Vol. I—Land, Report No. 36366-MD, World Bank, June 1, 2006.

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 next few years.

9. 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, which comprise nearly two-thirds of total government expenditures, has increased by nearly 6 percentage points of GDP. Public expenditures on capital and operation and maintenance of basic infrastructure, however, have remained very small and have declined as a share of GDP since 2000, with negative implications for public infrastructure, particularly the road network. The EGPRSP recognizes the importance of increasing public investment and improving public investment management. As noted below, planned increases in public sector wages will need to be tempered to make room for additional domestic capital expenditures. Foreign grant and concessional financing will play a significant role in covering the cost of increased public investment.

10. **External Sector**. As a small open economy, closer integration into the world economy and a rapid growth in exports must serve as an engine of growth. While strong economic performance in Moldova's main trading partners has encouraged a rapid increase in exports (averaging 19 percent over 2001-2005), the remittance-fueled increase in consumption as well as higher energy prices have pushed up import growth even faster (averaging 23 percent over the same period). As a result, the trade deficit has continued to worsen, exceeding 40 percent of GDP in 2005. With large inflows of workers' remittances (31 percent of GDP in 2005), the current account deficit has been more modest (averaging slightly over 4 percent of GDP since 2000). The overall balance of payments has been in surplus allowing for increases in international reserves.

11. Nearly 60 percent of Moldova's exports are in the form of agricultural products (including from the agro-processing industry) and predominately from the wine and beverage sectors. Though the direction of trade has been slowly redirected towards the EU, 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. With pressures on the real exchange rate to appreciate, the increased international competitiveness needed to close the trade gap will require an increase in domestic productivity. This will require significantly more domestic private and public investment, as well as foreign direct investment, than is currently undertaken.

12. Since Moldova imports nearly all of its energy needs, recent increases in energy prices have had a severe impact on Moldova. Fuel oil import prices rose by an estimated 44 percent in 2005. For the 2004-2005 period, Moldova paid $80/thousand cubic meters (mcm) for natural gas imports from Russia. Early in 2006, however, the price of natural gas was increased to $110/mcm and further increases (possibly to $160/mcm) in natural gas prices can be expected in the near future. The direct impact of this increase has been to widen the underlying trade and fiscal deficits. It has directly raised the cost of electricity, natural gas and oil products procured by the Government at all levels (adding 0.5 percent of GDP to government expenditures).

13. Since the Government has largely passed these higher energy prices on to final consumers, there have been rising pressures for additional subsidies and transfers. Currently, the biggest government transfer program related to energy is the nominal compensation scheme introduced in 2000 to assist more vulnerable categories of the population to pay for heating and electricity. In 2005, there were nearly 260 thousand recipients of this energy subsidy with expenditures amounting to 385 million lei or 3 percent of the general government expenditures. This compensation ranges from 25 to 50 percent of the cost of the service. While this energy subsidy program transformed the former system of privileges into a relatively more targeted program, the current program is still not very efficient in targeting the poor. The criteria used to define the vulnerable groups are not well defined – based on a categorical target system - and more than one third of the budget is misallocated to the non-poor. (The distributional impacts of higher energy prices are detailed in the poverty and social impact analysis of Section VI).

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. The macroeconomic framework currently in place is satisfactory. In May 2006, the Executive Board of the International Monetary Fund (IMF) approved a new three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) for an amount equivalent to Special Drawing Rights (SDR) 80.08 million (about US$118.2 million). The IMF supported program is designed to support growth and poverty reduction by maintaining macroeconomic stability, particularly in the face of strong inflows of remittances and sharply higher prices for imported energy. It also strives to improve the performance of the financial sector, building upon the lessons of last year's Financial Sector Assessment Program (FSAP). Key structural measures supported by the PRGF include modernization of the tax administration, improving corporate governance and transparency for state-owned enterprises (as well as reinvigorating the privatization process) and trade liberalization. The macroeconomic framework which underpins the authorities' program is aiming for further gradual disinflation in the coming years. Further, the fiscal program strikes the appropriate balance between the objectives of supporting disinflation and meeting the country's extensive developmental needs.

15. The export of labor and 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 31 percent of GDP, have increased disposable income and fueled a rapid growth in final consumption expenditures – the primary driver of the current economic recovery. In addition, migration and the inflow of remittances have also contributed to an increase in the equilibrium wage as well as the reservation wage of workers. While the relatively abundant inflow of workers' remittances is likely to continue over the foreseeable future, it is unreasonable to expect that these flows will continue to grow at the same rapid rate. Further, since the beginning of the economic recovery, increases in unit labor costs in Moldova have outstripped growth in labor productivity. Without increases in investment and innovation, it will become increasingly difficult to sustain past growth in labor productivity since the opportunities provided by labor shedding and factor reallocation in the economy are gradually being exhausted.

16. But a number of external shocks risk dampening economic growth in Moldova. In late March, Russia's consumer protection agency announced a ban on imports of wine from Moldova. As wine represents 30 percent of Moldovan exports, of which about 80 percent (10 percent of GDP) traditionally go to Russia, the impact of this ban – even if resolved relatively

quickly – will have medium-term effects on the macroeconomic outlook. Given its complete dependence on imported energy, the recent large increases in energy prices will put further pressure on the economy. Fuel oil import prices increased by over 40 percent in 2005 and natural gas prices were increased by 38 percent in early 2006 with further increases in natural gas prices expected (to $160/mcm).

17. As shown in Table 1, these external shocks are expected to contribute to slower real GDP growth in 2006 (4 percent) as well as a weaker medium-term outlook (with real GDP growth of 5 percent expected in 2007-2008). On the inflation front, the NBM is aiming to achieve inflation in the single-digit range over the PRGF program period. In an environment of strong foreign exchange inflows, this will demand continued sterilization efforts by the NBM. The recent increases in energy prices and a weaker exchange rate will necessitate relatively tight monetary policy in order to achieve the gradual reduction in inflation over the medium-term (with inflation targeted to decline to 7 percent per annum by the end of 2008).

Table 2. Moldova: Fiscal Financing Gap 2004–08
(In percent of GDP; unless otherwise indicated)

	2004	2005	2006	2007	2008
		Est.	Projections		
Revenues and grants	35.4	39.5	39.3	39.5	39.3
Of which:					
External Grants (% of GDP)	0.4	1.3	0.5	1.1	1.4
(US$ millions)			*15.8*	*36.2*	*52.4*
Expenditures and net lending (cash)	34.6	37.9	39.7	40.0	39.8
Overall surplus(+)/deficit(-) (cash)	0.8	1.7	-0.5	-0.5	-0.5
Financing	-0.8	-1.7	0.5	0.5	0.5
Net domestic	1.8	-1.6	0.2	-0.3	-0.3
Net foreign	-3.3	-1.0	-1.6	-1.1	-1.0
Privatization	0.1	0.1	0.1	0.1	0.0
Other (including project loans)	0.5	0.8	1.5	1.4	0.8
Financing gap (% of GDP)			0.4	0.4	0.9
(US$ millions)			*11.4*	*15.0*	*35.3*

Sources: Moldovan authorities (MTEF), IMF Article IV Staff Report, April 2006 and World Bank Staff estimates.
Note: Fiscal accounts are for the general government.

18. To support lower inflation, address the widening trade deficit and avoid crowding out private sector investment, fiscal policy will remain relatively tight and supportive of monetary policy over 2006-2008. As shown in Table 2, the IMF PRGF program targets an underlying general government budget deficit of no more than 0.5 percent of GDP over the program period. Bilateral and multilateral donors are expected to support the budget's efforts to meet the EGPRSP spending objectives with external grants and concessional financing. The 2007 fiscal financing gap of US$15 million is projected to be covered by the proposed first PRSC and program support by other multilateral and bilateral donors, including the United Kingdom (DFID), Sweden (SIDA) and the Netherlands.

19. As shown in Table 3, higher energy prices and slower export growth resulted in a significant widening of the current account deficit in 2005 and 2006. The external outlook has been negatively affected by the Russian ban on imports of Moldovan wine and the expectation that Gazprom will increase natural gas prices still further. At the same time, lower economic growth and some real depreciation will serve to slow import growth with the result that the current account deficit will improve in 2007-

Table 3. Moldova: Balance of Payments and External Financing Gap, 2004–08
(In millions of U.S. dollars; unless otherwise indicated)

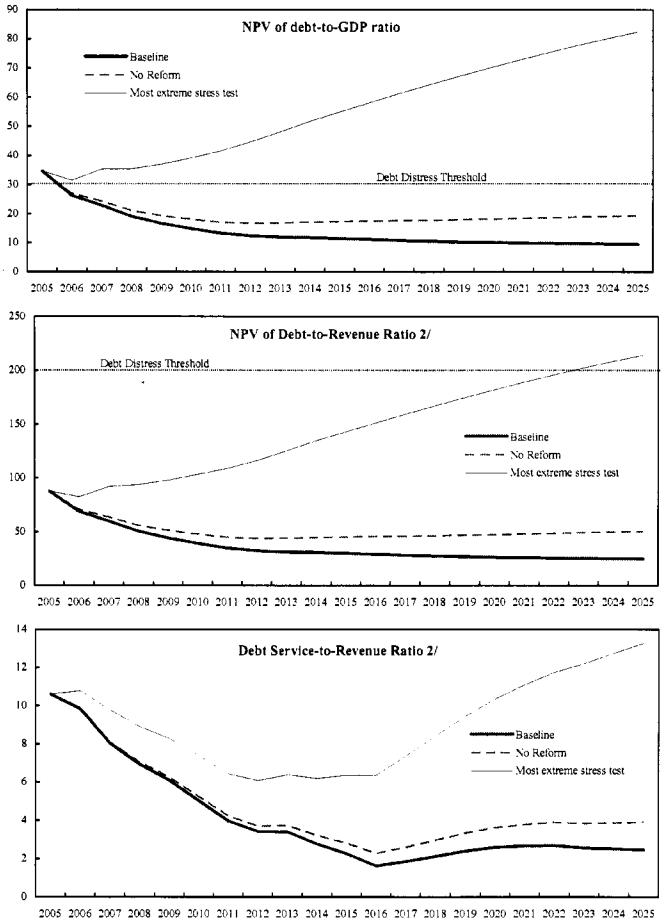
	2004	2005	2006	2007	2008
		Est.	Projections		
Current account	-52.9	-211.9	-263.6	-230.4	-239.4
(as a percent of GDP)	-2.0	-7.3	-8.5	-6.8	-6.2
Capital and financial account	78.2	211.1	285.6	298.7	299.7
Errors and omissions	124.5	97.1	0.0	0.0	0.0
Overall balance	149.8	96.3	22.0	68.3	60.3
Financing	-149.8	-96.3	-38.7	-108.7	-145.4
Use of Fund credit	-21.6	-21.4	9.2	11.9	12.9
Change of gross official reserves (increase -)	-148.0	-128.6	-50.8	-134.6	-171.0
Exceptional financing	19.8	53.8	2.8	14.0	12.7
Financing gap			16.7	40.4	85.0

Sources: Moldovan authorities, IMF Article IV Staff Report, April 2006 and World Bank Staff estimates.

2008. The 2007 external financing gap of $40.4 million would be covered by the proposed first PRSC, program support from the European Union (EU) and current official transfers from bilateral donors, including the United Kingdom (DFID), Sweden (SIDA) and the Netherlands.

20. **Debt Sustainability.** While Moldova is one of the most indebted countries in the region, rapid economic growth, appreciation of the US dollar with respect to other currencies (SDR, Euro, Yen), net repayment to creditors and favorable rescheduling operations have resulted in a rapid decline in the ratio of total external debt to GDP – falling from 106 percent of GDP in 2001 to around 55 percent in 2005. Public and publicly guaranteed (PPG) debt (including arrears) amounted to around $820 million or 28 percent of GDP at end-2005 (down from 65 percent of GDP in 2001). By 2005, debt to multilateral creditors, primarily the World Bank (International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)) and IMF amounted to nearly two-thirds of total PPG debt. Debt to bilateral creditors, primarily Paris Club creditors (and chiefly Russia) comprised the remainder of the total. Compared to 2001, debt to commercial creditors has declined to very small levels (less than 4 percent of total debt). External arrears amounted to US$56 million (2 percent of GDP) at end-2005 – owed mostly to Russia, the US and Japan. These arrears were reduced during 2004-2005 as a result of restructuring deals with bilateral creditors (Romania and Turkey), cancellation of state guarantees on some of the European Bank for Reconstruction and Development (EBRD) loans (Giurgiulesti and Vininvest) and commercial creditors (Gazprom and Hewlett-Packard). Domestic currency public debt is modest at around 10 percent of GDP (held primarily by the National Bank of Moldova). Private sector debt and energy arrears are approximately 17 and 10 percent of GDP, respectively.

Figure 1. Moldova: Indicators of Public Debt Under Alternative Scenarios, 2005-2025 1/



Source: IMF-Bank Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2015.
2/ Revenue including grants.

21. In 2005, the NPV of PPG external debt is around 24 percent of GDP or 50 percent of exports. The NPV of PPG debt to revenues ratio is around 62 percent (88 percent including

domestic currency public debt) while the ratio of debt service to revenues is around 9 percent. All of these values fall below the debt distress thresholds for countries with Moldova's Country Performance Indicator Assessment (CPIA) overall score.[2]

22. Consistent with the authorities' medium-term fiscal program, supported by the IMF's PRGF, a further decline in the debt-to-GDP ratio is projected, with the NPV of public sector debt-to-GDP ratio declining to 10 percent by 2025. The alternative scenarios and stress tests also show declining ratios over time (with the exception of the most extreme test which posits a permanently lower GDP growth and, being a static exercise, assumes that public spending would not adjust to this lower growth). [3]

23. Debt sustainability analysis suggests that Moldova does not face a structural debt sustainability problem. The May 2006 agreement with Paris Club creditors to restructure its external debt has alleviated pressing short-term liquidity difficulties (which had been resulting in the accumulation of external arrears) and frees up resources for other development needs. The Paris Club agreement consolidates roughly US$150 million due on debts contracted before December 31, 2000. This amount consists of arrears (US$68 million through end-April 2006) as well as repayments falling due from May 2006-December 2008 (US$81.8 million). The rescheduling is structured on the so-called "Houston Terms". This agreement is expected to reduce debt service due to Paris Club creditors during the program period from US$149.9 to US$60.8 million (mainly interest on the rescheduled amounts and payment on the arrears). Along with the funding from the proposed PRSC and other expected donor assistance, this rescheduling will reduce Moldova's financing gap over the program period.

C. POVERTY PROFILE [4]

24. A prolonged recession through the 1990s made Moldova the poorest country in Europe. By 1999, over 70 percent of Moldovans were poor and over 60 percent of the population was extremely poor. Moldova's social indicators, a measure of non-income dimensions of poverty, were also considered among the worst in the region.

25. The recent economic recovery has led to a massive movement out of income poverty. Between 1999 and 2003, over 37 percent of the population moved out of poverty in Moldova, marking the largest absolute decline in poverty in Europe and Central Asia over this period. The decline in absolute poverty was broad-based and poverty fell across all locations. Inequality, as measured by the Gini coefficient, has been on a slight downward trend since the late1990s. Starting in 2004, however, poverty reduction has stalled despite continued vigorous economic growth. Indeed, during the first three quarters of 2005, the seasonally adjusted poverty rate actually increased, heightening concerns that rapid economic growth is no longer reducing poverty.

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[2] According to the Bank's classification, the critical debt distress thresholds are: NPV/GDP = 40 percent, NPV/exports=150 percent and debt service/exports=20 percent.

[3] See joint IMF-Bank staff Debt Sustainability Analysis Annex included in the IMF Staff Report for the 2006 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility, EBS/06/61, April 21, 2006.

[4] See Annual Evaluation Report on the Implementation of the Economic Growth and Poverty Reduction Strategy, Government of Moldova, 2006, and Moldova, Poverty Update, Report No. 35618-MD, World Bank, April 25, 2006, for more details on recent poverty trends in Moldova.

26. Looking across geographic regions, as shown in Table 4, large cities have experienced continued declines in poverty rates while the poverty rate in small towns has stabilized. In rural areas, however, where close to 70 percent of the poor reside, poverty rates have been on an upward trend since 2003. The data suggest that members of households whose heads are engaged in agricultural activities face the highest risk of poverty. In addition, the agricultural sector accounts for the largest share of informal employment, where the poverty risk is higher than in the formal sector. The agricultural character of poverty in Moldova is not surprising in an economic environment where the agricultural sector has provided a significant source of income for many households while at the same time experiencing a prolonged contraction throughout most of the transition period. The continued underperformance of the agri-food sector is perhaps the most critical constraint to faster economic growth and poverty reduction.

TABLE 4: AN OVERVIEW OF POVERTY IN MOLDOVA

(In percentage points, unless labeled otherwise)

	1999	2002	2003	2004	2005 a/
National poverty rate	73.0	40.4	29.0	26.5	28.5
Large Cities	50.4	28.6	22.7	17.3	14.7
Small Towns	80.9	62.3	49.4	45.7	48.5
Rural Areas	76.9	51.0	35.7	37.1	42.5
GDP growth rate	-3.4	7.8	6.6	7.3	8.4
Gini coefficient	0.396	0.372	0.356	0.361	0.375

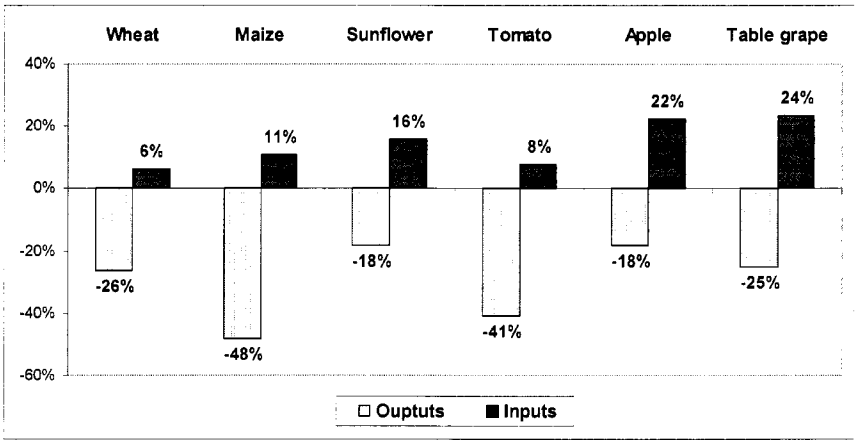
a/ 2005 Q1-Q3;
Sources: World Bank & National Bureau of Statistics.

27. While the initial turnaround of agricultural output and decline in rural poverty was associated with the land privatization and farm restructuring program that began in the late 1990s, the recent uptick in rural poverty coincided with stalled farm restructuring characterized by a slight reversal of the amount of land used by individual farms in 2002 and 2003. The delay in restructuring farms and getting land into the hands of individual farmers is having an adverse affect on agricultural output and farmer incomes. Calculation of total factor productivity (TFP) by farm type has shown that small, individual farms in Moldova are significantly more efficient than large, corporate farms. This is consistent with evidence from around the world, where agriculture in developed market economies is generally agriculture by individual family farms, and where many studies have shown that agriculture is not generally characterized by economies of scale. In fact, in Moldova today, individual farms produce over 70% of agricultural output on 50% of the land. By keeping 50% of land tied up in inefficient corporate farms, the land available to family farmers is reduced, which in turn reduces their income-generating opportunities and often restricts them to practicing subsistence agriculture. With few opportunities, many smallholders have no alternative but to rent their land at low rates to corporate farms, which usually pay in kind, and often do not pay at all. This further constrains incomes of smallholders.

28. There are two reasons why rental prices paid by corporate farms are low, and the same arguments apply to agricultural wages. First, due to their large size, corporate farms specialize in field crops such as cereals and oilseeds that are typically low-margin, and these margins are further reduced by government policies such as export restrictions and other market distortions. Second, corporate farms are less efficient (lower TFP) and less profitable (according to official figures, only 55% of corporate farms were profitable in 2004).

29. Distortions and imperfections in agricultural output and input markets reduce the scope for farm restructuring and rural poverty reduction. Analysis shows that agricultural producers are receiving less for their outputs and paying more for their inputs relative to international parity prices than they should.[5] The effects on six major commodities are reflected in Figure 2, which compares the prices received by Moldovan farmers to international prices, after accounting for transportation, handling and other costs. The results show that, on average for these six commodities, farmers received 29% less on their sales than they should have based on world market prices over the period 2000 to 2004. Further, the situation has not been improving over time, and for crops like wheat and tomatoes, it has worsened considerably. This has a direct negative effect on rural poverty by squeezing the incomes of farmers, and reduces the ability of peasant farms to succeed as viable businesses.

Figure 2: Prices Moldovan Farmers Receive for Outputs and Pay for Inputs Relative to World Prices, % (nominal rates of protection)



Source: Moldova Agricultural Policy Note Vol. II—Markets. Calculate as the average of Nominal Rates of Protection from 2000 to 2004 for outputs, and the average for 2000 and 2003 for inputs.

30. While peasant farmer incomes are squeezed by poor agricultural terms of trade, corporate farms are protected by favorable public expenditures and government policies. The repeated writing off, rescheduling and accumulation of debt without consequence has allowed inefficient corporate farms to continue operating at a loss. At the same time, many government support programs are targeted to large, corporate farms.[6] This is done by setting restrictions on minimum farm size or ownership structure, or by targeting crops grown primarily by corporate farms. The combined effect of such policies is to reduce the incentive for restructuring of the large corporate farms, and limit the flow of land and public support to peasant farmers.

31. This PRSC is designed to spur growth and rural poverty reduction through increased farm restructuring and enhanced competitiveness by improving policies in two key areas: Improving the investment climate through the development of agricultural output and input markets (see Pillar I.C below); Improving the efficiency and management of public resources for the agricultural sector (see Pillar II.C.1 below).

[5] See Moldova Agricultural Policy Note Vol. II—Markets; Report No. 36366-MD, World Bank, June 1, 2006.

[6] See Moldova Agricultural Policy Note Vol. III—Public Expenditures, Report No. 36366-MD, World Bank, June 1, 2006.

32. Despite Moldova's remarkable achievement in reducing income poverty, comparable progress has not been achieved along non-income dimensions of poverty. There are persistent or increasing disparities in access to education and health care. For example, while enrollment rates have increased during the recovery period, they have been driven mostly by the increased participation of richer households. Out of pocket expenses for public services, which have been on the rise, have impacted the poor disproportionately.

III. THE GOVERNMENT'S ECONOMIC GROWTH AND POVERTY REDUCTION PROGRAM

33. The EGPRSP was presented to the Boards of IDA and IMF in November 2004 and was the first full Poverty Reduction Strategy Paper (PRSP) prepared by the Moldovan authorities. It was developed in broad-based consultations with stakeholders and civil society, and benefited from a participatory process that was organized under the supervision of a Participation Council comprised of representatives of all stakeholder groups. This process has remained in place during the EGPRSP implementation period.

34. The EGPRSP establishes three medium-term objectives: sustainable and inclusive economic growth; reduction of poverty and inequality and increased participation of the poor in economic development; and human resource development. To achieve these objectives, the EGPRSP calls for a three-pillar strategy: (i) promotion of sustainable and inclusive economic growth; (ii) improved human development; and (iii) strengthened social protection of the most vulnerable groups.

35. Under the first pillar, the stated goals of the EGPRSP are improvements in the business environment and access to infrastructure, and maintenance of prudent macroeconomic management to promote sustainable growth. The EGPRSP attaches a high priority to improving the business environment and investment climate to reverse a decline in investment, and thus foster quality economic growth. To ensure that growth is inclusive for the rural poor and the marginalized populations, the EGPRSP focuses on furthering agricultural and rural development. Recognizing that improving human capital is key to economic growth, the second pillar of the EGPRSP rests on human resource development, through education and health. The EGPRSP focuses on measures to increase access to and improve the quality of education. Reforms of the pension and social assistance systems are at the center of the social protection strategy - the third pillar of the EGPRSP. Reform of the pension system will include the rationalization of the social insurance system to ensure its long-term financial sustainability and pension adequacy. The social assistance system will be strengthened through improved targeting and efficiency to ensure that benefits reach the most vulnerable poor. In achieving these strategic objectives, the EGPRSP is conscious of the constraint imposed by the insufficient functional and institutional adaptation of the public administration to the requirements set by the transition from a central planned economy to a market economy. Establishing a modern, efficient public administration is, therefore, recognized in the EGPRSP as an important element in achieving the development outcomes of the Government's poverty reduction strategy.

36. In April 2006, the Moldovan authorities prepared the first Annual Evaluation Report (AER) highlighting progress in implementing the EGPRSP from late 2004 to early 2006. In the Joint Staff Advisory Note (JSAN) the staffs noted that the AER provided a candid assessment of the accomplishments and shortcomings of the past year, focusing on outcomes

rather than inputs. The AER highlighted the continued poverty reduction, but also noted areas where policy implementation has been slower than originally envisaged. Staffs noted that reform momentum has been enhanced by the European Union-Republic of Moldova (EU-RM) Action Plan, approved in February, 2005. In those areas of endeavor where the two documents overlap, the EGPRSP and the EU-RM Action Plan are mutually consistent, and reforms have accelerated.

37. The report raised the appropriate concern that the decline in poverty among households in rural areas – where the majority of the poor live – has stagnated. In this regard, the quality of growth poses a major concern for the macroeconomic and poverty outlook. The AER recognized the need to implement sound policies and structural reforms aimed at revitalizing the business climate and creating the conditions conducive for private sector investment and productivity gains. Strengthening accountability and improving governance in the public sector, goals of the public administration reform effort, are also acknowledged as key priorities in the period ahead.

38. The report noted that, while the allocation of resources to cover EGPRSP priorities in the social sectors has been reasonable, the increase in the level of spending has not been accompanied by sufficient progress in improving the efficiency of this spending. In the area of social assistance, the AER noted that the system is still fragmented and inadequately targeted. In education, the growing availability of resources has still been insufficient to maintain the quality of education and plans to optimize the school network are highlighted. The report notes that while indicators on maternal and infant mortality are below targeted levels, increasing the efficiency of healthcare will be needed in order to maintain the benefit package of universal health insurance. The need to increase public investment in infrastructure is clearly recognized, but actual and planned budget allocations remain inadequate, raising doubts that the EGPRSP priority actions in this area will be met. The JSAN recommended that the authorities ensure better strategic linkages between the annual budgets, the Medium-Term Expenditure Framework (MTEF) and the EGPRSP. Strengthening the efficiency of public spending will also be needed if the priorities specified in that strategy are to be met.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. MOVING TO THE CAS HIGH CASE

39. The 2004 Country Assistance Strategy (CAS) was presented to the Executive Board against a backdrop of a difficult policy environment. Both the IMF (PRGF) and the World Bank Structural Adjustment Credit III (SACIII) programs had recently gone off track with less than one-third of the committed funds under these programs being disbursed. Further, the Government's Economic Growth and Poverty Reduction Strategy Paper (EGPRSP), which was adopted in mid-2004, contained policies and actions that reflected a radical departure from the Government's 2001 Economic Revival Program. These circumstances raised considerable concern about the government's commitment to the reform program articulated in the EGPRSP. As a result, the CAS adopted a cautious approach with the *Base Case* lending scenario including only investment operations targeted at the local and community level.

40. **CAS High Case Triggers**. At the same time, under a *High Case* lending scenario, the CAS left open the opportunity for a resumption of policy based lending (i.e. a PRSC) provided that Government ownership of the reform program was demonstrated in a good

implementation track record. To this end, the CAS developed a series of key reform benchmarks that would provide the basis for evaluating reform progress in critical areas: the maintenance of a stable macroeconomic framework and fiscal discipline, public sector reform and governance, improving the business environment, furthering pension reforms, and promoting liberal and market-oriented agricultural sector policies.

Table 5. Implementation of CAS High Case Triggers

CAS High Case Benchmark	Implementation
1. Meeting the benchmarks spelled out in the EGPRSP's annual implementation plan.	*Partially Accomplished* Completed first annual EGPRSP progress Report in April 2006 which provided a candid assessment of the accomplishments and shortcomings in implementing the EGPRSP action plan (see JSAN, April 28, 2006, Report No. 35980-MD).
2. Maintaining a stable macroeconomic framework and fiscal discipline.	*Fully Accomplished* New IMF PRGF program (May 5, 2006); Primary Fiscal Surplus of 2.7 and 3.0 percent of GDP achieved in 2004 and 2005; Paris Club debt restructuring agreement achieved (May 12, 2006).
3. Public Sector reform and Governance (a) Civil Service Reform (b) Public Financial Management (c) Public Procurement	*Substantially Accomplished* (a) Superseding the CAS trigger, the Government has embarked on a more ambitious Public Administration Reform effort - incorporating the civil service reform agenda - adopting a draft strategy and implementation plan. A Bank administered multi-donor Trust Fund is providing technical assistance to this reform effort. (b) Cash availability statements are issued by the Treasury on a monthly basis. (c) CAS triggers on single source procurement and open tendering have been fully satisfied. A satisfactory draft public procurement law has been prepared.
4. Improving the business environment (a) Reduce licensing and inspection costs and number of inspections; (b) Reduce import clearance time at inland terminal of Chisinau.	*Fully Accomplished* (a) CAS triggers on licensing and inspection costs fully satisfied as is the trigger on the number of inspections; (b) CAS trigger on import clearance time at the inland terminal of Chisinau has been fully satisfied;
5. Improving Social Protection: Pension reform	*Substantially Accomplished* (a) No new types of pension privileges have been introduced; (b) Database to record collection of pension contributions nearing completion. Approval of amendments to pension law will enable pension payments according to actual individual contributions.
6. Agriculture	*Partially Accomplished* Current land code maintained; requirement to export via the Universal Commodities Exchange abrogated; no direct administration of crop production; However, wasteful agriculture subsidies have increased.

41. As indicated in Table 5, most of the reform benchmarks established under the CAS high case have been fully or substantially accomplished demonstrating a track record of reform by the Government. In some areas, such improving the business environment (reducing licensing and inspection costs and import clearance times), and maintaining a stable macroeconomic framework (including external arrears clearance), the government has exceeded the CAS high case triggers. In the area of public sector reform, the Government has moved beyond the limited reform trigger established for the CAS and launched an ambitious public sector reform with donor support. In summary, this track record includes:

- *Meeting the benchmarks spelled out in the EGPRSP's annual implementation plan.* As noted earlier, the Government's first Annual Evaluation Report highlighted progress in implementing the EGPRSP and provided a candid assessment of the accomplishments and shortcomings of the past two years of reform.
- *Maintaining a stable macroeconomic framework and fiscal discipline.* Economic growth has continued to be strong, inflation has been under control, the general government budget has been in surplus, and external debt ratios have declined rapidly. A new IMF

PRGF program was approved by the IMF's Executive Board on May 5, 2006 with an agreed macroeconomic framework for the next three years. Following the IMF program, an agreement was reached with the Paris Club that resulted in the rescheduling of existing external arrears.

- *Public Sector Reform and Governance.* At the beginning of 2005 the Government embarked on a major public administration reform (PAR) effort aimed at streamlining the public administration, improving the system and capacity for government decision making, reforming the civil service on merit principles and improving the systems for aligning government strategies and resources. This reform effort is much more ambitious and extensive than envisaged under the CAS. With donor support, the Government has prepared a sound reform strategy and implementation plan which it adopted in December 2005. A Bank administered multi-donor trust fund has been established to support this reform effort. Efforts to improve public financial management are being supported by a Bank investment operation. Increased competition for public procurement contracts is evidenced by a decline in single source procurement from 51 percent to 45 percent of the value of contracts awarded (including utilities) and an increase in the use of open tendering from 28 to 40 percent of the value of contracts awarded.
- *Improving the Business Environment.* During the last few years Moldova has simplified business registration and licensing procedures, while reducing the required number of licenses and documents for business registration. In 2005, these reform efforts intensified with the adoption of the so-called "Guillotine" law which reviewed and streamlined business regulations still further (as evidenced by the improvement in Moldova's 2005 BEEPs results). As a result, licensing and inspection costs have declined as have the number of business inspections. In the area of trade facilitation, progress in implementing the Trade and Transportation Facility for Southeast Europe (TTFSE) project and the alignment of custom's legislations and regulations to EU standards have significantly reduced the time needed to clear the inland customs terminal. The adoption and implementation of the Asycuda clearance system will contribute to the acceleration of these improvements.
- *Improving Social Protection.* Steady progress has been made in implementing the 1998 pension reform program. No new types of pension privileges have been introduced and the overall retirement age has been raised from 60 to 62 for men and 55 to 57 for women. The Government has also made a commendable effort towards the system which bases actual pension payments on actual pension contributions with more than 75 percent of the 5.8 million required records now entered into the contribution database system.
- *Agricultural Reforms.* The 2001 Memorandum of Understanding (MoU) on Agriculture lays out a number of agreed policy principles. Overall, the Government has largely adhered to the principles contained in this MoU. In particular, the Government has resisted pressures to change the land code and is working with the Bank (as part of the Rural Investment and Services Project (RISP) to develop a pilot land re-parceling program. Government policy towards agricultural markets has been largely market oriented. Export restrictions that had been imposed in 2005 will be removed as part of the IMF PRGF program. The Government has refrained from imposing any policies directed at managing agricultural production. While the Government has been developing its extension and advisory services to provide support to independent farmers (under RISP) additional efforts will be required to rationalize subsidy and support programs to the needs of post-privatization agriculture. Given current fiscal constraints, the existing subsidy program consumes only a small fraction of the government budget. The PRSC

will support the Government's efforts to restructure agriculture expenditures, increasing the share of spending on agricultural services and investment, and reducing share of product and input subsidies.

Box 1. The EU-Moldova Action Plan

The EU-Moldova Action Plan, signed in February 2005, covers a wide range of issues, including democratization, health standards, legal reform, and economics. In the economic area, it is consistent with the EGPRSP and includes the following key elements:

Administrative reform and reform of the judiciary

- Adopting an ethics code for civil servants, judges and law enforcement bodies.
- Implementing a working program for regulatory reform.
- Amending laws concerning the independence and impartiality of the judiciary.
- Introducing administrative reform of local governments.

Macroeconomic stability and poverty reduction

- Making progress toward an agreement with the IMF on a credible economic program.
- Developing a Medium-term Expenditure Framework (MTEF) consistent with the EGPRSP
- Improving public finance management, including appropriate audit of budget revenue and expenditures.
- Developing a comprehensive strategy to modernize the tax administration.
- Upgrading and extending the treasury system, including by integrating into the single treasury account the social and health funds.

Improving investment climate

- Screening of national legislation to identify barriers to business establishment and to progressively abolish them.
- Taking steps to reduce over-regulation, improve transparency and predictability and reduce further the burden of licensing and inspection regimes.
- Setting up a dialogue on regulation, enterprise, and industrial policy with foreign investors.
- Enhancing the prudential regulatory framework for financial markets and supervision to bring it in line with that in the EU.
- Creating a national agency for competition protection, and providing it with sufficient budgetary means to carry out its mandate.

Trade promotion

- Harmonizing legislation and procedures with EU norms on certification and control of origin of goods in Moldova.
- Preparing a plan of steps toward fulfillment of EU requirements on animal health and for the processing of animal products, and for hygiene in food processing.

Source: IMF, Staff Report for the 2006 Article IV Consultation and Request for a Three-year Arrangement under the Poverty Reduction and Growth Facility, May 5, 2006.

42. **EU-Moldova Action Plan**. In addition to demonstrating progress in implementing these key reform benchmarks, the Government's commitment to economic reforms has been further reinforced by its stated EU aspirations which culminated in the adoption of an EU-Moldova Action Plan in May 2005 (see Box 1). This plan aims to establish an increasingly close relationship between the EU and Moldova and involves a significant degree of economic integration and deepening of political co-operation. Implementation of the action plan will significantly advance the approximation of Moldovan legislation, norms and standards to those of the European Union. Consistent with the EGPRSP, from which it is largely drawn, the policy framework contained in this EU action plan has sustainable development as its objective. In the 2005 elections, the Government retained its majority in Parliament giving it some breathing room to undertake major reforms before the commencement of the next political cycle.

43. **CPIA ratings**. The efforts by the Government to establish a demonstrated track record of reform have also been reflected in steady improvements in the Bank's Country Policy and Institutional Assessment (CPIA) of Moldova (see Table 6). The Bank's assessment of Moldova under this exercise has improved steadily over the last several years. In the most recent rating exercise, Moldova received an overall CPIA rating of 3.5, higher than the rating of the average IDA borrower. The improvement in Moldova's overall rating was held back by the continued accumulation of external payment arrears in 2005. The recent Paris Club agreement to restructure bilateral debt and clear external arrears will likely contribute to further improvements in Moldova's CPIA rating. Of particular note has been the increase in the critical Public Sector Management and Institutions (Governance) cluster rating. In the CPIA exercises done since the CAS, no single rating criterion for Moldova has been downgraded.

Table 6. Moldova 2005 CPIA ratings

	MOLDOVA	Average IDA Borrowers
CPIA Cluster A : Economic Management		
1. Macroeconomic Management	3.5	3.8
2. Fiscal Policy	3.5	3.4
3. Debt Policy	3.0	3.4
Average	3.3	3.5
CPIA Cluster B : Structural Policies		
4. Trade	3.5	3.8
5. Financial Sector	3.5	3.1
6. Business Regulatory Environment	4.0	3.3
Average	3.7	3.4
CPIA Cluster C : Policies for Social Inclusion/Equity		
7. Gender Equality	4.5	3.5
8. Equity of Public Resource Use	3.5	3.4
9. Building Human Resources	4.0	3.4
10. Social Protection and Labor	3.5	3.2
11. Policies and Institutions for Environmental Sustainability	3.5	3.1
Average	3.8	3.3
CPIA Cluster D : Public Sector Management and Institutions		
12. Property Rights and Rule-based Governance	3.5	2.9
13. Quality of Budgetary and Financial Management	3.5	3.2
14. Efficiency of Revenue Mobilization	3.0	3.4
15. Quality of Public Administration	3.0	3.0
16. Transparency, Accountability and Corruption in the Public Sector	3.0	2.9
Average	3.2	3.1
Overall CPIA	3.5	3.3

B. COLLABORATION WITH THE IMF AND OTHER DONORS

44. IDA partnership with the IMF in Moldova's development strategy has been excellent over the past few years. The Bank and Fund Boards endorsed the EGPRSP in November 2004 as well as the first annual progress report (May 2006). Bank and IMF staffs have executed joint work and have continued to carry out joint missions at least twice a year for macroeconomic policy dialogue with the Government. The IMF policy dialogue with the Government takes place in the context of the ongoing Poverty Reduction and Growth Facility (PRGF), covering the 2006-2008 period. The PRSC has been prepared in conjunction with the PRGF to ensure the consistency of the macroeconomic and structural policy reforms supported by both programs. The IMF is taking the lead on macroeconomic issues while IDA takes the lead on structural and social issues. In a number of areas where the mandates of the two institutions overlap, such as public finance, the work is being closely coordinated to ensure that consistent advice is provided to the authorities. The existence of an IMF program is an important input for the determination of the adequacy of the macroeconomic policy framework. (See Annex 3)

45. Donor support plays an important role in supporting the implementation of the EGPRSP and PRSC programs. Coordination between IDA, the United Kingdom (DFID), Sweden (SIDA), and the Netherlands has been especially strong since all these donors have been collaborating in the preparation of a single policy framework to be included in the PRSC. PRSC-1 was catalytic in starting improved donor harmonization in Moldova. During preparation of the PRSC, DFID, SIDA, and IDA carried out joint missions in consultation with the European

Union. This harmonization process was carried forward through a Development Partnership Framework signed between the Government, IDA, the Netherlands, the United Kingdom (DFID), Sweden (SIDA), the UN, IMF, and EU entitled "Co-ordination and Harmonization of Government and Donor Practices for Aid Effectiveness in the Republic of Moldova" signed in Chisinau on May 29, 2006. This Partnership Framework commits the parties to joint reviews, harmonization of indicators, and prior actions and synchronization with Government budget cycles with a view to reducing transaction costs of assistance to the Government.

C. Analytical Underpinnings and Relationship to Other Bank Operations

46. *Analytical Work.* The PRSC rests on a wide program of analytic work carried out by the Government, the Bank, and other donors that have helped inform the design of the PRSC. The recent Country Economic Memorandum (CEM) (2005) and Poverty Assessment (2004) and Poverty Assessment Update (2006) provide in depth analysis and recommendation related to growth and poverty reduction in support of the implementation of the EGPRSP. The studies underline the need to change the quality of growth in Moldova, moving away from the current consumption led, remittance fueled growth paradigm. They highlight the need to raise domestic productivity, particularly in the agricultural sector, by improving the investment climate so as to encourage greater investment and innovation as the most direct means to accelerate growth and reduce poverty in Moldova. The CEM, Agricultural Policy Notes (2006), Investment Climate Assessment (2004), the annual Cost of Doing Business Surveys, and the Trade Diagnostic Study (2004) provide a detailed analysis of the business environment, providing recommendations to reduce regulatory and administrative costs and improve trade facilitation as a means to encourage an acceleration in economic growth and poverty reduction. The CEM, as well as the Trade Diagnostic Study and Public Finance Review (2006), highlight the constraint to economic growth imposed by the deteriorating infrastructure and highlight the need to increase the currently low levels of public investment.

47. The Public Economic Management Review (2003) and the Public Finance Review provide recommendations on improving the efficiency and management of public sector resources. These studies examine public expenditures in the social sectors – education, health, social assistance, and pensions – and highlight the need to improve the strategic allocation of public resources by increasing efficiency of spending so as to free public resources to increase public investment. The studies also point to the need to establish a modern and efficient public administration, necessary in order to achieve the country's longer-term development outcomes. They provide recommendations on improving the MTEF process, public procurement practices, as well as public investment management. The Education Strategy Note (2006), the Health Policy Note (2007), Social Assistance Note (2007), and the Agriculture Policy Notes (2006) provide recommendations on improved public sector resource use to achieve better outcomes in these sectors.

48. The Bank's fiduciary work, Country Procurement Assessment Report (2003), and the Country Financial Accountability Assessment (2003), which has focused on the Government's financial and procurement systems, has been complemented by a recent multi-donor Public Expenditure and Financial Accountability Assessment (PEFA) (2006). The latest PEFA assessment has been produced during a period of significant overall reform of public financial management in Moldova. The MTEF is being strengthened and expanded, leading to improved budget preparation. The introduction of a new FMIS is planned which should offer

significant improvements in the quality and timeliness of financial information. A new procurement law is being developed, training and the development of a strategy for public financial internal control is ongoing. These studies provide an integrated assessment of public financial management performance and the impact of public financial management weaknesses, as well as the recommendations for reform which have informed the preparation of the PRSC.

49. *Bank Operations.* The CAS Progress Report recognizes the PRSCs as the main instrument of the Bank for providing support to the implementation of the EGPRSP. It also states that complementarity of efforts between programmatic support and investment lending is key to making efficient use of Bank resources. The current portfolio includes support for infrastructure (water and energy), private sector development, agriculture, community based development, public financial management, education, health, HIV/AIDs, and environment.

50. A number of investment projects support institutional reforms and capacity building to help the government realize its vision of a private sector led economy. The recently approved private sector Competitiveness Enhancement Project (2005) will 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 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. The Trade and Transport Facilitation in Southeast Europe Project (2003) seeks to reduce non-tariff costs to trade and transport and reduce smuggling and corruption at border crossings. The Second Rural Investment and Services Project (2006) for Moldova provides long-term support to accelerate agricultural recovery and growth so that Moldova's agricultural and rural sectors can play their full role in providing the underpinnings for future income growth and poverty reduction. The project provides information, knowledge, and know-how to newly established private farmers and rural population, strengthens the emerging rural private sector, and expands the outreach of formal financial sector to rural areas via the development of Savings and Credit Associations. PRSC support is aimed at leveraging these reform efforts and supporting complementary reform efforts to improve the business environment.

51. The Bank also supports a number of projects aimed at improving the efficiency of public sector resource use. The Public Financial Management Project (2006) aims to achieve effective and transparent management of public finances by providing assistance to improve budget formulation and execution, a new financial management information system, and better internal control and audit capability. A Bank managed, multi-donor trust fund (2006) has been established to assist the government in their public administration reform efforts. The IDF grant for the Development of Public Procurement Infrastructure (2004) follows up on the CPAR to assist the Government in the development of its public procurement system. The project supports Capacity building, further development of the procurement legislative framework, and increased automation of public procurement functions.

52. Bank operations have also focused on improving resource use in specific sectors. The Quality Education in Rural Areas Project (2006) supports the Government's education program to enhance the quality of teaching and learning in rural schools and improve the efficiency in public spending for education, particularly in the context of projected demographic

trends. The Primary Health and Social Assistance project (under development) would scale-up the Bank's previous interventions through competitive mechanisms established under the Health Investment Fund Project (HIF) (2000) and promote the use of improved clinical and management skills also supported by the HIF. It would support the Government's efforts to further improve service delivery with focus on ensuring equitable access, especially of the rural population, to quality health care and to build the clinical and management capacity of the health workforce to improve quality and efficiency, while taking measurable steps towards financial sustainability of the health care system. The Road Infrastructure Project (under development) would assist the Government in better mobilizing domestic resources by reforming road financing mechanisms and introducing competition in the execution of road maintenance contracts. The Public Expenditure Review PER process and analytic work, such as the CEM and Trade Diagnostic Study, play an important role in providing advice on strategic priorities and appropriate government processes for the expansion of infrastructure.

53. Finally, in the social sectors, Bank support is provided in the context of social development programs in health, education, and social protection. The Social Protection Management Project (1999) supports the Government's efforts to develop the capacity required to implement the pension reform and to support the development of an efficient and sustainable social protection system. The Primary Health and Social Protection project (FY07) aims to assist the government in scaling up efforts to improve the targeting efficiency of social assistance programs.

Box 2. Analytical Underpinnings and Links to Other Operations

Pillar I. Improving the Investment Climate

A. Reducing Regulatory and Administrative Costs

- Competitiveness Enhancement Project addresses the need to reform Standards, reduce regulatory burdens, and improve the quality of future regulations through the use of Regulatory Impact Assessment (RIA);
- Investment Climate Assessment (ICA) and Country Economic Memorandum (CEM) provided underlying analytical underpinnings;
- IMF PRGF program addresses privatization program, SOE management, debt restructuring, and implementation of RIA.

B. Improving Trade Facilitation

- Trade and Transport in Southeast Europe (TTFSE) program supports the implementation of Asycuda and simplification of Customs procedures geared towards improved trade facilitation;
- The Trade Diagnostic Study provided the analytic underpinnings, analyzing the main barriers to trade.

C. Developing Agricultural Markets

- Rural Investment and Services Project (RISP 2) supports the development of agriculture and business services in rural areas
- CEM and three Agriculture Policy Notes on Land, Markets, and Public Expenditures provides the analytical underpinnings;
- Managing Food Safety and Agricultural Health: An Action Plan (2006) which provides recommendations in the area of food safety and Sanitary and Phytosanitary (SPS) measures;
- IMF PRGF program addresses some key constraints on export side (UCE on grain) and Council of Creditors

D. Reducing Energy Vulnerability

- Energy II Project (with SIDA) aims to improve energy efficiency and reduce energy vulnerability;
- Poverty and Social Impact Analysis (a Note on the impact of higher energy prices in Moldova) provides analytical underpinnings;
- IMF PRGF program supports the Government's efforts to maintain cost recovery prices for natural gas.

Pillar II. Improving the Efficiency and Management of Public Sector Resources

A. Building a meritocratic civil service

B. Implementing a transparent and uniform remuneration system for civil servants

• The Bank will administer a multi-donor Public Administration Reform Trust fund with funding provided by DFID, SIDA, and the Netherlands; • Public Economic Management Report (PEMR) and Public Finance Review (PFR) provide analytical underpinnings. PFR prepared jointly with DFID, SIDA and EU.
C. Improving the Strategic Allocation of Public Resources • Public Financial Management (PFM) project (with SIDA and the Netherlands) provide analytical underpinnings and diagnostic, addresses key PFM issues, and provides capacity building; • DFID support to the Medium-Term Expenditure Framework; • Multi-donor support for Public Expenditure and Financial Accountability (PEFA) Assessment; • IMF PRGF program addresses some key constraints on cash management.
C.1. Agricultural Spending • CEM and Agricultural Policy Note on Public Expenditures provide analytical underpinnings and diagnostic.
C.2. Transportation Infrastructure • Road project is under preparation and will provide capacity building and technical assistance; • Trade Diagnostic study and Public Finance Review provide analytical underpinnings and diagnostic
C.3. Education spending • Quality Education in Rural Areas Project addresses access problems in rural areas; • Education Policy Note; • PFR provides analytical underpinnings and diagnostic on improving efficiency of education spending;
C.4. Health spending • Primary Health and Social Assistance project under preparation; • Health Policy Notes and PFR provide analytical underpinnings and diagnostic on improving efficiency of health spending.
D. Public Procurement • Institutional Development Fund (IDF) to Develop Public Procurement Infrastructure In Moldova; • Country Procurement Assessment Report (CPAR) provides analytical underpinnings, exploring the strengths and weaknesses of the public procurement system.
Pillar III. Strengthening Social Protection Systems
A. Pension Reform • Social Protection Management Project; • PFR provides analytical underpinnings and diagnostic on financial sustainability of pension system.
B. Social Assistance • Primary Health and Social Assistance Project under preparation; • EU Food Security Program and DFID/SIDA financing pilot projects on improving targeting efficiency; • PFR and Social Assistance Note provides analytical underpinnings and diagnostic on improving the efficiency of social assistance spending.

V. THE PROPOSED OPERATION AND POLICY ACTIONS

A. OVERALL DESCRIPTION

54. The objective of the proposed PRSC is to support the Government's economic growth and poverty reduction strategy. The proposed PRSC selectively supports the following areas of the EGPRSP and EU Action Plan where the sustainability of the key reforms requires consolidation, prioritization, cross-cutting support, and deepening to make real progress on the growth and poverty reduction agenda:

1. *Improving the Investment Climate,* through key policy actions to improve the investment climate and foster a more competitive enterprise and farming sector. With the impetus behind the current consumption led, remittance driven growth expected to wane, sustaining and accelerating future growth and poverty reduction in Moldova will depend on increases in domestic productivity. Achieving faster productivity growth, as well as

employment generation, will depend on the extent to which firms and farms address current low levels of investment and innovation. Key to Moldova's efforts to accelerate economic growth and poverty reduction will be improving the performance of the agriculture sector. Similarly, reducing the destabilizing economic impacts of external price shocks will require improvements in energy efficiency.

2. *Improving the efficiency and management of public resources*, by helping the government build a meritocratic civil service, improve the strategic allocation of public finances - with an enhanced focus on pro-growth investment spending on physical and human capital, and increasing competition in public procurement. Better governance and public institutions are central to growth and poverty reduction. The insufficient functional and institutional adaptation of the public administration to the requirements set by the transition from a centrally planned to a market economy is a key constraint to the efficient management of public resources. Establishing a modern and efficient public administration is necessary in order to achieve the country's longer-term development outcomes. Increased public investment spending, particularly in public infrastructure, will be needed in order to support Moldova's private-sector led growth. This will require enhancing the strategic allocation of public resources by improving the MTEF process, public procurement practices, and including better public investment management. Reforms in a number of key sectoral areas can also improve the efficiency of public resource use, yielding increased fiscal space for more public investment spending without crowding out the private sector.

3. *Strengthening Pension and Social Assistance Systems* by supporting further reforms to pension and social assistance systems, including better targeting of vulnerable groups by these programs. The recent slowdown in poverty reduction highlights the need to improve the quality of growth in Moldova and strengthen existing social safety nets. The PRSC would support the Government's reform efforts to strengthen the effectiveness and future fiscal viability of the pay-as-you-go pension program by supporting efforts to complete the 1999 pension reform, including efforts to unify the pension system for all types of pensioners. Improving targeting efficiency of social assistance programs and gaining efficiency in program administration will be a necessary element of Moldova's poverty reduction efforts.

Table 7. Prior Actions for PRSC1	
Policy Area	**Measures implemented before PRSC-I**
Maintain Macroeconomic Stability	*Maintained a satisfactory macroeconomic framework* In 2005, real GDP growth was 7.1 percent, inflation was 10 percent and primary fiscal deficit was 3.0 percent of GDP. On May 5, 2006 the IMF Executive Board approved a new PRGF program. On May 12, 2006, Paris Club creditors agreed to a restructuring of external debt.
Pillar I. Improving the Investment Climate	
A. Reducing regulatory and administrative costs of business regulations	*Adoption of Government decree on Establishment of a Registry of Official Acts Regulating Business Activity based on regulatory review.* Government adopted Decree No 1030 on Establishment of a Registry of Official Acts Regulating Business Activity. Implementation of the "Guillotine" Law resulted in eliminating regulations no longer needed or without legal standing.
B. Improving trade	*Introduction of risk-based selectivity using Asycuda selectivity module at the*

facilitation	*Chisinau Customs terminal.* The Moldovan Customs Department introduced risk-based selectivity by using the Asycuda selectivity module. By reducing documentary and physical examination of imported goods, this contributed to the reduction of the average monthly import clearance time at their inland terminal of Chisinau to 70 minutes.
C. Developing agricultural markets	*Total Liberalization of agricultural exports by making the Universal Commodities Exchange voluntary for all commodities* Government Decision No. 384 was amended making the Universal Commodities Exchange purely voluntary for all commodities as of September 30, 2006.
Pillar II. Improving The Efficiency and Management Of Public Sector Resources	
A. Building a meritocratic civil service	*Adopt a strategy to ensure competitive merit based recruitment of civil servants including procedures for open competition for vacant positions, appointments and a system of civil service appeals.* Decision of the Parliament of the Republic of Moldova # 1227-XV approved the Concept of the Personnel Policy in the Civil Service. Approved central public administration strategy.
B. Implementing a transparent and uniform remuneration system for civil servants	*First phase of the remuneration reform implemented increasing base salary for civil servants.* The new law on public sector pay approved by Parliament, begins to address the problem of low pay in the civil service, The Government decision implementing this law for civil servants was passed in May 2006.
C. Improving the Strategic Allocation of Public Resources - Agricultural Spending	*Create level playing field for all agricultural support programs.* Government Decision modified existing procedures/regulations removing all restrictions on access to subsidies and supports based on title, farm ownership structure, or size.
D. Public Procurement	*Increased competition for public procurement contracts* Increased competition evidenced by a decline in the use of single source procurement from 51% to 10% of the value of contracts awarded, including utilities, and increase in the use of open tendering from 28% to 57% of the value of contracts awarded.
Pillar III. Strengthening Social Protection Systems	
A. Completing Pension System Reform Program	*Continue implementation of individual account system* Government reduced data entry backlog of individual contributions by ensuring that 100 percent of 2005 contribution data submitted to the Pension Fund by the submission deadline (March 31, 2006) was entered into the computerized contribution database.

Pillar I: Improving the Investment Climate

55. In analyzing the policy impediments to growth, the EGPRSP - and the Bank's own analytical work - identifies the following factors as major constraints to private sector development in Moldova: unstable legal and regulatory framework; excessive bureaucracy reflected in the large number of permits, licenses, and authorizations; and, excessive interventions by control bodies. The recent 2005 BEEPs survey, for example, shows that "uncertainty about regulatory policies" and "business licensing and permits" are ranked among the biggest perceived problems to private sector activity. 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 the underperforming agricultural sector will be of particular importance in accelerating growth and poverty reduction in Moldova. This pillar of the PRSC seeks to help Moldova confront the challenges to economic growth identified in the EGPRSP and address some of the critical binding constraints to growth and poverty reduction.

A. Reducing Regulatory and Administrative Costs of Business Regulations

56. During the last few years Moldova has simplified business registration and licensing procedures and reduced the required number of licenses and documents for business registration. These efforts have contributed to a decline in the perception of corruption in the country, as measured by the decline in the BEEPs results on bribes paid as a percent of sales and the percent of firms saying unofficial payments are frequent. In 2004, the Government intensified its efforts to improve the business environment by adopting the "Concept of Regulatory Reform". This strategy established the framework and priorities for implementing regulatory reform, including curbing business inspections, simplifying business licenses and tax administration, and limiting mandatory reporting for statistical purposes. This effort led to adoption of a more radical law – the so called "Guillotine" law – which mandated a comprehensive review of business executive regulations and eliminated those regulations that were no longer needed or did not have legal basis. In parallel, the Government undertook steps to improve quality of the law making by developing a National Regulatory Reform Strategy that targets reform of the regulatory system. [7]

57. The Government recognizes that, despite these reform efforts, Moldova still has one of the highest regulatory compliance costs in the region. The EGPRSP stresses the importance of: (i) further streamlining of business registration, and post-registration procedures of issuing permits, licenses and similar documents; (ii) continuing of the process of reducing the number of state controls and inspections; and (iii) increasing the efficiency of paid regulatory services offered by public authorities, by setting fees for these services at cost recovering levels or providing services for free whenever there are no additional costs. The key elements of the Government strategy will be reflected in a framework law on principles of state regulation of economic activity, currently under preparation. The strategy will focus on reducing the cost of doing business, streamlining and simplifying regulations affecting opening and operation of business in Moldova, and introducing mechanisms to improve systematically the quality of new and existing regulations. Ultimately, the strategy will provide an explicit framework to accelerate on-going reforms of laws and regulations contemplated in the current government program.

58. The PRSC program will support the government efforts to further reduce regulatory compliance costs. The Government has already made remarkable progress in achieving reform benchmarks supported under the *PRSC1*. The results of the Guillotine Law implementation were reflected in the recently adopted Government Decree No 1030 on "Establishment of a Registry of Official Acts Regulating Business Activity". In parallel, the Government is pursuing a

[7] In *Doing Business 2007*, Moldova's overall global standing on the ease of doing business has declined substantially this year, slipping from 88th to 103rd. Although the decline is relative, reflecting the fast pace of reforms in other economies and the expanded coverage of the report, the deterioration is also due to remaining inefficiencies in Moldova's business environment, particularly in the field of construction licenses and permits. The report also makes note of Moldova's recent progress with implementation of regulatory reform, which due to the timing of the report, have not been fully reflected in the Doing Business rankings. Nevertheless, it is clear that further reforms are needed to make Moldova's economy more competitive and more attractive for local and foreign investors.

systemic approach to the regulatory reform implementation and improvement of quality of new legislation by adopting a comprehensive medium-term regulatory reform strategy and enacting a framework "Law on Basic Principles and Mechanisms of State Regulation of Business Activity", which has been submitted to the Parliament.

59. For *PRSC2* and *PRSC3*, the Government will continue to implement the regulatory reform strategy. It will complete the review of existing laws regulating business activities and undertake to further amend its business regulations in accordance with the Government Decree on the results of regulatory review. It will improve the quality of regulation of business activity by adopting the Law on Basic Principles and Mechanisms of State Regulation of Business Activities and implementing an Action Plan that includes the introduction and use of Regulatory Impact Assessment (RIA) to the legislative process.

60. At the end of the PRSC program, based on the implementation of the regulatory reform strategy, it is expected that there will be a significant reduction in regulatory compliance costs, as measured by the Cost of Doing Business Surveys (carried out under the auspices of the Competitiveness Enhancement Project) and confirmed by Moldova's indices in the Doing Business reports. Specifically, it expected that the average level of licensing and authorization costs per firm will fall from its current level of 52 percent of GDP per capita in 2004 to a level of around 30 percent GDP per capita. Further, the Government will maintain a frequency of inspections at an average of 8 inspections per year – down from its current level of 12 inspections per year – with the average cost of inspections per firm at or below 30 percent GDP per capita.

B. Improving Trade Facilitation

61. The Moldova Customs Service (MCS) has improved significantly over the past two-three years, aligning legislation and regulations to EU standards, as well as automating the Customs declaration processing in the course of implementing ASYCUDA-World. Data collected on custom clearance times indicates a significant reduction in processing times relative to last year. Progress in implementing the TTFSE project holds the promise that recent improvements in the Customs Service will be accelerated.

62. However, inefficient and costly border procedures still exact a significant cost on businesses that have to use them as well as the authorities that have to administer them. These impediments lead to poor export competitiveness, make the country less attractive to foreign investment, and reduce the ability of domestic firms to participate in global production networks. Many of the control mechanisms imposed by Customs and other border related agencies are designed to control fraud and increase revenue collection on existing transactions. The MCS still collects about 70 percent of total State Budget revenue, essentially through customs duties, VAT on imports, and excise taxes. Given its importance in mobilizing fiscal revenues, Customs has been under constant pressure to demonstrate its capacity to continue boosting its revenue collections. As a result, the strategy followed by Customs has put a significant emphasis on documentary requirements and checks, and introduced tough measures to address, in the short-term, corruption. Introduction of risk management and selectivity in the declaration process, and of targeting in the physical inspection of goods has been regarded, until recently, as "loosening" the control with the risk of diminishing the revenue collection and making room for smuggling.

63. In addition to the emphasis on revenue collection, there are currently up to nine agencies present at border crossing points. While one-third of the border entry processing time is rightly attributed to the Customs Service, another one-third is taken by the other agencies that are present at the border (often just to collect fees). In the surveys carried out under the TTFSE project, it is estimated that about half of the remaining time spent by trucks at border crossings reflects the poor organization of traffic flows resulting from the high number of agencies present at the border. Further, the sporadic unavailability of staff of these agencies contributes to unjustified delays of vehicles and passengers. Consolidation of these efforts would contribute to greater efficiency and improved trade facilitation.

64. A new organizational structure of MCS was approved in June 2005, which includes a dedicated risk analysis unit and a post release audit unit. The current implementation of a risk management system was augmented by the introduction of post release audit, both supported by the TTFSE project. This is expected to lead to simplified and rationalized procedures while increasing compliance by the business community. Enforcement of the newly approved regulations on Customs Brokers, transit procedures, and Customs regimes will provide for further simplification and transparency, but also leads to a serious restructuring of the Customs brokers' profession. Implementation of the above reforms is meant to reduce clearance and border crossing processes by Customs, thereby reducing the transaction costs of trade.

65. Under *PRSC1*, introduction of risk management and selectivity, using the on-going ASYCUDA-World clearance system, has resulted in further reductions in import clearance times. For *PRSC2* and *PRSC3*, a system of Customs border and clearance performance indicators and reporting, to be maintained after the TTFSE project closing,[8] will be agreed upon, and the number of control agencies at the border will be reduced in line with EU practice. Customs will collect fees on behalf of other agencies.

66. The implementation of the reform program is expected to reduce the average monthly import clearance time at the main terminal of Chisinau and the average monthly border crossing entry time to 30 minutes. Physical inspections by MCS, currently near 100 percent, will not exceed 30 percent of total declarations on a monthly basis.

C. Developing Agricultural Markets

67. As illustrated above, Moldovan farmers receive less for their outputs and pay more for their inputs relative to international parity prices than they should. This squeezes farmer incomes, reduces the scope for farm restructuring, and decreases returns to factors such as land and labor. The causes for this are various policy distortions and market imperfections that vary by sub-sector. For commodities like cereals and oilseeds, a government requirement that forces all exports to pass through the Universal Commodities Exchange (UCE), which is dominated by a small number of multinational agribusinesses, restricts exports and creates a wedge between international and farmgate prices. Domestic wheat prices are also reduced by state market interventions aimed at stabilizing prices for urban consumers, such as profit margin caps on bread and the management of the state grain reserves. For higher-value agricultural products like fruits, vegetables, livestock products, and wine (which is the largest export), a major market constraint is the inability to meet and certify international quality standards. Improving standards

[8] Expected closing date is September 30, 2007

will be key to accessing higher-value markets such as EU countries and increasingly even domestic supermarkets.

68. On the input side, much of the technology in modern agriculture is encapsulated in advanced seed and seedling varieties. In the case of Moldova, farmers are being denied this technology through restrictions on imports. Government protects domestic seed producers and research institutes by controlling the importation of new varieties through a complicated licensing mechanism, including lengthy testing requirements. The reliance on domestic seed monopolies increases costs and reduces farm productivity. Another major constraint is the lack of access to credit. This is being addressed in part through the new World Bank financed Rural Investment and Services Project II (RISP II). However, the long-term viability of the Savings and Credit Associations (SCAs) being supported under the project depends on strengthening the legal and oversight environment, which is beyond the scope of the project.

69. To accelerate and sustain growth in the sector, it is necessary to complement farm restructuring with measures to improve the functioning of agricultural input and output markets. Improving market opportunities will be key to increasing producer prices, farm and farm worker incomes, and to spurring the investment and innovation needed to keep Moldovan products competitive as they access the EU and global market places.

70. The EGPRSP affirms the importance of these issues and includes objectives to promote sustainable growth by continuing reforms in the sector, and building a strong commercial and institutional framework based on market economy principles. The EGPRSP recognizes that excessive regulation and inconsistent policies and their implementation have created a particularly poor business environment in the agricultural sector. It therefore aims to stimulate private initiative through market mechanisms and liberal agricultural policies. These policies are outlined in the EGPRSP and the Memorandum of Understanding on Agriculture (MOU) signed with the World Bank in 2001.

71. Consistent with the EGPRSP and MOU, Government has largely adhered to market principles by maintaining the Land Code, amending the Law on Production Cooperatives, and generally refraining from setting or influencing prices (with some exceptions). Government has also supported post-privatization agricultural enterprises through RISP project activities like provision of extension and advisory services, and the formation of SCAs. However, the commitment to market principles should be deepened in several areas.

72. Under PRSC1, Government will totally liberalize agricultural exports by making use of the UCE purely voluntary for all commodities. This is a reform that will affect commodities that represent over one third of the value of total agricultural production, and it is something that can be done at virtually no cost (simply by issuing a decree). To better inform agricultural producers on international market opportunities and trends in commodity prices, Government will begin disseminating information on regional (Ukraine and Romania) prices for cereals and oilseeds in the local media, as a precursor to the development of its own market information system. The Government has also agreed to undertake a study on improving its policies towards grain price stabilization, including the use of a profit margin ceiling on bread and the management of state grain reserves, to see if policies with less distortionary implications can be implemented.

73. For PRSC2, Government will conduct a review of the impact of its export market liberalization efforts, with an emphasis on cereals and oilseeds. If the review finds that producer prices continue to be depressed relative to international parity prices, PRSC2 will require Government to implement additional measures needed to ensure that farmers receive a fair price relative to international price parity, including transparent mandatory minimum oilseeds producer price formula benchmarked to international prices (to address potential monopsony issues in the market). Government will also undertake and begin implementation of recommendations of its study on improving grain price stabilization. In addition, Government will begin implementation of an Action Plan that will, among other things, cover the liberalization of the import regime for seeds and seedlings, improvements in the agricultural product standardization and certification system, and the development of a market information system to include the collection and dissemination of information on domestic cereal and oilseed prices. To enhance the sustainability of the SCAs supported under RISP and RISP II, a new law based on international best practice will be passed to provide for a multi-level of licensing with corresponding reporting and supervisory requirements and with proper enforcement tools.

74. For PRSC3, the Government will continue implementation of the Action Plan, including the scaling up of the market information system to cover all basic commodities accounting for at least 5 percent of value of agriculture production. Government will also complete the implementation of the recommendations of the grain price stabilization study.

75. At the end of the PRSC program, it is expected that the gap between prices received by farmers and international parity prices (measured by nominal protection coefficients) for cereal and oilseed crops will be reduced by 25 percent – implying an increase in producer prices, and hence income, received by domestic farmers. Price information on all basic commodities, in both domestic and international markets, will be reported at least weekly—and where possible, daily—in the local media. The liberalization of the seeds and seedlings market will result in a 25 percent increase in the new varieties registered, with the maximum time to evaluate and test seeds and seedlings reduced to one and four years respectively.

D. Reducing Energy Vulnerability

76. The recent increase in energy prices exposed Moldova's high vulnerability to external energy price shock. Due to the near total dependence on imports in meeting its primary energy needs and a relatively high energy intensity of its economy (in terms of the energy consumption per unit of GDP), Moldova faces significant downside risks to its economic outlook as the energy prices, and particularly the price of natural gas, continue to increase. Higher oil prices in 2005 and 2006, and the steep increase of the price of natural gas from $80 to $110 per thousand cubic meters (mcm) in January 2006, are expected to increase the cost of energy imports from $456 million in 2005 to about $600 million in 2006. While the cost of electricity imports in 2006 is expected to remain at the 2005 level (about $62 million), this cost is also likely to increase as the price of natural gas supplied by Gazprom (Russia) to Moldova and Ukraine continues to approach the European parity price which is currently in the order of $230/mcm.

77. Energy sector reforms, which started with the establishment of an independent energy regulatory agency (ANRE) in 1997 and culminated in privatization of about 70 percent of the electricity distribution market in 2000, prepared Moldova to deal with the energy price shock

in the gas and electricity sectors through necessary tariff adjustments and maintenance of financial discipline. ANRE raised domestic gas tariffs by 37 percent in February 2006, passing the full cost increase of imported natural gas to the final consumers. This, however, is less likely to happen in the district heating sector (which is dominated by Termocom – the state-owned company supplying heat in Chisinau) because heating tariffs are regulated by municipal councils. The Government recognizes that the mispricing of heat supply is the main source of quasi-fiscal activities in the energy sector (estimated at about $15 million in Termocom) and that heat tariffs need to be adjusted to the cost recovery level in order to return Termocom to financial viability (and enable the much needed capital investments in the sector). At the same time, the Government also recognizes that the rising energy prices require improvements in the social safety net, particularly its better targeting in order to efficiently protect poor households which may require energy subsidies of about 1.7 percent of GDP in 2007.

78. The Government recognizes that Moldova is highly vulnerable to energy price increases, and that upward price pressures are likely to be a fact of life in the coming years. In developing its policy response, the Government also recognizes that: (a) gas imports are likely to continue to play a pivotal role in the energy balance of Moldova in the long-term; and (b) Moldova has in its hands the task of reducing its energy vulnerability by improving energy efficiency, reducing energy waste, and developing its own energy potentials – all of which require significant investments. Therefore, under the *PRSC2*, the Government will develop and start implementing a comprehensive energy efficiency strategy including measures to (i) gradually adjust energy tariffs (for gas, electricity and heat) to full cost recovery level; (ii) maintain the high cash collections rates for natural gas and electricity; (iii) return Termocom and Combined Heat and Power plants to financial viability; (iv) develop incentives and other measures to promote and facilitate investments in energy efficiency, energy savings, and alternative (renewable) energy resources; (v) improve targeting and ensure adequate funding for the safety net protecting the poor from the energy price increase; and (vi) improve institutional capacity in the government and ANRE for contingency planning and rapid response to an uncertain evolution of energy prices in the medium-term.

79. Oil and gas price pressures are driven by market forces that are essentially beyond the influence of policy makers in Moldova, except for the policies governing energy (gas and electricity) transits through Moldova. In this area, under PRSC3, the Government aims to establish Moldova as a preferred route for the energy trade between the CIS energy market and the Energy Community in South East Europe (ECSEE), which is a part of the EU Internal Energy Market. The on-going benchmarking of the energy sector legislation with provisions of the ECSEE Treaty will provide a sound basis for adjustments of the power market design in Moldova, including solutions to (i) cross-border electricity trade and congestion management; (ii) power system balancing and settlement; and (iii) gradual power market opening. Furthermore, the Government and ANRE will adopt an action plan for legal and regulatory compliance of the Moldova's gas and electricity markets with the ECSEE. Adopting and implementing such an action plan would go a long way in improving transparency and regulation in the energy sector which are essential in attracting energy trade and related investments.

80. At the end of the PRSC program, it is expected that Moldova's energy intensity, measured by the total primary energy use (toe) per $1000 of GDP at PPP rate will be reduced by 10 percent. Financial discipline in the sector will be maintained or improved, with cash collection ratios about 90 percent for natural gas and above 95 percent for electricity. Further

cost recovery of gas, electricity, and heat tariffs for all categories of consumers (including households and budgetary institutions) approaches 100 percent, thereby eliminating any source of quasi-fiscal deficits in the sector. The poverty and social implications of these objectives are explored in the Poverty and Social Impact Analysis Section of this document.

Pillar II: Improving the Efficiency and Management of Public Resources

A. Building a Meritocratic Civil Service

81. Moldova aspires to improve the quality of the public administration as a measure to deepen the impact of the government policies and raise quality of services to the citizens. Since approval of the law on public service in 1995, the Government of Moldova introduced elements of a modern civil service. However, officials agree that the civil service has a deficit of highly skilled staff capable of performing analytical work, developing modern legislation, and providing high quality policy advice to the policy-making officials. Raising civil service professionalism in Moldova will require improved civil service training, performance management, and adequate incentives. It is also important to establish a sound legal protection for unbiased performance of the civil service duty as required by law, without interference and undue influence.

82. For *PRSC1*, The Government of Moldova has adopted a Strategy of Central Public Administration Reform which sets out an ambitious agenda aimed at modernizing its civil service to European standards. Competitive merit based recruitment and a sound system of remuneration lie at the core of the civil service reform. The approval of the new civil service law, which establishes merit principles in recruitment, defines responsibilities to act in accordance with the law, obligations to raise professionalism, and rights for legal and social protections is the first step supported by PRSC. The Government plans to adopt a Civil Service Law compatible with the international practice under *PRSC2*. Following the approval of the law and secondary legislation, the Government of Moldova plans to progressively introduce appointments to the civil service positions only on a competitive basis and according to merit. By *PRSC3*, all civil servants appointed to vacant positions will have been selected through competitive procedure. By that time the Government will have established a civil service database which will trace appointments, promotions and career changes of civil servants. The Civil Service Law shall also establish legal protection of civil servants against violations of the law. The central civil service managing body will ensure supervision of the observance of the law and will act as a first instance of appeal for civil servants.

83. At the end of the PRSC program, all new civil servants to administrative posts in ministries and central agencies will be appointed through an open, competitive, merit based selection process as specified in the new civil service law

B. Implementing a Transparent and Uniform Remuneration System

84. As noted, public sector wages in Moldova are low. The new Law of Public Sector Remuneration (2006), which increases the basic salaries for civil servants and differentiates among 23 various salary grades, has begun to addresses the problem of low pay in the civil service (under *PRSC1*). However, this new system of remuneration does not fully resolve several problems: high pay compression; high ratio of additional payments (base pay is only 25-30

percent of take home pay); weak guidance for managers on how to implement performance related benefits; and a lack of a central database on pay across the various ministries/agencies. As increments between the salary grades are very small, remuneration does not play a role in career motivation. The difficulty of introducing a modern motivating pay system in the civil service stems from an ineffective system of job classifications and absence of an analytical basis to establish equitable pay. The factors determining the size of remuneration for civil service jobs are not defined. This prevents the decision on salary levels from using sound analytical basis, giving rise to perceptions of imbalance between the pay and job demands and obligations.

85. The PRSC supports the Government efforts leading towards the modernizing of the civil service pay system. The Civil Service Law should clearly define the scope of the civil service which should cover permanent administrative positions in the public administration. By *PRSC2*, the Government will develop a modern and efficient system of classification of the civil service posts, including criteria for assessment of posts against a system of criteria characterizing the job (e.g., required level of knowledge and skills, managerial and decision-making responsibility, the value of job outputs, etc.). By *PRSC3*, the Ministry of Economy and Commerce in cooperation with the civil service management body, should develop (amend existing) legislation which introduces transparent and equitable pay and implementation of that legislation should commence.

86. It is expected that by the end of the program, by consolidating multiple salary supplements into the base pay, the size of the base pay should reach at least 75-80 percent of the total take-home pay and adequately reflect the value of the position as measured by views of staff in annual public official surveys. Further, in contrast to the current situation, information on public sector pay in will be centrally available for review and analysis through the development of a central financial management information system (under the Public Financial Management (PFM) project).

C. Improving the Strategic Allocation of Public Resources

87. Efficient governments allocate public resources to policy priorities to attain decisive impact with government programs. Moldova has been strengthening its resource allocation processes by introducing an MTEF and expanding the coverage of sectors included in the MTEF. In 2006, the Government included agriculture in the MTEF resource planning in addition to the existing health, education, and social protection sectors. This priority responds to the sectors relevance to the poverty reduction strategy. For the first time, the 2007-2009 MTEF is expected to have a technical annex on public investment spending. Thus, Moldova has increasingly focused its public expenditure planning, thereby facilitating the more effective allocation of resources to EGPRSP objectives. As part of *PRSC1*, the MTEF framework will be approved by the Government and submitted to Parliament for information in advance of the 2007 budget.

88. The Government realizes that the effectiveness of the MTEF process can be improved if the policy priority framework is agreed in advance of the MTEF planning. Therefore, under *PRSC2*, the Government has agreed to strengthen the central policy coordination capacity to facilitate Government's agreement on the policy priority framework early in the MTEF process. Currently, the Ministry of Economy has developed a policy unit charged with coordination of implementation of the EGPRSP. This unit has introduced quantitative monitoring indicators and prepares a report for the Parliament of implementation of

EGPRSP objectives. Similar policy capacity is being established in six line ministries. The Government agreed that the policy prioritization function should be raised from the administrative level to the Cabinet level. This will allow for the development of political consensus on policies and help turn the budget into a more effective anti-poverty policy instrument.

89. The Government has already committed to establishing a central policy unit directly reporting to the Cabinet of Ministers (in the Government Strategy of Central Public Administration Reform). The Government has now committed itself to establishing a similar policy unit in the Government Apparatus. It is expected that under *PRSC2* the Government will develop and adopt a legal framework underpinning policy coordination. By *PRSC3*, the policy unit of the Government Apparatus will have reached its operational capacity necessary to prepare a proposal on policy framework to be approved by the Cabinet of Ministers as a guiding document for MTEF. In the meantime, the Ministry of Economy is acting as a policy coordination center for EGPRSC and EU-related priorities. As the capacity of the Central Policy Coordination unit in the Government Apparatus reaches adequate level, they will provide strategic and day to day support to the Cabinet policy decision-making.

90. Key to the improved allocation of public resources is the effective and efficient management of public investment. While there has been improvement in public investment management processes in recent years, much work is left to be done. In particular, there is a need to better integrate externally financed projects, centralized investments, and other sources of public investment into a single common public investment program, as part of the MTEF process, with a common procedure for the identification, prioritization, preparation, and appraisal of projects. Public investment decisions also need to be better supported by economic feasibility studies that elaborate on the economic rationale for investment projects, their projected impact, and whether the outcomes are achieved at lowest cost. To improve the allocation of scarce public resources and sharpen the strategic focus of public investment, *PRSC2* and *PRSC3* will support, on a pilot basis, the Government efforts to implement new procedures for public investment decisions.

91. By the end of the three-year PRSC program, the strategic focus of annual budgets will be improved by the stronger linkage between the MTEF and annual budget laws. Moldova should also expect to see increased use and awareness of economic cost-benefit analysis in the public sector leading to improvements in the quality of public investment projects selected for funding.

92. *Restructuring Public Expenditures.* Since 2000, the Government has placed a heavy emphasis on increasing social spending – pensions, social assistance, education, and health spending comprise over 65 percent of total general government expenditures. With fiscal resources scarce, improving the efficiency and targeting of social spending, particularly in the education and health sector, will be required if the government is to achieve the growth and poverty reduction objectives of the EGPRSP. Sustained economic growth will also require more pro-growth public investment spending, particularly on the transportation infrastructure, and an improved allocation of agriculture spending to enhance long run capacity in that sector.

C.1 Agricultural Spending

93. Since 2001, farm restructuring has stalled, with approximately 50 percent of agricultural land being used by large, corporate farms that are largely unreformed since the Soviet collective farm period. These corporate farms are less efficient than individual farms, and often operate at a loss. To spur growth and poverty reduction in agriculture, the natural process of land flow to the more efficient individual farms should be re-energized. This process is currently being blocked by government efforts to preserve corporate farms through policies and public expenditures that allow the accumulation and writing off of debt and channel subsidies to large farms. By removing these blockages, the PRSC will facilitate continued farm restructuring. It will also help to create the fiscal space necessary to provide the growth enhancing public services and investments required to increase the competitiveness of the new class of independent family farmers.

94. Over recent years, the size and variety of product- and input-specific subsidies to the agricultural sector have been growing rapidly. This is often done without apparent strategic planning or prioritization in line with the EGPRSP and MTEF. The subsidy programs also vary from year to year, and actual amounts allocated from the budget can be changed rapidly and can vary significantly from plan. For example, subsidies under the Agricultural Support Fund (ASF) alone grew from MDL 36 million in 2004 to MDL 180 million in 2005 (compared to a budgeted amount of MDL 60 million), and increased again in the 2006 Budget to MDL 220 million. This represents an increase of over 500 percent. In addition, the nature of subsidies has changed over time. While the ASF began by providing credit subsidies that were open to all farmers, more recent subsidies such as those for Machinery Technology Stations (MTS) and plantation of vineyards and orchards are geared towards large, usually corporate or cooperative farms. For 2006, the Agricultural Support Fund increases Government participation in "picking winners" by subsidizing the production of specific crops, such as sugar beet and tobacco, where Moldova probably does not have a comparative advantage, and which are primarily grown by corporate farms. The majority of subsidies for 2006 (MDL 145 million) will go towards the purchase of inputs like fertilizers and pesticides. Such programs do not have a track record of supporting long-term growth. The Government recognizes the need to reduce such subsidies and use the resulting fiscal space to increase investments in sustainable growth-enhancing measures such as development of standards, research, extension, agricultural education and training, and investment in market infrastructure.

95. Under PRSC1, the Government has refrained from providing any debt relief for agricultural enterprises/producers, except in the case of one-off relief for firms undergoing privatization. This will force the large, corporate farms that are inefficient and poorly managed to restructure. The Government has also removed all restrictions on access to subsidies and supports based on farm ownership structure or size, which will reduce the current bias towards large farms, increase opportunities for individual farms, and further promote restructuring.

96. For PRSC2 and PRSC3, Government will begin restructuring of agriculture expenditures by significantly increasing expenditure on growth-enhancing services, as a percentage of total agriculture expenditures, over the next three to five years and by reducing the corresponding share of subsidies. Within the diminishing expenditure share for subsidies, priority will be given to measures that demonstrably enhance the long-run productive capacity of the sector by supporting the creation of long-lived assets, for example, new vineyards, orchards, new genetic livestock strains, etc. The share of purely recurrent subsidies, such as product or

input subsidies, will be correspondingly reduced. Further, Government will develop and begin implementing an Action Plan to streamline and modernize the agricultural research, training, and education system that will include: international benchmarking; rationalization requirements; and examination of land and funding needs. Government will also undertake an evaluation of the existing anti-hail rocket system (which now consumes a large portion of the Agriculture budget) and alternative measures.

97. At the end of the PRSC program, the share of subsidies in total agriculture expenditures will be substantially reduced (from 43 percent of the budget in 2006 to 30 percent in the 2009 budget). Correspondingly, within the subsidies category, the increase in the share of capital/investment expenditures will increase to 90 percent of total subsidies by the 2009 budget.

C.2 Transportation Infrastructure

98. The rapid deterioration of Moldova's transportation infrastructure over the transition period has significantly increased the cost and reduced the quality of transportation services with a particularly strong impact on the country's poor. The deterioration in public infrastructure is particularly noticeable in the road sector, where over 86 percent of the national road network has passed the economic lifespan and some 27 percent is in need of urgent rehabilitation due to very bad technical condition. Currently, the annual budget for road maintenance represents only about ten percent of the needed expenditure. The State Road Administration (SRA) within the Ministry of Transport and Communications still operates based on the Soviet model, with no clear separation of planning, procurement, and supervision of road works. The present overall situation is hindering the development of a strong private road construction industry and impeding the efficient use of the scarce state budget resources for road maintenance and rehabilitation. While the volume, cost, and schedule of works are defined by contractual agreements between SRA and contracting companies, the efficiency of these companies is limited due to the lack of competition in the contract award process, and also due to the absence of a clear linkage between results and payments.

99. *PRSC2* will support the EGPRSP objectives of improving the effectiveness of road works contracts for maintenance, repair, and rehabilitation through the preparation of a road sector strategy that will include a reform of road financing, introduction of participation of road users in the oversight of road maintenance financing, and increased competition in the execution of road maintenance, repair, and rehabilitation contracts. Under *PRSC3* the above mentioned transport strategy and related legislation on road financing reform will be approved and adopted by the Government.

100. By the end of the PRSC program the actual funding for road maintenance, repair, and rehabilitation included in the MTEF (to at least $50 million) will be significantly increased and [some percentage of] civil works contracts will be awarded competitively.

C.3 Spending on Education

101. Moldova's public expenditure on education, currently 7.3 percent of GDP in 2005, is comparable to OECD and upper-middle income countries. However, there are a number of inefficiencies and inequities confronting this sector. In terms of access, Moldova is lagging behind many of its neighbors. Inequities between income groups are acute, with the problem even more pronounced if one makes the distinction between urban and rural students.

102. Inefficiencies, mainly resulting from the slow adaptation of education expenditures and norms to changing demographics, are reflected in the fall in average student/teacher ratios over recent years. Similarly, the average school size is lower than a few years ago with large variations in school sizes across the country and between urban and rural areas. A continuing anomaly in Moldova's education system is the large number of non-teaching relative to teaching staff (non-teaching staff represent 37 to 48 percent of total staff compared to 27 percent in OECD countries). Another example of inefficient spending is high heating costs in education - the result of the high price of energy on local markets, but also the poor insulation of most school buildings and the large amount of space per student. While the number of students in each school is falling, the size of school buildings remains the same with average space utilization expected to fall to 50 percent by 2010.

103. The inefficiency in the public finance of education is partly due to the methodology for allocating budgets to schools. There is little wrong with the per capita financing formula used, which is essentially one of "money follows the student", with per-student allocations coming from the state budget. The problem is that school directors are not allowed to use their allocation flexibly – the amount that they must spend on salaries is determined by the number of teaching hours in their school which is in turn determined by the number of classes (however few students they may contain). In some schools with very small classes, the salary bill (based on the number of classes) thus exceeds the total allocation (based on the number of students). In many schools, the high wage bill leaves little or no public money for furniture, materials, repairs, etc. The formula funding system is generating signals but they cannot be acted on. As a result, rayons, mayors and schools have to search for ways to make up for the shortfall, including mayor and village budget resources, local taxes, and extra-budgetary revenues, and the growth of "unofficial payments" from individuals is tolerated.

104. To improve education quality and reduce the urban-rural gap, the government program aims to start optimizing the school network and increasing efficiency of spending. At present, a school mapping exercise is being conducted to provide a solid information-base for improved resource planning. For *PRSC2*, based on the completed school mapping exercise, a strategy to optimize school networks will be developed. The strategy will, among other things, identify schools for optimization, define efficiency target indicators, and pilot a new funding formula. For *PRSC3*, the Government will begin implementation of the optimization strategy covering at least 20 percent of identified schools and allocating school budgets under the revised funding formula to pilot schools.

105. By the end of the PRSC program, student/teacher ratio, student/non-teacher ratios, and the share of expenditures on non-wage quality related items (e.g. textbooks, learning equipment, teacher training, etc.) will have increased in pilot schools.

C.4. Spending on Health

106. Moldovan health sector was pushed into reforms as a result of the economic crises of end 1990s, which saw public health expenditure fall to 2.9 percent of GDP in 1999-2000 and real public health expenditure per capita to US$10, much below regional averages. The Government responded to financial crisis by closing unnecessary health infrastructure, and emphasizing more cost-efficient service delivery at primary care settings. Public health expenditure increased to 4.3% of GDP in 2005, the Government has initiated a public investment program to modernize hospital equipment, and has spent more on primary care with the

assistance of donor funding (IDA, Dutch and Japanese Government). The reform agenda however is still incomplete and has not yet achieved the original aims of equitable coverage of the country with good quality primary care. The current set-up of health service delivery by Rayon Health Authorities, providing both primary as well as hospital care, allows for cross-subsidies to hospitals from revenues intended for primary care services, weakening primary care and covering inefficiency in the hospital sector. The number of vacancies in rural health centers is continuously high, with 10-25% vacant family practitioner positions based on the current norm of 1500 persons per doctor. Direct contracting with autonomous primary care providers would increase efficiency and transparency in the health sector.

107. The increase in public health expenditure is mainly due to the launch of health insurance in 2004, with the Government contributing for non-working population groups such as the pensioners, children, and students. The health insurance coverage is estimated at 83-84% of residents, but rayon health authorities provide considerably lower estimates at 60-75%. The main coverage gaps are among the rural population and urban self-employed, both connected to contribution collection capacity. Therefore, although the Government contributes to the health insurance scheme for the non-working population, there is still considerable risk of poverty to cost of illness among the rural population and the self-employed.

108. The Government intends to pursue reforms to increase equity and efficiency in the health sector. In support of this objective, under PRSC2 and PRSC3, the Government will maintain at least 30% allocation to primary care from the Health Insurance (HIC) budget. Further, under PRSC2, the Government will (a) prepare a procedure for direct contracting with primary care centers, and (b) will develop a strategy for increasing health insurance coverage, including measures for strengthening collections and information campaigns on insurance benefits. Under PRSC3, the HIC will contract at least 5% of primary care providers directly.

D. Public Procurement

109. Given the fact that most countries spend from 5 to 15 percent of their GDP on public procurement, the World Bank and international and bilateral donors firmly believe that establishment and maintenance of an efficient public procurement system can help achieve substantial savings in public expenditure in Moldova. The Bank has been actively involved in supporting public procurement reform in Moldova since 1997 when, with the assistance of the Bank, a law was enacted on Procurement of Goods, Works, and Services for Public Needs (No. 1166-XII dated April 30, 1997). Since then the Bank has remained engaged in assisting the Government improve public procurement, most recently through an IDF Grant to the public procurement agency. Throughout this time a steady improvement in some aspects of public procurement has been observed while at the same time a distinct deterioration in the institutional framework has occurred.

110. Under *PRSC1*, competition for public procurement contracts was increased with a significant drop in the number and value of public procurement contracts awarded using sole source and a steady increase in the number and value of contracts awarded through open tendering. However, there is still some progress that can be made to reduce the amount of restricted tendering.

111. Under *PRSC2*, the Government will address the pressing need to reform the institutional framework by reestablishing the Public Procurement Agency as an independent entity under the Cabinet of Ministers, responsible to the Prime Minister. This will be coupled with a steady increase in the human resources of the Agency from the present 7 persons to a maximum target of 35 persons by the time of *PRSC3*. At the same time, the Agency may establish a moderate regional presence with small offices in the north and south of the country. The newly reestablished Agency should develop a clear Action plan covering 2006-2010 (ratified in time for *PRSC2*) which should cover items such as: development of the Agency, development of a national training and certification program with at least 80 persons trained by *PRSC3*.

112. By the end of the PRSC program, the level of sole source procurement and open tendering will remain below 10 percent and will rise to at least 70 percent, respectively. If additional effort is made to increase open tendering to 75 percent by the end of the PRSC program, then Moldova could become rated "A" under the PEFA Indicator-19 (Competition, value for money and controls in procurement).

Pillar III: Strengthening Pension and Social Assistance Systems

A. Completing Pension System Reform

113. Although the administration of the social insurance system has improved in the last three years, outstanding issues still need to be addressed. The 1999 reform of the pay-as-you-go pension system has met some of its short-term objectives, such as making pension payments on time, in-cash (as opposed to in-kind), and without the need for budget transfers. Pension reform, however, remains incomplete and the general pension law (1999) is not being fully implemented. The EGPRSP lists the following four areas as major unfinished business: (i) financial stability of the (pension and social insurance) system; (ii) fragmented and non-uniform pension legislation; (iii) significant and, in many cases, unfair redistribution of resources among different categories of insured persons; and, (iv) relatively low levels of pensions and indemnities.

114. The 1999 reform law mandated that pension payments be made based on actual paid contributions rather than on stated wages to reduce uncertainties on revenue-expenditure gap, increase transparency, and improve equity. Nevertheless, this reform objective has not yet been completed. Originally, the contribution-based pension payment was planned to start in January 2005. While the National Social Insurance House (NSIH) has progressed in developing the IT system, supported by the Social Protection Management Project, the contribution data entry into the system has experienced significant delays. More than a year after the original target date, 75 percent of the needed data has been entered. Although the recently initiated scheme of submitting contribution data through electronic formats is an indicator of positive progress, the contribution-based pension payment is not likely to start until after January 2007.

115. Other major issues in Moldova's pension system include the pension privileges for certain categories of the population and certain sectors as well as agricultural pensions. Privileged pensions are in effect for several groups in the population, including the military, prosecutors, civil servants, Chernobyl liquidators, and members of Government. These pensions are considerably higher than those received by general pensioners. These special pensions are received by roughly only 2 percent of old-age pensioners but amount to about 14 percent of public expenditures. Although the Government has not introduced new categories of privileged

pensions, eligibility criteria have been somewhat loosened during the recent years. Because the beneficiaries of the privileged pensions are socially and politically influential, phasing out of the privileges has been difficult. Consequently, the privileged pension expenditures are increasing.

116. Issues relating to agricultural pensions are even more complex. There is a substantial redistribution from non-agricultural workers to agricultural workers. Currently, agricultural workers contribute 20-22 percent of their wages to the pension scheme while their pensions amount to nearly half of all old-age pension expenditures. This problem was not solved through the 1999 pension reform, even though agricultural pensions were reduced to 85 percent of those of non-agricultural workers. Contributions for agricultural workers are set at a very low level.

117. To continue pension reforms, the Government plans to: (i) implement the contribution-based pension payment benefits; and (ii) unify the pension system for all types of pensioners (non-farmers, farmers and privileged). Under *PRSC1*, the Government has: (i) reduced data entry back log of individual contribution so that 100 percent of 2005 contribution data submitted to the Pension Fund has been entered into the computerized contribution database; and (ii) developed an agricultural pension reform strategy.

118. For *PRSC2*, (i) the pension law will be amended to enable pension payments to be made based on individual pension contributions; and (ii) the Government will adopt a strategy to unify the pension system for all types of pensioners (non-farmers, farmers and privileged). Under *PRSC3*, the Government will begin: (i) paying pensions based on contributions registered in the individual accounts; and (ii) implementing the strategy to unify the pension system.

119. At the end of the program, (i) individual accounts will have been established for 100 percent of all known pension contributors, meaning that all contribution data (*declarations*) received by the Pension Fund will have been entered into the computerized contribution database; and (ii) correlation between contributions and payments will have increased for all types of pensioners (targets to be determined during appraisal).

B. Enhancing the Distribution Efficiency of Social Assistance Benefit

120. Today Moldova's social assistance system consists of some 13 types of cash benefits. The largest of all is the energy and housing subsidy called "nominal compensation", which is meant to be targeted towards the poor and vulnerable households. The total expenditure has averaged slightly above 200 million lei/year for approximately 250,000 beneficiaries. The "nominal compensation" transformed the former system of privileges into a categorically targeted program focused on relatively more vulnerable population. In light of recent and projected increases in energy prices, this program could have a critical role in reducing the adverse shock on the poor and the vulnerable (A PSIA analysis on this impact has been undertaken).

121. One of the major issues in Moldova's social assistance system is the targeting efficiency. "Nominal compensation" and all other social assistance programs employ some form of categorical targeting. However, Type I and Type II errors both appear to be high. Over the last few years, it is estimated that the poorest 20 percent of the population have received only 6.6 percent of total social assistance benefits. It was also estimated that roughly 45 percent of the

benefits are received by the non-poor. Given the extent of in-kind and informal income in Moldova, any type of income targeting is likely to lead to substantial errors of inclusion; thus some type of categorical targeting may be a necessity. Nonetheless, it is still necessary to improve the targeting of social assistance programs to ensure that they are focused on the poor and the vulnerable.

122. Another major shortcoming is weak record keeping and information sharing across the various social assistance programs. At present, social assistance programs are administered by several government agencies, including NSIH, Ministry of Health and Social Protection, Territorial Social Assistance Offices, and Territorial Social Insurance Offices, each of which has independent beneficiary registries and payment databases. The existing arrangements make it very difficult to assess the overall impact and effectiveness of social assistance programs to the government. They also make it more difficult for the poor and the vulnerable to access social assistance programs.

123. To improve targeting of social assistance programs and gain efficiency in program administration, the Government's reform agenda focuses on: (a) developing and adopting a strategy for improved targeting for social assistance programs, in particular, the "nominal compensation" program; (b) undertaking a financial and impact assessment of social assistance programs; (c) developing and implementing an information system for improved record keeping and information sharing; and (d) consolidating/rationalizing the administration of social assistance programs.

124. Under *PRSC2*, the Government will: (i) adopt a time-bound social assistance reform action plan for improved poverty targeting including converting some of the categorical targeting to mean-tested ones, and (ii) design a unified database of the beneficiaries of cash-equivalent social assistance programs. Under *PRSC3*, the government will: (i) begin the implementation of the action plan; and (ii) start the installation of the unified database.

125. By the end of the program, it is expected that the share of poverty-targeted social assistance program budget in the total social assistance program budget will have increased.

VI. OPERATION IMPLEMENTATION

A. POVERTY AND SOCIAL IMPACT ANALYSIS

126. The PRSC team has endeavored to assess the likely distributional consequences of major policy reforms supported by the proposed credit on the welfare of different stakeholders, with a special focus on the poor and vulnerable. While such policy reforms are aimed at promoting efficiency in the use of public resources, accelerating economic growth, and fostering poverty reduction, particularly in rural areas where the poorest households reside, adverse distributional consequences in the short-run are nonetheless possible in at least three components of the proposed operation. These include interventions aimed at achieving the following: (i) supporting the Government's efforts to maintain cost recovery energy tariffs by continuing to allow full-pass through of energy price increases; (ii) implementing the strategy for optimizing school networks; and (iii) capping budget share of expenditures on agriculture subsidies. In light of these potential social consequences of reform, recent analytics on the social impact of rising energy prices, options for reform in the education sector, and mitigation measures for easing the

reform process have informed the PRSC preparation process. The PRSC team has also been in close consultation with Government and other key stakeholders, along with the donor community, to discuss the preliminary findings from these analyses.

127. *Raising energy tariffs to cost recovery levels.* Allowing energy tariffs to rise to full cost recovery levels and facilitating a full pass-through to consumer of recent energy price increases—while maintaining hard budget constraints on energy producers, suppliers, and consumers—can promote energy conservation, energy efficiency and investment in the modernization of utility assets. The government has in place a social assistance system, including natural gas and energy compensation, to assist poor and vulnerable households. In 2005, about 2 percent of GDP was allocated toward social assistance, with utility subsidies accounting for 40 percent of this amount. And while cost recovery tariffs for natural gas have been in place since 2000, a lifeline tariff also covers monthly consumption up to 30 cubic meters. The budget for natural gas and energy subsidies has been increased in response to the price shock. The government has indexed its budget allocation for natural gas and energy compensation (including subsidies for firewood and charcoal) to offset the two rounds of gas price increase and protect recipient households from the gas price shock in 2006. In particular, the government recently allocated 15.7 million lei in additional funding for gas and energy subsidies, to account for the recent increase in natural gas prices in July.

128. However, given that the Government maintains a categorical targeting system, in the short-run such a reform program may have unfavorable social implications. In the recent World Bank "Note on the Impact of Energy Prices Changes in Moldova", which was delivered to the Government and discussed at a press conference during the pre-appraisal mission, the analysis indicated that higher energy costs have had a significant impact on the poor since these consumers have little capacity to reduce already low demand in response to rising energy prices.[9] Further increases in the cost of energy will certainly create additional pressure on the budgets of the poorest households. The note calculates that the likely fiscal cost of protecting the energy consumption of the poorest households is within the current spending envelope. The PRSC team, drawing from the results of this analysis and a chapter on social protection (in the forthcoming Public Finance Review), has also encouraged the government to develop better targeted social safety nets for the most vulnerable groups in the economy. A pilot program for means-testing is currently underway. The impact on vulnerable groups will be monitored using quarterly Household Budget Surveys.

129. *Optimizing the school network.* The proposed operation supports an educational reform strategy that involves piloting the optimization of the school network to promote more efficient use of public resources in the education sector by decreasing the share of non-teaching staff in total employment, lowering overhead costs, and bringing pupil-teacher ratios closer to international (e.g., OECD) norms. However, such an optimization program may generate fiscal savings that may be allocated toward quality-enhancing education inputs (such as textbooks), but may have important social consequences as well, at least in the short-run. For example, the program may lead to greater out-of-pocket payments for selected households or communities (e.g., to pay for commuting costs), particularly in the rural areas. There may also be nontrivial

[9] See Iaroslav Baclajanschi, Lawrence Bouton, Hideki Mori, Dejan Ostojic, Taras Pushak, and Erwin R. Tiongson, "The Impact of Energy Price Changes in Moldova", World Bank Policy Research Working Paper No. 3960, July 2006.

public employment losses (and subsequent pockets of political resistance against) associated with such a program. In addition, the reform program may need to take into account variations in local capacity for managing mergers, as this may lead to increases in geographic disparities in school quality. The forthcoming Moldova Public Finance Review on the education sector calculates the fiscal savings from such a strategy, but nets out the cost of protecting the access to education services of the poorest households by subsidizing commuting costs and the cost of providing separation packages to retrenched staff.

130. *Capping budget share of expenditures on agriculture subsidies.* Government expenditures on agriculture are relatively low in Moldova compared to other countries in the region. Further, there is little or no empirical evidence indicating that subsidies for agricultural inputs such as fertilizer, irrigation operations, energy, and pesticides have benefited the poor. Indeed, the Government's restrictions on these subsidies by farm size suggest that these benefits were received by larger (i.e. wealthier) farms. The proposed operation is supporting the restructuring of agricultural expenditures by redirecting expenditures on agriculture product- and input-specific and insurance subsidies towards growth enhancing measures, including agriculture services and capital expenditures/investment. With restrictions on farm size removed, these new expenditures will likely benefit small (i.e. poorer) farmers.

B. IMPLEMENTATION, MONITORING AND EVALUATION

131. The administration of this credit will be the responsibility of the Ministry of Finance. To facilitate program implementation and the coordination of activities, the Government has appointed an Inter-ministerial Steering Committee chaired by the First Deputy Prime Minister. This Committee is composed of representatives of key Ministers. The Steering Committee will be assisted by a Technical Committee comprising high level staff from various line ministries, including the Ministries of Agriculture and Food Industries, Economy and Trade, Education, Finance, Industry and Infrastructure, Health and Social Protection, Transportation and Telecommunications, and the Moldova Customs Service.

132. A multi-donor supervision effort will be aligned with the existing government-led monitoring and evaluation system for the EGPRSP, the Moldova-EU Action Plan and the MTEF. The Steering Committee will be responsible for monitoring the PRSC program and all benchmark and outcome indicators. These benchmarks and indicators can be found in the PRSC Policy Matrix in Annex 2. The specific benchmarks and outcomes to be monitored have been drawn from the Government's overall development program, thus providing significant benefits in reducing transaction costs for the Government. The overall reform effort will be reviewed by the Government in close coordination with regular multi-donor missions to ensure continued implementation of the program within an adequate macroeconomic policy framework. Given satisfactory progress, Moldova's reform program will be supported by subsequent PRSCs under the programmatic lending framework, subject to the approval of the Board of Executive Directors.

C. FIDUCIARY ASPECTS

133. *Pubic Financial Management (PFM).* Strengthening public financial management is an important part of the public sector reform component of the EGPRSP. The PFM section of EGPRSP largely incorporates recommendations of a series of diagnostic reports (Public Economic Management Report (PEMR), Country Financial Accountability Assessment (CFAA),

Country Procurement Assessment Report (CPAR)) produced in close collaboration with the Government. The priority areas of activity under the Government PFM reform strategy include: (i) improving public resource allocation by introducing modern budget preparation practices; (ii) strengthening financial discipline by modernizing the treasury system and budget execution procedures; (iii) improving public debt management to minimize debt service costs; (iv) improving fiscal administration and increasing the effectiveness of financial controls; (v) increasing the efficiency of budget management through introduction of an integrated financial management information system; (vi) harmonizing the budget and fiscal legal framework with European Union standards.

134. The progress achieved in implementation of the strategy by the end of 2005 is captured in the PFM performance report based on the PEFA (2006) methodology through a multi-donor effort. The overall conclusion of the report is that weaknesses in the current PFM system in Moldova are mainly due to institutional capacity issues typical for a country in transition. The fiduciary risk assessment annex to the report notes that Moldova remains a high risk country but has good chances to improve its rating to "medium" risk provided ongoing reforms are implemented effectively and efficiently. The progress achieved in the main areas of PFM reforms and the remaining weaknesses are summarized below.

135. *Budgeting*. The Government has been undertaking noticeable efforts to consolidate the budget formulation process to address the PEMR and CFAA findings on its fragmentation. The Law on budgetary system and budgetary process was amended in 2004 to introduce the concept of National Public Budget[10]. The MTEF, introduced in 2002, has a three year time horizon and is updated annually on a rolling basis. It integrates with the national public budget framework approved by the Government at the inception phase of the annual budget cycle. Extra-budgetary means and extra-budgetary funds (amounting to less than 10% of Central Government budget) are integrated in the MTEF and the annual budget documentation. The PRSC supports further development of the strategic focus of the MTEF through establishment of a central policy unit to support the Cabinet of Ministers in defining medium-term policy priorities. The remaining weaknesses in the budgeting area noted in the PEFA report include the need to maintain adherence to the existing budget calendar and improve expenditure planning at the line ministry level linking it to sectoral policy priorities. Further strengthening of budget formulation methodologies is a component of the PFM project currently under implementation.

136. *Internal controls over the budget execution*. Moldova has made important progress in developing the national treasury system. Controls over budget execution have been significantly strengthened through gradual expansion of the treasury coverage that started in 1997 with the state budget only and has now expanded to include the budgets of territorial administrative units, extra budgetary funds and means, and the revenues of the social and health insurance budgets. Expenditures of the latter two budgets, as well as the donor financed contributions to investment projects, however, remain outside the treasury operations. This is an area requiring further improvement in the treasury coverage. The PEFA report identifies a number of weaknesses related to treasury operations. The proper model of the treasury single account is missing at the moment and is being developed under the PFM project, and also being monitored by the IMF under the new PRGF program. The PEFA report also points to a need for

[10] The national public budget is composed of: (i) State budget; (ii) State Social Insurance budget; (iii) budgets of administrative-territorial units; (iv) funds for compulsory insurance for medical assistance.

further improvements in cash management and forecasting. Until 2006, no regular cash forecast updates were prepared, but the practice was improved this year through introduction of monthly updates (part of the CAS high case triggers). The solution still has to be found on the mode of communication of the cash availability information to the spending units that could prevent them from creating unfunded commitments and generating arrears. Improvements are also required in monitoring of arrears, as information on the arrears' age profile is unavailable. All of the above weaknesses are being addressed under the PFM project. PEFA report also notes the relative weakness of the treasury controls over payroll expenses, which is relying primarily on integrity of accounting staff of spending units (since the payroll function is performed by each individual spending unit using either manual calculations or separate isolated IT modules, payroll lists are not reconciled with personnel data). The FMIS being designed under the PFM project envisages a pilot payroll module as a first step in addressing the weakness.

137. *Procurement*. The 2003 CPAR concluded that the public procurement system was weak and needed substantial strengthening. Single Source Tendering (SST) was happening "far too often, often in contravention of the procurement law". In 2001, it was reported that 67 percent of all contracts used SST. CPAR recommendations formed the basis for the improvements undertaken by the Government in the procurement domain in the last several years (part of the CAS high case triggers). The Public Procurement Law was amended and the Public Procurement Agency was authorized to register contracts before they can be processed by treasury, with particular attention paid to SST cases. As indicated by the PEFA report, based on the data for 2004-2005, the SST practice has been significantly reduced (SST cases accounted for 8 percent of the total number of contracts and 10 percent of their overall amount in 2005), while the percentage of contracts awarded using open tender procedure reached 22 percent of the total number of contracts and 57 percent of the overall amount in 2005. With the assistance of the Bank IDF, the new Public Procurement law was drafted (but is still to be approved) to bring Moldova closer to the international standards in this area, and capacity building activities for public procurement agency and spending units were conducted.[11] There remains, however, a concern about the sustainability of the progress achieved, related to the lack of clarity on the status of the Public Procurement Agency. Its recent merger with the Agency for Material Reserves, Public Procurement and Humanitarian Aid has created a direct conflict of interest undermining the independence of the public procurement function.[12] The PRSC program supports measures to improve public procurement through: (i) enactment of the new Public Procurement Law[13], including provisions for independent Public Procurement Agency; (ii) further decreases in the number and value of contracts under SST, and increases in the number of contracts and value of contracts awarded by open tender.

138. *Accounting and reporting*. The Government is preparing for important changes in public sector accounting and reporting in the context of the PFM project. The new integrated budget classification and chart of accounts system is being developed on the basis of the

[11] The main activities supported by IDF Grant were: (a) Creation of Agency's and spending units' capacity through TA and training: (i) training of Agency staff in English; (ii) development of training curriculum for professional procurement, to be provided in local institution; (b) Development of legislative framework in procurement according to WTO requirements; (c) Computerizing of public procurement functions, including using of internet for publishing and accessing of information related to public procurement: (i) web-site development; (ii) development of performance measurement methods; and (iii) development of national database related to performance of public procurement.

[12] This merger was part of the inception phase of the Government program of public administration reform, which started with reorganization of central government agencies and personnel cuts.

[13] Drafted with IDF assistance.

GFS2001 standards to be launched with the new FMIS. The existing budget classification, which is broadly compliant with GFS 1986, is expected to be in use at least until 2008. There is an ongoing program to replace, within the same timeframe, the multiple versions of the chart of accounts currently in use by different levels of budget entities with a unique chart of accounts compliant with cash-based IPSAS. The Ministry of Finance is also developing a strategy to introduce accounting standards for the public sector and sequence accounting reforms. It is expected that in the medium-term the Government will maintain cash-based accounting for the treasury and modified cash based accounting for the budget institutions. The new FMIS will enable the Government to produce consolidated financial statements showing financial position of the Government, and not only the budget execution reports, as is the practice at the moment.

139. *Internal auditing*. The internal auditing function of the Government is at an early stage of its development. Small internal audit units have been established in the Ministry of Finance (MOF), State Tax Service, Customs and National Social Insurance House. In addition, there is a Control and Revision Service (CRS) under the Ministry of Finance. In most cases, the CRS is performing ex-post verification of budget execution. Development of the modern internal audit function within the Government is a component of the PFM project.

140. *External auditing*. PEFA report mentions that the Court of Accounts (COA) at present is largely carrying out transactions level testing. Audit methodologies require further improvements despite introduction of a number of internal manuals and guidelines following the 2003 CFAA. Modern audit concepts were introduced into the Court of Accounts Law through 2005 amendments. PEFA report observes the need for the Parliament to pay sufficient attention to the audit reports. The current system of nominating members to the top management body of the COA does not guarantee independence and is prone to political influence in the working of the COA. The Court of Accounts has indicated its willingness to develop into a modern external audit institution along the EU counterparts. Technical assistance has been offered by the Swedish and British national audit offices to support the implementation of the COA Strategic Development Plan.

141. *PFM reforms and immediate measures needed to strengthen public financial management framework*. Weaknesses in public financial management system are well understood in Moldova and a broad PFM reform program is under way. Major assistance is already being provided by the Bank through the PFM Project, co-financed by SIDA and the Dutch Government. The PFM project is supporting improvements in: (i) budget preparation and budget execution methodologies; (ii) accounting and reporting; (iii) development of Financial Management information system and cash management; (iv) internal auditing; (v) building sustainable domestic capacity for PFM related training. In coordination with the PFM project, DFID is providing support to the strengthening of the MTEF process, and TA for the Court of Accounts is being planned by the donors. Several high priority reform measures are included in the IMF's PRGF and the proposed PRSC (as indicated in the sections above). The existing instruments already mobilized through a concerted multi-donor effort appear to be sufficient to support the critical PFM agenda. No additional fiduciary risk mitigation measures are considered necessary for the present PRCS operation.

D. DISBURSEMENT AND AUDITING

142. *Disbursement and Funds flow*. The proposed Credit, SDR 6.8 million (US$10 million equivalent), will follow the Bank's disbursement procedures for development policy lending. The Credit will be disbursed in one tranche immediately upon effectiveness and is not tied to any specific purchases and no procurement requirements will be needed. The funds will be deposited at the existing treasury USD account[14] opened by Ministry of Finance/State Treasury with the NBM, which forms part of the official foreign exchange reserves. The government will utilize the proceeds of the credit in foreign currency for crediting the local currency equivalent into the treasury single account for financing budgeted expenses. If, after depositing the Credit proceeds, the proceeds are used for ineligible purposes, the Bank will require the recipient to refund the amount directly to the Bank, in which case the Bank will cancel an equivalent un-disbursed amount of the credit.

143. *Accounts and Auditing*. The administration and accounting of the Credit proceeds will be the responsibility of the State Treasury of the Ministry of Finance. The standard country rules will be followed by treasury for administration and accounting. The Government will maintain accounts and records, or ensure that such items are maintained, showing that credit disbursements were in accordance with provision of the Financing Agreement. Such accounts and records will be maintained in a form acceptable to the Bank. The proceeds of Credit deposited at the treasury account with NBM will be used for converting into local currency to cover budget expenditures. The MOF will be responsible for the Operation's administration and for preparing the withdrawal application, maintaining the deposit account as required. The Operation will be subject to ratification by Parliament before it becomes effective. The MOF, with the assistance of the NBM, will maintain records of all transactions under the Operation in accordance with sound accounting practices. Within 30 days of the NBM being credited, the MOF will provide to the Bank a confirmation that the amount of the Operation has been credited to an account that is available to finance budgeted expenditures.

144. The IMF had conducted a Safeguards Assessment (SA) of the National Bank of Moldova (NBM) in 2002 and noted that general quality of the financial reporting at NBM is satisfactory. The Safeguard Assessment identified a few weak areas including: (i) a lack of an independent supervisory board and audit committee; (ii) weak accounting policies for calculation of distributable profit to the Government; (iii) vulnerability of NBM loans to governments becoming impaired; and, (iv) lack of properly functioning internal audit department. The NBM has made major efforts in establishing a modern internal audit department. NBM financial statements have received unqualified (clean) audit opinions from international auditors for the past three years in a row. The management letters issued by the auditors in 2004 and 2005 did not contain any significant internal control issues. In view of this, there are no additional fiduciary safeguards considered necessary as far as management of the deposit account is concerned.

E. ENVIRONMENTAL ASPECTS

145. The PRSC team has made an effort to assess and address the likelihood of significant effects of policies supported by the PRSC on the environment, natural resources, or forests including assessment of the government's systems for reducing adverse effects and

[14] Used for receiving support from donors and for making external payments.

enhancing positive effects. There are three areas of the proposed PRSC that may require further attention with respect to environmental issues. These are policy interventions aimed at implementing the following: (i) reducing the regulatory burden; (ii) removing agricultural export restrictions; (iii) passing the full cost of energy price increase to customers; and (iv) introducing cost-benefit analysis in public investment planning.

146. *Reducing the regulatory burden.* The PRSC supports ongoing efforts to reduce the regulatory and administrative costs of business regulation and promote private sector development and boost job creation. The PRSC builds on the Government's recent enactment of the "Guillotine" law mandating a comprehensive review of business executive regulations, leading to the identification of regulations that are no longer necessary or do not have legal basis. This exercise has had a limited impact on environmental regulation so far. Of the 99 regulations identified by the Guillotine process for elimination, only [four] are related to environmental regulations, most of which were found to have inadequate legal basis. As the Government moves forward and implements next stage of the regulatory reform strategy, it is not clear how the new requirement will impact the environmental licensing system, if at all. The PRSC team, along with the Competitiveness Enhancement project will monitor the likely impact, including any unintended consequences, of the next stage of the regulatory reform program.

147. *Removing agricultural export restrictions.* The PRSC is encouraging the Government to adopt a number of measures to develop agricultural markets by liberalizing agricultural exports. In principle, the increased profitability of agriculture activity may lead to the so-called "extensification" or encroachment of previously forested lands for agriculture production. It may lead to "intensification" with rising use of harmful fertilizers and pesticides leading to soil degradation, water run-off, and a general degradation of water quality with attendant health impacts.

148. On the other hand, there are offsetting developments and ongoing programs as well as institutional safeguards that mitigate potential environmental effects of "extensification." First, the Forest Code and several environmental laws in place prohibit the transfer of forest lands for agriculture production. Moreover, a number of ongoing projects financed by the World Bank are serving to mitigate the likely effects of increased agricultural activity. For example, among the components of the Bank's "Persistent Organic Pollutants (POPS) Stockpiles Management and Destruction Project" are those aimed at institutional strengthening, the modernization of current legislation (i.e., those related to the Stockholm Convention), and the introduction of broader chemical safety approach in the country consistent with European Union legislation. The project also has a special activity under Component 2 (Prevention of new Stockpiles of Obsolete Pesticides) that aims to provide support in promoting best practices in Pest Management in crop production, including Integrated Pest Management. Furthermore, the "Renewable Energy from Agricultural Wastes GEF Project" is promoting the use of biomass for heat—in place of fossil fuel—through the efficient use of primary agricultural wastes. The project aims to demonstrate (by installing demonstration biomass units technologies used in neighboring countries) practical and efficient use of agricultural wastes, such as cereal wastes, typically burned on the field. Furthermore, the GEF "Agricultural Pollution Control Project" is expanding the use of environmentally-friendly agricultural practices by farmers and agricultural enterprises to reduce nutrient discharge from agricultural sources to the Danube River and Black Sea. Between 1990 and 2002, Moldova also experienced modest rates of reforestation (about 600-700 ha annually) Between 2002 to 2006 it has also afforested by about 7,000 hectares

annually, thus extending the forest cover by about 35,000 hectares. Moreover, the program managed by the WB PCF's "Soil Conservation Project" is aimed at helping restore to productive use some 20,000 hectares of degraded agricultural lands.

149. *Raising energy tariffs*. The World Bank is recommending an increase in domestic gas tariff in response to the recent increase in the price of imported natural gas and to pass the full cost of the increase to consumers. This measure, by allowing energy prices to reflect their real cost, is aimed at encouraging consumers to save energy and use energy more efficiently. In the short-run, however, such price increases are likely to have distributional effects. The rising cost of energy may have substantial health and environmental consequences, as households consume cheaper, and often dirtier, sources of fuel. For example, the elevated use of dirty fuels may degrade air quality and pollution may in turn lead to the deterioration of population health. Moreover, widespread burning of wood promotes deforestation. It may then contribute to the loss of critical environmental functions provided by forests and trees.

150. The World Bank is supporting two measures aimed at mitigating the likely environmental effects of households switching to dirty fuel. First, the World Bank is encouraging the Government to improve the targeting of energy subsidies to shield the poorest households, the same households more likely to switch energy sources, from the impact of rising energy costs. Second, a number of ongoing projects supported by the Community Carbon Development Fund managed by the World Bank are promoting energy conservation (Energy Conservation & Emissions Reduction) and the development of less expensive, and cleaner, heating systems involving some 240 communities (Biomass Heating in Rural Communities Project).

151. *Introducing cost-benefit analysis in public investment planning.* The PRSC is strengthening the capacity to carry out public investment planning by gradually introducing cost-benefit accounting. While major infrastructure investments may indeed have environmental impacts, the rationale for introducing economic analysis to the planning process and into environment impact assessment procedure is to assess the broader costs of any major public investment, including its longer-term environmental costs.

F. RISKS

152. The risks for this operation include (i) fiduciary risks; (ii) implementation capacity at the central and decentralized level; (iii) external shocks; and (iv) political economy risks.

153. *Fiduciary risks remain high and should be monitored.* The Government's continued efforts to strengthen public financial management and procurement systems are reducing fiduciary risks with regard to the use of public funds, but they remain high. To mitigate the risk, the Government must continue to push forward on implementing the recommendations and reform measures outlined in the most recent CPAR, CFAA, Public Finance Review (PFR) and PEFA. The PRSC program, as well as the Bank's and donor's work in these areas, is providing assistance to the Government in this endeavor.

154. *Implementation Capacity is a medium risk.* The Government has limited institutional capacity which could delay the implementation of the reforms. For instance, should PRSC resources be used to finance higher capital spending, as indicated by the Government, most line ministries have limited capacity for the systematic selection and appraisal of projects,

implementation, and evaluation. This may lead to the sub-optimal allocation of budgetary resources. To mitigate these risks, all the reform areas benefit from Bank and donor-supported TA and capacity building programs or investment operations (see Box 2).

155. *Destabilizing external shocks are a high risk.* Moldova and Russian state oil firm Gazprom may reach an agreement to increase Moldova's gas prices to European levels of $110/mcm in early 2006, up from $80/mcm in the previous three years. Negotiations with Gazprom would lead to still higher gas prices (up to $160/mcm in 2006 and potentially higher in the coming years). As noted in the PSIA section, the increase in natural gas prices may have significant poverty and fiscal implications. In particular, this raises the cost of energy consumed by households and enterprises. The burden of the price increase may fall disproportionately on the poor and on households with limited alternative sources of fuel. The price increase also creates two sources of budgetary pressures. First, it raises the cost of energy procured by government. Second, it leads to pressures for increased energy subsidies and transfers limiting resources available for investment spending. Under this operation, the Bank is promoting reforms to improve the efficiency of the energy sector. The Bank, along with the IMF and other donors, has some flexibility in the amount of PRSC financing to respond, if needed, to external shocks.

156. *Political economy risk may delay key elements of the program.* Moldova's past uneven commitment to policy reform creates some uncertainty that the Government will implement some of the more politically challenging reform items on the EGPRSP agenda and that a stop-and-go cycle for reform may once again emerge. However, recent progress on implementing the reforms underlying the high case triggers, and a visible political commitment to the EGPRSP and EU-Moldova action plan give some comfort that the reform agenda laid out in those strategies will be pursued. In addition, the EGPRSP participation process has created a strong national consensus for the reform program. Similarly, Moldova's EU aspirations are widely shared among the population.

157. The close linkage between the PRSC-supported reform agenda and substantial donor assistance (DFID, SIDA, the Netherlands and EU) planned for Moldova is a mitigating factor. The Government has also prepared the Letter of Development Policy, spelling out its own reform agenda (see Annex 1). In a number of sectors where the resistance to reform by vested interest is expected to be strong, such as agriculture, road maintenance contracting, social assistance, and pensions, the operation is bolstered by coordinated donor advocacy for trade and Private Sector Development reform, proposed Bank and donor projects (i.e. road rehabilitation), and the government's own champions of pension and social assistance reform.

ANNEX 1

GUVERNUL
REPUBLICII MOLDOVA

GOVERNMENT OF THE
REPUBLIC OF MOLDOVA

Nr. 2606-132 Chişinău 19 septembrie 2006

LETTER OF DEVELOPMENT POLICY

Mr. Paul Wolfowitz
President
The World Bank
1818 H Street, N.W.
Washington DC, 20433

Moldova's Reform Program for Economic Growth and Poverty Reduction

Dear Mr. Wolfowitz:

The Economic Growth and Poverty Reduction Strategy (EGPRSP) represents the supreme policy framework for a medium term sustainable development of the Republic of Moldova and the achievement of the Millennium Development Goals (MDGs). The strategy sets out objectives and priorities, achievement of which is feasible in a medium term, but is also necessary to fulfill global long term objectives that come out of provisions of the Government's Plan of Activities "Revival of the Economy– Country Revival," the European Union – Republic of Moldova Plan of Actions, and correspond to standards and practices generally accepted nationally, as well as internationally.

These objectives are:
i) sustainable and socially oriented development;
ii) country reintegration;
iii) European integration.

In order to achieve long term development objectives in a dynamic and efficient manner the Government will direct its medium term efforts towards fulfilling the following goals:

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i) sustainable and comprehensive economic growth;
ii) poverty and reduction in inequality, extending participation of poor in the development of the economy; and,
iii) human resource development.

The poverty reduction support credit aims to support the Government in the implementation of the EGPRSP. Given that EGPRSP and the European Union – Moldova Action Plan are in the final implementation phase, the Government intends to revise and adjust both of these strategic documents. The current EGPRSP will be extended to 2007 by updating the policy matrix/action plan and estimate costs. At the same time, the Government will initiate work to update and extend the EGPRSP together with the programming process under the EU-Action Plan for 2008-2010 period.

A. BACKGROUND

I. Poverty Profile and Poverty Trends

Since 2001, the Republic of Moldova has seen important progress in ensuring and maintaining a strong economic growth. The GDP increased by more than 30 percent, while the rate of absolute poverty fell by 41 percent, reaching the level of 29 percent in 2005. Nevertheless, GDP per capita remains low, and living standards are far inferior to those in the European Union. Poverty and a lack of competitive employment opportunities have triggered massive labor migration, and this phenomenon has given rise to new social and macroeconomic problems. Remittances, estimated at about 30 percent of GDP, stimulate consumption but at the same time complicate the conduct of monetary and foreign exchange policy. Migration also serves to erode the tax base.

However, despite all efforts made within the program of general reforms, Moldova remains, by any standard, to be a poor country, is positioned on the 113th place out of 177 countries, according to the 2004 Human Development Report, having a Human Development Index (HDI) at 0.681 (data from 2002).

The poverty profile of Moldova is conditioned by economic, but also partially demographic factors, including: (i) low productivity of labor in the farm sector; (ii) insufficient development of regional economies; (iii) a growing number of persons supported by the active population (i.e. pensioners); (iv) low levels of pensions and social allowances; and, (v) significant differentiation of wages among various sectors of the economy. In 2005, poverty is also spread out unevenly with the highest poverty incidence being in small towns (48.5%), while poverty in rural areas is slightly lower (42.5%). Poverty in big cities is the lowest (14.7%).

Poverty kept on falling in urban centers, but in the rural areas, where 63% of the country's population lives, it grew during 2004 and 2005. The high poverty incidence in rural areas is determined by stalled farm restructuring and lack of progress in "individualization" of agriculture, inadequate public support for the emerging class of family farmers, the difference in prices for farm and non-farm products that ensued from the liberalization of prices, the relatively low productivity of labor and small incomes of persons employed in agriculture.

II. Source of Economic Growth

The revival of the national economy has been accompanied by an exacerbation of the disequilibrium between the size of internal demand and the volume of production. The growth rate of final consumption in the 2000-2002 period was twice as large as the GDP growth rate. As a result, the size of final consumption for each of these years exceeded the GDP by 1-3 percentage points. The main factor responsible for the rapid growth in consumption has been the growth in household consumption resulting from an increase in the sizes of pensions, salaries, allowances and compensations, as well as the massive in flux of remittances.

Although the net effect on the GDP – growth of imports counterbalanced by higher growth of consumption – was still positive, the sustainability of such model is questionable. Therefore, the challenge is to evolve to an investment-led growth model.

Growth rates and the results of economic development will depend to a great extent on the environment surrounding enterprise and investment activities, both at national, as well as local levels. For the medium term, the Government will undertake measures to improve substantially the investment and business climates by promoting a stable, transparent and efficient regulatory policy, by developing competition and supporting small and medium businesses. This will mobilize the economy's investment potential, made up of remittance accumulations, resources of the banking sector and the shadow economy, concessional official development assistance, as well as foreign direct investment.

In order to change the paradigm and quality of growth, it is necessary to mobilize new resources and factors of growth, by attracting a considerable volume of investments, first of all in the processing industry and in infrastructure, so as to diversify the economy and replace labor force export with export of service and merchandise.

III. Creating Fiscal Space

Public investment in Moldova is low. In order to increase public investment, without undermining macroeconomic stability or increasing the already large share of Government expenditures as a percent of GDP, fiscal policy will need to remain tight. The Budget will need to focus on ensuring efficiency of public expenditures, as well as on redistributing existing resources from programs of smaller importance to priority programs that have a substantial impact on economic growth and poverty reduction. Resources will be allocated among sectors based on an analysis of sector expenditure programs, taking into account factors of strategic influence over the development of sectors, as well as possibilities to streamline expenditures in some sectors identified within the medium term expenditure framework.

IV. Sound Macroeconomic Framework

Fiscal Policy

Over the last years few years, fiscal policy has remained tight. In 2005, the surplus of the general government grew to about 1.6 percentage points of GDP, due to additional revenues, and the necessity to accumulate resources on a special account aimed at reducing arrears on external debt to Paris Club creditors. Starting from 2005 the Government also accumulated sufficient resources to start to repaying credits previously received from the National Bank of Moldova (payments in the amount of Lei 127 million, or 0.3 percent of GDP, were made in 2005).

The budgetary process has been improved as a result of the implementation of our Medium-Term Expenditure Framework (MTEF), and by preparing estimates of the national public budget, including the state budget and local government budgets, the state social insurance budget and the compulsory medical insurance budget, as well as special funds. In order to broaden the tax base, VAT exemptions have been eliminated on agriculture, as well as on the import and supply of pesticides and fertilizers, equipment, technology and complimentary parts. The VAT rate on medicines has been increased from zero to 8 percent.

External Debt Policy

In the absence of external financing for the budget, external debt service became a serious burden for the budget, reaching 40 percent of the total state budget revenues (2001). Throughout 2003-05, the general government reported primary surpluses of about 2½ percent of GDP, and Moldova's external debt indicators improved significantly. Robust economic growth over this period as well as prudent limits on external borrowing allowed the Government to reduce the ratio of public and publicly-guaranteed debt from 79 percent of GDP in 2000 to about 33 percent of GDP in 2005.

Paris Club creditors agreed on 12 May 2006 with the Government of Moldova to a restructuring of its external debt in accordance with the so-called "Houston Terms". This agreement followed the International Monetary Fund's approval of Moldova's arrangement under the Poverty Reduction and Growth Facility on 5 May 2006 in support of the Government's ambitious reform program. As a result of this restructuring, expenditures aimed towards external debt service before the Paris Club throughout the implementation of the program signed with IMF fell from $149.9 million to $60 million, thus contributing towards a better economic outlook and providing additional fiscal space for the reform agenda.

Monetary and Exchange Rate Policy

The key challenge of monetary policy during 2005 was managing the pressure of foreign currency inflows. These inflows were mainly associated with remittances sent by Moldovan workers from abroad, which put considerable pressure on the level of inflation and the exchange rate. During most of 2005 there was upward pressure on the leu, and it took considerable effort on the part of the NBM to bring inflation back down from near 15 percent in the first part of the year to 10 percent by end-year. This was achieved despite strong growth in energy sector prices. With energy prices continuing to rise in 2006 inflation pressures are expected to mount.

The NBM proposed an amendment to its main law by moving towards inflation targeting and away from the dual objective of prices as well as exchange rates. This reinforces the floating exchange rate regime, by which the NBM intervenes only to smooth out excessive volatility in the exchange rate. During 2005 the real effective exchange rate of the leu registered an appreciation of 2.4 percentage points, relative to December 2004. Reserves grew by almost $130 million in 2005, reaching 2.2 months of prospective imports at end-December.

At the same time, Moldova's external vulnerability continued to grow. Largely owing to the external shocks coming from higher energy prices as well as the recent wine exports ban from the Russian Federation, the trade balance deteriorated by almost 9 percentage points of GDP in 2005 and continued to worsen into the first half of 2006. This calls for an urgent diversification of Moldova's export markets which remain limited at the moment, reflecting continued dependence on traditional CIS markets. In 2005 the CIS absorbed about 51 percent of total Moldovan exports (compared to only about 30 percent went to EU markets) out of which the wine exports to Russian Federation accounted for almost a quarter.

B. KEY PILLARS OF THE PROGRAM

I. GENERAL STATEMENT

The economic growth from past years occurred in the background of a slow economic restructuring, of a fall in the rate of industry growth, especially of the processing sector. Rise in the final consumption and the gross capital accumulation is determined to a great extent by the flux of incomes coming from citizens of the Republic of Moldova working abroad and partially by the increase in salaries. Given these conditions in the situation of low level of investments, vulnerability to external factors, the outlook of a sustainable growth and poverty reduction may become uncertain if urgent actions are not undertaken to redress the situation. These actions would include among other: (i) actual optimization of the business climate; (ii) improvement in the management of state assets, and (iii) promotion of the public-private partnership.

The low level of public expenditures targeted towards financing capital investments inhibits opportunities for a future economic growth. In this context, it is necessary to establish a tax regime that will allow for the generation of resources that will be targeted towards public investments.

The results following the implementations of several programs of social assistance are rather insufficient, especially given an inefficient allocation of public resources. The lack of financial resources makes it impossible to satisfy the demand for social services, thereby causing an expensive widely covering institutional support. The government is aware that the present system for social assistance needs revision, so that the poorest parts of the population are protected and concomitantly, a fiscal sustainability of the system is ensured.

Starting with the motivation to adopt important and radical changes, the Government undertook the management and implementation roles, with support from the poverty reduction support credit, in the realization of a program based on the following major pillars:

(a) improving the investment climate;
(b) improving the efficiency and management of public sector resources and
(c) strengthening social protection systems.

I. Improving the investment climate

For the medium term development period, the main target is to ensure significant improvement of the investment climate so as to create accelerated growth opportunities of private internal and external investments. The major objectives of the state policy in this area are macroeconomic stability and the promotion public sector reform including that of the regulatory framework.

Along with the main objectives of the general policy, it is envisioned that other medium term tasks will also be accomplished towards improving the investment climate, such as: (i) improvement of the legislation to protect the rights of investors and creditors; (ii) limit the barriers to investment activities; and, (iii) improve the incentive-based tax regime for local and foreign investors.

An important element in the improvement of the investment climates resides in the fight against corruption. As a rule, enterprise activities are most affected by corruption. It is recognized that corruption is very expensive for entrepreneurs. To a large extend, corruption affects economic agents in the process of obtaining licenses and when undergoing various inspections. The poor population from the rural area is also affected as such, especially the population running commercial activity. The Government believes that eradication of corruption is a crucial condition for ensuring the continuation in economic growth and poverty reduction. The Government approved a set of legislative and normative documents aimed to provide a legal framework which would prevent and fight against corruption. An extensive list of anti-corruption measures is envisaged in the National Strategy of prevention and fighting of corruption and in the action plan for the implementation of this strategy. Objectives of this strategy are correlated with actions, which are intended to be implemented by the Government within Threshold Program to meet eligibility conditions for "Millenium Challenge Corporation" fund.

A. Regulatory framework reform

Regulatory reform - which was initiated by the Government in 2004 and continued throughout the year 2005 - aims to create open, flexible, and low-cost business opportunities in order to promote investments and business innovations. Only such conditions can offer the possibility for the Moldovan economy to rapidly adjust to new market risks and opportunities, and thus the possibility to ensure competitiveness of the local production.

This reform, which represents a complex and a long-term effort, presumes two major phases: (i) deregulation and streamlining, and (ii) consolidation of capacities for good regulation within Government institutions. During the years 2004-2005, some actions were undertaken for the first phase, namely: (a) simplification and centralization of the licensing procedures, (b) optimization of the registration procedure, (c) diminution of conflicts of interest between inspectors and the function of checking conferred to control agents. The Law on the revision and streamlining of the normative framework regulating enterprise activity (the regulatory guillotine) was drafted and implemented, which led to a significant reduction in the number of normative acts regulating enterprise

activity, as well as for the reduction in costs surrounding authorization documents.

The Law on Basic Principles and Mechanism for Enterprise Activity Regulation was adopted by the Parliament. This starts the next new phase of reform, representing a higher level of revision of legislation, namely revision of laws and decisions of the Parliament.

Regulatory reforms provide necessary but not sufficient conditions for establishment of more competitive enterprise sector in the Republic of Moldova. Global markets have become increasingly stringent in terms of product quality and performance. Conformity with international standards such as IS0 9000 has become a de facto requirement for external 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.

WTO membership and the EU/Moldova Action Plan, which underlines European integration, placed strong accent on the necessity of upgrading the MSTQ system. The Government started developing a three-fold strategy focusing on: (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), (iii) promoting use of MSTQ services by enterprises to improve quality and conformity with international standards; and (iv) development of capacity with regard to supervision of production quality and consumer protection in line with the European Union practices. Significant improvements in the legal MSTQ framework have already taken place, with a number of important laws adopted.

B.Improving trade facilitation

Improvement of the investment climate also involves simplification and streamlining of procedures for border crossing and Customs clearance. That includes reduction in the number of documentary and physical controls, which can lead to better export competitiveness, attraction of foreign investment and better integration in the global economy. With support from Trade and Transport Facilitation in Southeast-Europe project, the Customs Service of the Republic of Moldova has already made important steps towards reducing clearance time and promoting trade.

In this context, starting from January 2006 the Customs Service initiated the implementation of risk analysis and selectivity, with the goal to improve results and efficiency of clearance procedures. The system will be augmented by the

introduction of post release audit. That is expected to lead to simplified and rationalized Customs procedures while increasing the detection of irregularities and thus compliance on equal conditions by the business community. The whole process will enable the Customs Service to reduce the frequency of physical inspection of imported goods and substantially reduce import clearance time.

In April 2006, the Risk Analysis Unit within Customs Service started to introduce into the selectivity module of the Automated System for Customs Data (ASYCUDA) World Informational System the first risk criteria that were established following various analysis and studies performed. The Customs System switched to selectivity during the process of Customs clearance. All external economic transactions are examined through ASYCUDA World to evaluate the risk factors and possible impact on the economy.

Development of a sustainable reporting system will be an important element in the monitoring of performance at border crossings and during Customs clearance. The Customs Service plans to implement a "single window stop" principle for document processing both at border crossings and at the inland clearance terminals.

The implementation of the "single window stop" principle was initiated by the Customs Service at its main terminal of Chişinău, starting from April 2006. This involves submission of Customs documentation at the entry/ reception points and their return at the moment of merchandise physical control; that eliminates contact of the Customs officer with the economic agent, and thus reduces in frequency of corruption.

Elimination of duplication of procedures, by reducing the number of agencies present at border crossing points, will also contribute to greater efficiency and improved trade facilitation. The performance indicator of the ongoing project of Trade and Transport Facilitation in the Southeast Europe is reduction of the average time needed for import clearance as well as for the border crossing entry time to 30 minutes.

C.Development of agricultural markets

The largest real sector of the national economy, which is also directly dependent on the investment climate, is agriculture. This sector has an important role to play both in poverty reduction - because it is the main occupation of a large part of the population on the poverty threshold, but also because it serves as an important source for industry development and export growth.

The growth rate of the agricultural sector remains modest. During 2001-2005 the volume of agricultural production only increased by 16 percent. Agriculture remains the sector yielding the lowest productivity and labor remuneration

indicators. Contributing with 18% to GDP (nearly 30% when agroprocessing is included) and offering jobs to about 45% of the labor force, the low productivity and insignificant growth rates in the agricultural sector have negative implications for the growth perspectives for the economy. The poverty rate is highest among farmers and farm workers (at the level of 45-50% in 2005), which despite some improvements in earlier years, started growing again in 2003. The recent poverty estimates for the Republic of Moldova clearly shows that the poverty rate among farmers and farm workers has increased in last two years (2003-2005) by at least 12 percentage points.

The Government is committed to promoting sustainable economic growth, in the agricultural sector in particular, by enhancing sector competitiveness and encouraging private initiatives and investments. The Government reconfirms its commitment to implement sound agricultural policies and support all types of farm structures that exhibit efficiency and productivity enhancements towards developing a competitive and profitable agricultural and rural economy, operating on market principles.

These market principles include no minimum prices or fixed prices of any kind; no designated buyers; no export restrictions; no licensing requirements for import or export; no determination of land to be planted under particular crops or production levels to be achieved; and no government institutions assigned to administer the production or processing of any crop.

The Government recognizes the Land Code as a fundamental piece of legislation framing land relations in the country, and reaffirms its commitment to respect a land code that adheres to market-oriented principles, namely that it: (a) clearly defines and protects landowners' rights; (b) provides for the enforcement of real property rights through efficient institutions and effective courts; (c) facilitates and supports secure transactions of property rights, backed by formal contract procedures, and provides a court system that settles any disputes in a timely manner; (d) provides for property rights information to be available to all persons who request it; (e) puts restrictions on transactions only under exceptional circumstances in conformity with existing legislation; (f) facilitates registration and transactions at low cost with minimum fees and taxes in the shortest possible time after application; and (g) protects land as a resource on environmental and health grounds.

One of the main challenges facing the sector is the problem of low producer prices. A critical step needed to address this problem is increased market access for producers and enhanced competitiveness of the sector. In the context of agricultural export liberalization, the Government has canceled the legal requirement regarding the export of grains taking place exclusively through the Universal Commodity Exchange. This requirement not only places a constraint on cereal exports, but also favors the big players on the domestic cereal market,

thus reducing the competition and pushing down the producer prices. A Decision, No. 946, removing this compulsory requirement was adopted by the Government on 18th of August 2006. It is expected that this action will contribute to reducing the gap between the domestic producer prices and the international parity prices for cereals and oilseeds by at least 25% by 2009 (as measured by the 2006 Nominal Rate of Protection (NRP) compared to the 2005 NRP). To explore this issue further, the Government, in consultation with the World Bank, has developed the terms of reference for a study on improving the stabilization of cereal prices on the domestic market.

The Government assumed the responsibility to implement an Action Plan (to follow the approval of the Agricultural Strategy for the period 2006-2015) that would include, inter alia, (i) liberalization of the import regime for seeds and seedlings, (ii) improving certification and standardization system for agricultural products, and (iii) development and dissemination of a Market Information System to inform farm producers on a regular basis about market opportunities and trends, both domestically and in major regional markets (such as Romania and Odessa). The Government believes that these three issues are of major importance for the future development and efficient functioning of agricultural markets in Moldova, as well as for the creation of a competitive and profitable production sector.

Moldova farmers pay more for inputs relative international markets. Liberalization of these markets is a Government priority. Specifically, the Government is committed to undertaking a set of measures for the liberalization of the present import regime for seeds and seedlings and plant materials, by improving and streamlining the national regulatory system for the registration of new varieties, acknowledging the fact that a free and quick access of Moldovan farmers to new advanced technologies is a precondition for the domestic agricultural products to achieve a higher competitiveness on global markets. Following the implementation of these agreed measures aimed at liberalization of the seed market, it is expected that the number of newly registered varieties in the Republic of Moldova will increase in the next years (until 2009) by at least 25%.

Over the long term, the Government will work towards adopting the EU registry of plant varieties to enable its farmers to have access to the best available international technology that is embodies in these varieties. In the meantime, farmers access to the best international technologies should be enhanced by a reform of the Moldovan plant variety registration system involving a significant reduction in the evaluation period; a reform of the composition of the National Council to exclude interested parties from membership; and by the establishments of an independent appeals mechanism for rejected applications.

The Government acknowledges the importance of harmonizing national legislation with European and international standards, especially given the

current critical need to enter new markets that are more stable and more secure than the traditional ones. This will also require changes in institutions and approaches, as well as significant investment. Towards this end, the Government has already begun the implementation of the National Program for the development of technical regulations. The Ministry of Agriculture and Food Industry (MAFI), as the party responsible for developing the 31 Technical Regulations related to agricultural and food products, has managed to approve so far 12 of those, the remaining 19 to be drafted and approved by the end of 2006.

Credit is an essential input to agricultural production, and it is currently a major constraint for farmers. The Government has been working with the World Bank through the Rural Investment and Services Projects (RISP I and II) to increase farmers' access to credit by supported rural Savings and Credit Associations (SCAs). These SCAs - covering more than 530 associations and 96 thousand members – can contribute to the sector's future growth and development. Further, SCAs give access to financial services for a large part of the population, which do not have access to traditional services of the banking sector. Despite the accomplishments obtained, the system of associations faces a series of important challenges, such as a great number of small associations, an unsustainable support system, and an outdated legal framework. The rapid growth in the size of member deposits and the inefficient supervision of association activities also represent major challenges for the system. To ensure the long-term sustainability of the SCAs, it will be necessary to improve the legal and regulatory environment for their supervision. The Government, therefore, will soon finalize the draft law on savings and loan association, based on the most successful international practices. Establishment of a new legal, regulatory and supervisory framework will ensure a favorable environment for a prudent and sustainable growth of the system of associations, will contribute to the development of business, and thus to a rise in incomes and poverty reduction, especially in the rural areas.

D.Reducing energy vulnerability

Reducing the vulnerability of Moldova to external energy price shock is a serious challenge facing the Government. Rising energy prices, particularly the increase in the price of natural gas, have reemphasized the need improve energy efficiency and to diversify types of energy and sources of energy supply to Moldova. Without improvements in energy efficiency and diversification of energy supplies, the rising energy prices may have a significant negative impact on the already low level of competitiveness of local production, as well as the living conditions of the population.

The Government recognizes that a sound tariff policy is key for the improvement of energy efficiency and the diversification of energy supplies. Therefore, the Government will help ensure that tariffs for natural gas, electricity and heat are

gradually adjusted to the full cost recovery level for all categories of consumers. It will also help ensure that cash collection ratios are maintained above 90% for natural gas and above 95% for electricity. If successfully implemented, these measures would help attract investments in energy efficiency projects in the public and the private sector causing the reduction of energy intensity of economy. The tariff policy will be also a cornerstone of an energy efficiency program which the Government will develop and implement to help improve financial viability of energy enterprises, including Termocom.

The Government will revise the existent legal and regulating framework, to the aim of adopting and implementing an Action Plan for ensuring legal conformity of gas and power markets in Moldova with norms established by the Energy Community of the South-Eastern Europe. In addition, focus will also be placed on drafting new normative acts in non-regulated areas – thermal energy, renewable energy sources, and adoption of the National Program for capitalizing renewable energy sources by the year 2010.

II. Increasing efficiency and improving management of public sector resources

The general objectives of the medium and long term tax policy is based on the following principles: (i) to ensure stability and predictability of public revenues; (ii) to ensure fiscal equity; (iii) to stimulate economic activity by rationalizing the system of tax incentives, so as to preserve those incentives that are targeted towards supporting economic growth and poverty reduction.

At the same time, the conclusion of the evaluation of public expenditures and financial responsibility shows that the relationship between actual expenditures and the budget is sound, as a result of the revenue surplus following the positive economic evolution and improvement in the tax administration. In general, the control and monitoring of the budget execution are good and are accompanied by well-established procedures. At the same time, we are aware that Moldova's system of internal control and audit no longer meets the requirements of effective financial management at the organizational level. The Government plans to establish a system of internal control and audit compatible with EU requirements for Public Financial Internal Control framework. Although the system of public procurement is improving, the need for improving awareness, practice, and enforcement of procurement legislation is significant.

Improving access of the population, first of all of the poor, to basic medical services through primary medicine development, to qualitative educational services, consolidation of the financial stability in the social insurance system, as well as streamlining of the social service delivery system by targeting these services towards the most poor, represent the main challenges facing the Government in the upcoming medium term. The policies proposed through the

credit for poverty reduction are aimed to improve efficiency and resource management in the public sector.

The Republic of Moldova has undergone major and radical changes over the transition period which, along with integration into international structures, demand that the public administration in general and the Government in particular adapts to new requirements. The Government has assumed the leadership in implementing a reform of the central public administration as one of its priorities. This reform will contribute to increasing the country's international competitiveness by establishing an efficient administration, capable of attaining policy objectives adopted by the country's leadership.

A. Meritocratic civil service

The objective of the reform that started off in the second half of 2005 is to establish a modern and efficient system of central public administration, in accord with the European Union's principles of good governance. The reform implies the transformation and modernization Moldova's public administration through the reorganization of the central public administration, optimization of the decision-making process, and establishment of a professional civil service.

The Concept of the Public Service Personnel Policy, approved by Parliament (resolution No.1227-XV of July 18 2002) envisages introduction a competitive, merit-based system for staff recruitment and selection in the civil service. This would ensure objectivity and transparency in the hiring of personnel in public autorities which, in turn, would lead to better professionalism. These objectives have not lost their importance today and the Government is fully committed to the implementation of the stated objectives. In the context of the mentioned Concept, the Government approved a Regulation which establishes the manner in which contests to select candidates for vacant civil service positions are organized and held, as well as the method of conflict resolution in the respective area. In the absence of effective enforcement of merit principles, the adherence to this Resolution still gives concerns to the Government.

To ensure that civil servants are competitively selected the Government, based on the results of the functional review of the Governmental Apparatus, will set up a civil service management structure, responsible for the implementation and monitoring of the civil service reform.

In order to create a professional group of permanent civil servants that would be responsible, accountable, impartial, efficient, and accessible by citizens, the following objectives are to be accomplished:

- designing a new system of classification and grading of civil service positions;
- strengthening the central coordination of human resources management;

- improving a system of financial and non-financial incentives for civil servants.

To achieve the mentioned objectives, the Implementation Plan for the Strategy for Central Public Administration Reform (SCPUR) provides for a series of actions to be realized over 2006-2008. One of these actions provides for the drafting in the second half of 2006 of the Law on Civil Service and Statute of Civil Servants. The draft law will, among other issues, include provisions regulating hiring for public service and merit-based promotion of civil servants. After the adoption of the respective law, the Government will design, adopt and implement new legislative provisions regulating human resources in the civil service.

B. Implementing a transparent and uniform remuneration system for civil servants

The Government has already taken some measures to the conditions of civil service remuneration, as well as of persons responsible for technical maintenance of public authorities. The base salary levels were raised (the share of the base salary in the total salary increased from 22% to 55%), while several increases and supplements were reduced or annulled altogether.

The process aimed to improve the incentive-yielding system for civil servants will continue throughout the next two years. In the first semester of 2007 especially, a system for civil service remuneration will be drafted, which will consolidate the existing allowances and supplements into the base salary in line with the new classification and gradation of civil servants. The variable part of the monthly salary shall be comprised of performance bonuses.

C. Improving the Strategic Allocation of Public Resources

The preparation of the MTEF in Moldova as a tool for medium-term strategic planning during the last five years underpinned the reform of methods and procedures regulating budgetary planning. The budgetary legislation was amended to ensure that the MTEF is an indispensable part of the budgetary cycle. The MTEF serves as a strategic framework for the national budget and facilitates the process of preparation and examination of the annual budget. The implementation of MTEF has increased transparency and improved understanding of the budgetary process within the Government and the civil society.

The MTEF for 2007-2009 is based on an analysis of sectoral expenditure programs. It provides for a better correlation between sectoral policy priorities - stipulated in the EGPRSP and other srategic documents - and process of resource allocation. It was also based on a detailed analysis of expenditure programs,

including strategic expenditure planning in four pilot sectors: education, health protecton, social assistance and the farm sector, which, given the set out objectives, determine the reform actions within the programs, with implication on budgetary management and performance indicators in the respective areas.

The MTEF includes a technical note on the analysis of public investment expenditures, as well as related medium-term priorities. In infrastructure sectors, the priority will be given to the sectors with greater social and economic impact. For the following three years, the priority sectors for investment will be road and transport infrastructure, the energy network, water supply and sewerage. These areas are considered of priority in the context of Moldova's integration with European structures as well.

The Government will establish a unit for strategic planning within the Government Apparatus, which will be responsible for advising the Government on medium-term policy priorities and for the methodological coordination of strategic planning units in pilot-ministries. The MTEF for 2008-2010 will reflect a cost-benefit analysis of major investment projects with internal financing for two sectors of the national economy. Starting with the MTEF for 2009-2011, the Government, following a proposal by the strategic planning unit, will adopt an annual resolution, which will set out priority sectors within medium-term expenditure policies.

D. Agricultural Spending

The Government recognizes the need to re-think and streamline the agricultural spending, since the current system has showed to exhibit a number of weaknesses and shortcomings. Thus, within the current system the small farmers, which have proved over the years more productive than the large ones, often lack state financial support. In addition, most government programs are targeted at product- and input-specific subsidies, which have a short-sighted effect and do not promote sector growth. Therefore, the Government is committed to re-direct agricultural expenditures towards growth- and productivity-enhancing activities and long-term capacity improvements. The need to create incentives to restructure agricultural enterprises, and promote the individualization of agriculture and better use of resources is also on the Government's agenda.

The Government recognizes that practices involving cancellation or accumulation of farm debts are counter-productive and do not stimulate financial discipline. For this reason, the Government will undertake the necessary measures to exclude such subsidies starting next year (2007). Exceptions to the general rule will be made only for old debt of those state farms that undertake privatization and restructuring will be taken on a case by case basis.

The Government is aware that the development of agricultural services (including extension, training, education, research, marketing, infrastructure

services, such as wholesale markets, cooling storages, packaging units, etc.) plays an important role in competitiveness enhancement process of the farm sector. The second component of agricultural expenditures, called subsidies, will be reduced year by year: in 2007 the share of subsidies will drop by 3 percentage points, and in 2008-2009 by 5 percentage points of total agricultural expenditures.

Subsidies are, in turn, divided in two categories: recurrent subsidies (amounts allocated to specific agricultural products/inputs) and investment subsidies (plantation of vineyards, orchards). Within the limit set for subsidies (as a share of total agricultural expenditures), the investment component will increase, while the recurrent one will reduce with the objective of reaching the ratio of 90%/10% by the year 2009, the biggest part pertaining to investment subsidies.

The Government agrees that setting equal rules of the game within the state supported schemes is an absolutely necessary condition allowing establishing equal opportunities for all producers – regardless of the farm ownership structure, legal form or size of the enterprise/farm - and eliminating inefficiency-yielding distortions within the sector. This objective will serve as a basic principle in the development of any future state-supported program in agriculture. In addition, the eligibility criteria that are currently in place for various state support programs will be revised towards eliminating/amending the provisions that allow for a subjective approach or non-transparent procedures for public resource allocation.

At the moment, a thorough assessment of the existing research, training and education system is required. In this context, a separate study will be carried out to investigate this important topic, and the help of the WB in the field of international benchmarking will be particularly useful. In addition, the Government will carry out an evaluation of the anti-hail rocket system currently applied in Moldova, and based on the cost-benefit analysis will decide on the continuation/termination of the current system. The study will also contemplate some alternative system(s) suitable for the Republic of Moldova.

E. Transport Infrastructure

According to the agenda of EGPRSP objectives for the year 2004-2006, the reform of road transport infrastructure includes the implementation of a program of commitments stop the degradation of the road network and start its gradual reconstruction, create a sustainable system for sector financing, modernize the technical evaluation of roads, and negotiate with international financial institutions to obtain credits for projects aimed at rehabilitating the national roads of European importance.

The country's road network infrastructure has considerably deteriorated during the transition period: of the total 3,325 km of national roads, 87% have passed

their economic lifespan and some 30% are in a very bad technical condition. About 95% of the road network is paved, but most of these roads do not correspond to the technical standards.

Creation of a sustainable and transparent system of road financing is a priority on the agenda of central and local public administration. To that end, the Government plans to invest more in the sector - including through increased annual budget allocation – while focusing on road maintenance and repair to reduce the backlog on national roads in poor condition. At the same time, the Government will address the existing spending inefficiencies in the sector through gradually improving the management capacity of the State Road Administration and clarifying its role and functions, and improving the competition in the award of road maintenance and repair contracts. The Government is also considering developing a partnership with the private sector, including foreign companies, to rebuild and manage national roads.

Implementation of modern systems for road technical evaluation and for the optimization of maintenance and repair processes will be addressed by the strategy for transport infrastructure management and financing which the Government intends to draft throughout the following year. Based on the adopted strategy and regulations on sustainable and transparent road financing, the Government will substantially increase available financing for road maintenance.

F. Education System

Policies regulating the education system represent one of the most important factors in the development of the human capital, which in its turn constitutes one of the pillars at the base of economic growth and social cohesion in the country. Acknowledging the important role that education has and considering constitutional provisions, as well as other commitments, the Government of the Republic of Moldova formulated the following general objective in EGPRSP: Ensuring access to quality education and ensuring the efficient and sustainable functioning of the education system in a way, which facilitates its role in developing human resources and the economy. In the same time, one of the main MDG focuses on "achieve universal primary education."

Education expenditures have declined compared to the 1990s (reaching 7,3% of GDP for 2005),but are still higher than the OECD average (4.9%). The system is characterized by inefficient use of financial, human and material resources. Allocation of public finances to schools is regulated by a formula of unit financing lei/student. Various expenditure requirements, however, limit the flexibility of use of the education budget.. The greatest portion of education spending is on teacher salaries (more that 60%) and on utilities (about 15%),

with quality related expenditures constituting only about 10% of education budget.

The education expenditures per pupil vary significantly among institutions, by 2-3 times. The ratios of pupil/teacher and pupil/non-teachers are low. The lack of didactic materials and the lack of modern means of teaching lead to reduction of the quality of studies, having a negative impact on the level of assimilation of new information.

Another issue is the widening social inequality in Moldova, which contributes to reduced access to education of vulnerable social groups. There are significant differences regarding access to education of children from rural and urban localities. The completion ratios of rural students in secondary and higher education is 76% and 6%, respectively. This compares with 81 % and 29% for students from urban localities.

In order to improve the quality of education and to reduce the gap between the urban and rural village, the Government set the objective to optimize the network of schools and to increase efficiency of public resources spending. For these, the process of mapping institutions of general education was completed, which includes more than 150 network and economic-financial indicators. Based on the school mapping exercise for general education institutions, measures will be taken for the optimization of the institutions in rural areas. By the end of 2009, it is planned to reorganize 20% of schools identified as candidates for optimization. School mapping also will help with definition of basic package of free education services.

In addition, existing financing formula will be revised for schools – piloted under the project called "Quality education in rural area of Moldova". Combined with school autonomy and optimization of schools networks, this revision will contribute to improvement of quality by increasing efficiency, in this way providing resources for increasing salaries for teachers and increasing of quality related expenditures, as didactic materials, equipment and professional trainings.

G. Health Sector Reform

The health care sector is in the process of being reformed, the mandatory health insurance was introduced starting with January 1, 2004. In the first years of health insurance, the two lowest income quintiles however have not received the same benefits as other quintiles due to large share of uninsured people in those groups. The main goal of the Government regarding the healthcare sector reform program, mentioned in EGPRSP, is to increase access of the population, and, especially, of the poor, to basic health services through the development of primary medical care. There is evidence that the health care insurance, which provides free of charge services on the basis of the Uniform Program has improved population's access to health services.

This objective is consistent with the existing disease burden, which largely affects the poor and according to international experience prevention measures have a very effective impact on health, especially, in case of poor family.

Another objective of health care reform is improve efficiency in the use of financial, human and material resources within the health protection system, through a continuous rationalization of the hospital sector and implementation of mandatory insurances for medical assistance in order to maintain financial stability.

The present health care organization, whereby primary care and hospital services are provided by the same legal entities, allows for subsidizing of hospital services from budgets that are planned for primary health services, thereby weakening the primary health services and concealing inefficiencies in the hospital sector.

In order to resolve these gaps, the Government will take measures that will allow direct contracting of primary health centers. The Government will preserve at least 30% of allocation for primary health assistance from the budget of health insurances and will draft a strategy aimed to broaden the span of health insurance coverage. The health insurance company will directly contract at least 5% of primary assistance providers and, following the implementation of the strategy for insurance coverage, health insurance will include 85% of the residential population.

H. Public Procurement

Creation and maintenance of an efficient system of public procurement can help secure substantial savings of public expenditures. For these reasons, since 1 January 2005, was initiated the decentralization of the system of public procurement, which clearly delineated attributions and responsibilities in the process of public procurement of goods, works and services for public money. This measure led to increasing of transparency in the process of public procurement, through posting announcements, publishing relevant information, results, reports, template documents, projects etc, both in the Public Procurements Newsletter, as well as on the web.

There were also held meetings with potential providers, were granted necessary methodological support to specialists involved in public acquisitions, was published the Guide for Public Procurements (a manual containing all instructions, including standard documentation that is necessary to initiate and perform procedures of public procurement). Control over the procedure of one source procurement was made tighter. The Regulation on the List of forbidden providers (entrepreneurs) participating in the process of public procurement was approved by Decision of the Government, which provides method of setting up

and monitoring the list of forbidden providers who do not honor their contractual commitments, with an eventual exclusion of those from public procurement procedures for a certain period of time.

In order to adjust the legal framework regulating public procurement, the Government, drafted the new Law on public procurement, which envisaged establishment of an Independent Agency for Procurement, with the corresponding staff and budget, in accordance with central public administration reform. The draft of the respective law will be submitted to the Parliament for examination and approval by the end of this year. To facilitate eventual implementation of the newly adopted law, it is planned to draft a plan of action for law execution.

III. Strengthening social protection systems

A. Completing the pension reform

The pension system started to face common problems to Central and Eastern European countries during the 1990s. The revenues from contributions diminished as a result of low tax compliance and the decrease in the number of working people. Moreover, the fragmented pension legislation which comprises numerous pension facilities violates the principle of "social equity" and undermines people confidence in the pension system.

The 1999 Reform of the pension system accomplished its set-out medium term objectives: timely payment of pensions in conditions of limited budgetary transfers. Despite this, however, the pension reform stays to be incomplete, while the pension law has not yet been fully implemented. Although the Law on 1999 reform provides that pension payments be made based on actual contributions that are paid, and not based on salaries declared, the National House for Social Insurance has been substantially lagging behind with the introduction of data on contributions.

The Government took measures so that 100% of the declarations made by insured persons in the year 2005 and presented by 1 April 2006, was included in the state Register for individual evidence by June 1 2006. The Government is committed to keeping the contribution database up-to-date.

Participation in the system of social insurance by persons employed in the agricultural sector remains to be a problem, as the means accumulated from their contribution payments do not cover even a third of expenditures necessary for pension payments. At present, employees of the agricultural sector contribute with around 6% of the BSSI (the budget of state social insurances) revenues, but benefit from 53% of it. It is proposed to solve this situation through the

implementation of the Strategy on reforming the pension system for persons employed in the agricultural sector, and also in non-wage sector (self-employed), which provides for switching to the principle of paying income contributions in fixed sums, with possible subvention by the state. The respective strategy is already drafted and is now being coordinated with the relevant institutions.

In order to continue reform in the pension sector, the Government plans to draft a strategy aimed to unify the pensions systems for all categories of retired persons (non-farmers, farmers and privileged persons), and also to amend the pension Law, so as to allow for payments based on individual social insurance contributions.

B. Increasing the distribution efficiency in the system of social assistance benefits

The results of social assistance programs evidence a rather high level of inefficiency, especially due to the fact that resources have not been allocated correspondingly. The main objectives for social assistance focus on ensuring optimization of the social payments system, by targeting them towards the most poor and focusing on social groups facing situations of risk and the successful transition from a categorical to a means-tested system.

The EGPRS also includes, as a base element, measures aimed to increase efficiency in the social assistance system, targeted towards the most vulnerable population. To this aim, the Government has already approved the Concept for increasing efficiency in the social assistance system, by pointing out a series of conceptual items, such as the Plan of actions for increasing efficiency and method of payment of nominal compensations. Based on these, the pilot project for testing the mechanism for payment of nominal compensation was launched, which will include testing of revenues from families of nominal compensation beneficiaries, which will serve as basis for switching to a system where social assistance (first of all, nominal compensations) will no longer be given by categories, but depending on the necessity and total revenues of the family/person.

In the same time, the Government will adopt an additional plan of actions aimed to implement the reform of the social assistance system, which will include concrete measures for updating the legal and normative framework, as well as for the creation of a single individual account for paying all social payments. The Government is committed to develop a plan that establishes a timeline for social assistance reform in order to introduce improved targeting for poor, which would ensure the transition from a categorical to a means-tested system and the implementation of this time-bound action plan.

Maintenance of registers in an unsatisfactory manner, the insufficient dissemination of information among various programs of social assistance, as

well as management of the social assistance program by several governmental agencies make it difficult for the Government to evaluate the general impact and the efficiency of the social assistance program. In this context, the Government will draft and implement an information system aimed to ensure better maintenance of registers and to disseminate information more widely.

Finally, let me assure you that my Government is determined and committed to continue with the necessary actions and reform to improve the performance in priority areas such as improve governance, infrastructure, education and social service and give a new impetus to private sector development aiming to deliver a higher quality of service to Moldavian citizens, ensuring a sustained growth perspective for the country. I am sure that my country can rely on the continuous support of the World Bank and yours personally,

VASILE TARLEV
PRIME MINISTER

ANNEX 2. PRSC POLICY MATRIX

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
Pre-requisite: Maintain Macroeconomic Stability	**Maintained a satisfactory macroeconomic framework**	**Maintain satisfactory macroeconomic framework**	Maintain satisfactory macroeconomic framework	GDP growth of at least 4% in 2007 and 5% thereafter; inflation kept at 10.5% in 2007 and in single digits thereafter; fiscal stance consistent with macroeconomic framework; total PPG debt levels at sustainable levels.
Pillar I. Improving the Investment Climate				
A. Reducing regulatory and administrative costs of business regulations	**Adopted a Government decision on Establishment of a Registry of Official Acts Regulating Business Activity based on regulatory review.** **Adopted Law on Basic Principles and Mechanisms of State Regulation of Business Activity.**	**Implementation of the transitional provisions of the Law on Basic Principles and Mechanisms of State Regulation of Business Activity**	Completion of full review of laws regulating business activities on the basis of the Law on Basic Principles and Mechanisms of State Regulation of Business Activity	Reduced of regulatory compliance costs - CODB survey shows percent of management time spent on meeting regulatory requirements reduced from 17% in 2004. Average firm licensing and authorizations costs reduced from 52% of per capital GDP in 2004 to 30%). Frequency of inspections at or regional average.
B. Improving trade facilitation	**Introduced risk-based selectivity using Asycuda selectivity module at the Chisinau Customs terminal.**	Decision on sustainable Customs border and clearance performance indicators and reporting system.	Reduce number of agencies at the border crossing points (in line with the EU practice on border organization and structure) and customs collects fees at the border on behalf of other agencies.	Physical inspection by MCS not to exceed 30% of total declarations on a monthly basis. Reduce average monthly import clearance time at the inland terminal of Chisinau and average monthly border crossing entry time to 30 minutes.
C. Developing agricultural markets	**Liberalized agricultural exports by issuing and publishing a Government**	Conduct review of export liberalization of cereals and oilseeds and implement any		The gap between prices received by farmers and international parity prices for cereal and

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
	decision making the Universal Commodities Exchange purely voluntary for all commodities.	additional measures needed to ensure that farmers receive a fair price relative to international parity prices (including, if appropriate, a transparent mandatory minimum oilseeds producer price formula benchmarked to international prices).		oilseed crops as measured by nominal protection coefficients (NPCs) at the factory (processor) gate has been reduced by 25% relative to 2005. Improvement in rural poverty headcount.
	Developed terms of reference for a study on the impact on grain price, covering the use of profit margin ceilings on bread, management of state grain reserves, and external trade policies.	Complete study and begin implementation of recommendations of study on improving grain price stabilization. (including policy statement)	Complete implementation of recommendations of study on improving grain price stabilization.	
	Begun dissemination of information on international prices for cereals and oilseeds in local media.	**Begin implementation of an Action Plan to cover, inter alia, liberalization of the import regime for seeds and seedlings; improvements in agricultural product standardization and certification system; and development of a Market Information System, including scaling up dissemination of cereal and oilseed prices to cover prices on domestic markets.** Adopt law on Savings and Credit Associations (SCAs) providing for multi-level licensing with corresponding	Continue implementation of action plan, including scaling up of market information system to cover all basic commodities that account for at least 5% of value of agriculture production.	Price information on all basic commodities representing at least 5% of value of agriculture production for both domestic and international markets reported in local media at least weekly. New varieties registered have increased by 25%. Maximum time to evaluate and test seeds reduced to 1 year, and 4 years for seedlings. Implementation of SCA law.

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
		reporting and supervisory requirements, and proper enforcement tools.		
D. Reducing energy vulnerability.	Regulator increased domestic gas tariffs in response to the increase of price of imported natural gas (from 80 to 160 $/mcm) passing full cost increase to consumers.	Benchmark energy sector legislation with provisions of the ECSEE Treaty and adopt and start implementing an Action Plan for legal and regulatory compliance of the Moldova's gas and electricity markets with the ECSEE.	Adopt amendments to the power market rules that would provide solutions to: (i) cross-border electricity trade and congestion management; (ii) balancing market and settlement rules; and (iii) gradual power market opening. Develop and start implementing an energy efficiency program, including measures needed to return Termocom to financial viability and reduce energy losses.	Increase energy efficiency by reducing by 10% energy intensity measured by the total primary energy use (toe) per $1000 of GDP at PPP rate, in comparison to the base value in 2005. Cash collection ratios above 90% for natural gas and above 95% for electricity. Cost recovery of gas, electricity and heat tariffs for all categories of consumers (including households and budgetary institutions) approaches 100%. The regulatory framework in the electricity market compatible with relevant provisions of the ECSEE Treaty and the EU electricity directives. Energy as a share of household expenditures as reported by Household Budget Survey.
Pillar II. Improving The Efficiency and Management Of Public Sector Resources				
A. Building a meritocratic civil service	**Approved a strategy to ensure competitive merit based recruitment of civil servants including procedures for open competition for vacant positions, appointments and a system of civil service**	**Adopt new Civil Service Law that defines the scope of the civil service, contains guiding principles for competitive merit based appointments and promotions, posts classification and grading**	Implement new Civil Service Law.	New civil servants to administrative posts in ministries and central agencies appointed through an open, competitive, merit- based selection process as specified in new civil service law.

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
	appeals.	**and institutional responsibilities civil service management**		
B. Implementing a transparent and uniform remuneration system for civil servants	**First phase of the remuneration reform implemented increasing base salary for civil servants.**	Develop a pay system that consolidates multiple supplements and bonuses into the base pay reflecting the new civil service classification and grading framework.	Legislation underpinning the new affordable, transparent, and uniform pay system for civil servants is adopted, and implementation started.	Base salary makes at least 75-80% of the total take-home pay and adequately reflects the value of job of the position-holder. Information on the public sector pay is centrally available for review and analysis.
C. Improving the Strategic Allocation of Public Resources.	MTEF framework for 2007-2009, including a technical annex on public investment spending, is approved by the Government and submitted to Parliament for information in advance of the 2007 budget.	A central policy unit is established to support the Cabinet of Ministers in defining medium-term policy priorities. Government approves a decision to integrate a medium-term policy priority statement into the MTEF. For two sectors, submission to MTEF 2008-10 should reflect an ex ante analysis of expected benefits/cost of their largest domestically financed investment projects.	Based on the Government's national programs, the Cabinet of Ministers issues a policy statement defining the list of policy priorities as guidelines for the preparation of the MTEF for 2009-2011. Based on the experience of two sectors, approve new procedures for public investment decision in all sectors.	Strategic policy focus of annual budgets improved through a stronger linkage between the MTEF and annual budget laws. Improvements in the quality of public investment projects selected for funding; Increased use and awareness of economic cost-benefit analysis in the public sector.
C.1. Agricultural Spending	No provision of post-1999 debt relief for agricultural enterprises/ producers, except in the case of one-off relief for firms undergoing privatization. **Created level playing field for all agricultural support programs by removing all restrictions on access to**	Reallocate agricultural expenditures by: increasing the share of services and reducing share of subsidies over the next three to five years. Develop an Action Plan to streamline and modernize the agricultural research, training and education system that will	Continue reallocating agricultural expenditures to growth enhancing measures. Implement the Action Plan to streamline and modernize the agricultural research, training and education system, as well as	No new debt write-offs for agricultural enterprises/ producers have occurred. Share of agriculture expenditures on subsidies reduced by 3 percentage points in 2007, and 5 pp every year thereafter. Peasant farmers' share of Agricultural Subsidies.

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
	subsidies and supports based on farm ownership structure or size and developing objective and transparent eligibility criteria.	include: international benchmarking; rationalization requirements; land and funding needs. Evaluate efficiency of special service for the active influence of hydrometeorological processes and alternatives.	the special service for the active influence of hydrometeorological processes.	
C.2. Transportation Infrastructure		**Prepare strategy for transport infrastructure management and financing, with emphasis on road maintenance, reconstruction and capital repairs that includes (i) mechanisms for reform of road financing; (ii) introduction of competition in the execution of road maintenance contracts; and (iii) participation of road users in the oversight of road maintenance financing.**	Strategy for Transport Infrastructure Management and Financing adopted and legislation on road maintenance financing reform enacted	Actual funding from all sources for road maintenance, reconstruction and capital repairs reaches the amount of US$50 million in 2007 and US$90 million in 2009. 80% of the additional funding for road maintenance (beyond the 2006 funding level) is used for road maintenance contracts awarded through competitive bidding.
C.3. Education Spending		**Strategy to optimize school networks, based on completed school mapping, identifies schools for optimization, defines efficiency target indicators and pilots new funding formula.**	Begin to implement strategy covering at least 20 percent of schools identified for optimization; school budgets allocated to pilot schools by revised funding formula.	Student/Teacher and Student/Non-teacher ratios increased from 12.7 and 24.9 (2005) for public general schools. Share of expenditures on non-wage quality related items increased.
C.4. Promote efficiency of health care spending		Procedure for direct contracting with primary health care centers adopted.	HIC contracts at least 5% of primary health care centers directly	Share of health insurance budget allocation to primary health care increased to 30%.
D. Public Procurement	**Increased competition for public procurement**	Enactment of new Public Procurement Law which	Maintain Independent Procurement Agency with	No more than 10% of number contracts and 10% of the total

Objective/Issues	PRSC-I (2007) (Prior Actions)	PRSC-II (2008) (Triggers in bold)	PRSC-III (2009) (Expected Actions)	Outcome/Monitorable Indicators
	contracts (decline in single source procurement from 51% to 45% of the value of contracts awarded; increased use of open tendering from 28% to 40% of value of contracts awarded)	includes an Independent Procurement Agency with appropriate staffing and funding, in accordance with the Government's central public administration reform. Development of an Action Plan approved by Government	appropriate staffing and funding. Implementation of Action Plan	value of contracts awarded by single source procurement. At least 50% of number contracts and 70% of the total value of contracts awarded by open tender. Publication of an Annual public report on the conduct and results of public procurement.
Pillar III. Strengthening Social Protection Systems				
A. Completing Pension System Reform Program	**Continue implementation of individual account system by ensuring integrity of 2005 contribution data in NSIH database.** Development of Agricultural Sector Pension Reform Strategy.	**Pension law amended to enable pension payments to be made based on individual pension contributions.** Government adopts strategy to unify the pension systems for all types of pensioners (i.e. non-farmers, farmers and privileged).	Begin provision of pensions based on contributions registered in the individual account. Government begins implementing the strategy to unify the pension system	Individual accounts established for 100 percent of all known pension fund contributors. Increase correlation between contributions and expenditures for all types of pensioners.
B. Enhancing the distributional efficiency of social assistance benefit system		Adopt time bound social assistance reform action plan for improved poverty targeting. Design a unified database of the beneficiaries of cash-equivalent social assistance programs	Beginning implementing social assistance reform action plan. Begin installation of the unified database of the beneficiaries of cash-equivalent social assistance programs	Share of poverty-targeted (i.e. means tested) social assistance program budget in the total social assistance program budget increased from 17.7% in 2005.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

International Monetary Fund
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Washington, D. C. 20431 USA

Public Information Notice (PIN) No.
FOR IMMEDIATE RELEASE

IMF Concludes 2005 Article IV Consultation with the Republic of Moldova

On May 5, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Moldova.[1]

Background

Economic growth has continued to be robust, although the drivers of growth—household consumption and construction—remain heavily dependent on inflows of remittances (now equal to some 30 percent of GDP), as well as strong wage growth. Real GDP growth in 2005 was over 7 percent, as it has been since early in the decade. Inflation has gradually abated. After peaking at over 14 percent in April 2005, it fell to 10 percent (year-on-year) in December, despite a sharp pickup in energy prices in mid-2005.

Fiscal policy has remained tight. The general government posted a cash surplus of about 1.7 percent of GDP in 2005, about twice the level of 2004, and considerably tighter than the deficit predicted in the revised 2005 budget (½ percent of GDP). The main factors driving this fiscal performance were better-than-expected Value Added Tax revenues, delays in implementing foreign-financed project investments, disbursement of a grant from the European Union on December 29 for which expenditures had been included in the 2006 budget, and some spending restraint on the part of the government.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

Monetary policy was tightened in 2005, despite continued strong inflows of remittances. Sterilization efforts were stepped up in the second and third quarters before easing in the fourth quarter, as the balance of payments weakened in light of higher energy prices and the National Bank of Moldova (NBM) moderated its foreign exchange purchases. The NBM's balance on sterilization operations rose from an average of 1.1 percent of GDP in 2004 to an average of 2.9 in 2005, reaching 3.5 percent of GDP at end-February 2006. As a result, reserve money growth slowed during the year, falling to 16½ percent at end-September, before rising seasonally in December. At the same time, broad money growth remained strong (at 35 percent for the year as a whole). Lending and deposit rates have remained high, despite plentiful liquidity on the
T-bill and interbank markets. Financial sector soundness indicators have remained generally strong, reflecting partly strong economic performance of the recent years.

Moldova appears to follow an asymmetric, managed floating exchange rate regime. Since early 2004, it would appear that downward pressure is accommodated while upward pressure is absorbed by the NBM through purchases of foreign exchange. The leu appreciated in real effective terms in 2004, but with a weaker balance of payments and lower inflation than in key trading partners, this tendency leveled off in 2005. Reserves have grown as well, doubling in dollar terms since end-2003, though as a share of imports they remain modest at about 2.2 months.

The trade balance deteriorated significantly in 2005, owing in large part to the impact of higher energy prices. Energy (particularly fuel oil) imports rose in value terms by about 50 percent in 2005 (to about 5 percent of GDP), while export growth slowed modestly. The structural reform agenda has been reinvigorated by Moldova's aspirations for closer integration with Europe. The European Union–Moldova Action Plan, signed in February 2005, provides, along with the authorities' Economic Growth and Poverty Reduction Strategy Paper (EGPRSP), a road map for advancing a broad reform agenda, including in areas public administration, public expenditure management, and management of state enterprises.

Executive Board Assessment

Executive Directors welcomed the strong economic growth and significant poverty reduction in recent years, the moderation of inflation, and the strengthened fiscal position, and commended Moldova's authorities for their commitment to structural reforms and balanced macroeconomic policies. At the same time, they noted that growth has been fueled mainly by domestic spending, which was financed by workers' remittances. Directors agreed that maintaining macroeconomic stability in light of robust inflows of remittances while diversifying the economy and bringing poverty further down remain the key challenges going forward. They also stressed the importance of improving the business environment to support greater private sector investment and thus to help reverse the large migration of labor and strengthen the external position.

Directors commended the authorities for their disciplined macroeconomic policies and considered that the short-term fiscal stance constituted an appropriate balance between the objective of supporting disinflation and meeting the need for larger public investment and

social spending. Looking ahead, most Directors encouraged the authorities to repeat the fiscal over performance of recent years, though some Directors favored devoting revenue in excess of budgeted amounts to poverty reduction and infrastructure spending if the macroeconomic environment permits it.

Directors welcomed the authorities' efforts to modernize public sector management to improve the efficiency of government operations. They observed given the large size of the government, that the public administration reform currently underway should lead to a leaner, more focused, and transparent government structure. While Directors welcomed the decision to fully pass through energy price changes, they expressed concern about the large increases in public sector wages in 2006 and urged the authorities to ensure that the wage profile remains consistent with priorities identified in the medium-term expenditure framework.

Directors welcomed the decline in inflation during 2005. Nevertheless, they noted that inflationary pressures remain, particularly in light of the increasing energy prices and the tightening labor market, and urged the authorities to be prepared to tighten monetary policy. Directors also encouraged the authorities to permit greater exchange rate flexibility to minimize risks to the disinflation path and facilitate the economy's resilience to balance-of-payments shocks. In this context, they welcomed the authorities' decision to amend the National Bank law to establish price stability as its key objective and stressed that this legislative change needs to be matched by steps in monetary policy implementation.

Directors welcomed the authorities' renewed push for structural reforms and underscored their importance to sustain the economic revival and maintain external competitiveness. They stressed the importance to improve the environment for private initiative and investment also by reducing licensing and registration requirements and other administrative barriers and strengthen the legal and institutional framework and governance. They encouraged the authorities to accelerate implementation of the structural policies envisaged in their Economic Growth and Poverty Reduction Strategy (EGPRSP) to encourage investment, reverse the current emigration trend, and use the strategy to make progress in achieving the MDGs. Directors also noted that the EU-Moldova Action Plan—which is consistent with the EGPRSP—will serve as a useful roadmap for the ambitious reform agenda.

Directors noted that financial sector stability indicators were largely positive, but urged the authorities to address remaining vulnerabilities. They emphasized the crucial importance of financial sector development to underpin economic and employment growth. Directors considered that Moldova's financial sector, and the economy more broadly, would benefit from a presence of reputable international banking institutions. In this context, they welcomed the authorities' intention to privatize Banca de Economii. Directors also commended the authorities for strengthening the AML/CFT framework and their objective of bringing it in line with best practices over the medium term.

Directors welcomed the sustained improvement in Moldova's external debt position and expressed hope that Moldova will be able to normalize its relations with Paris Club creditors and restructure its stock of arrears in the near future, underscoring that this would facilitate access to fresh donor financial support.

Directors were encouraged by Moldova's subscription to the Fund's Special Data Dissemination Standard as an important step to further improve transparency, timeliness, and comprehensiveness of economic and financial data.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Moldova: Selected Economic Indicators

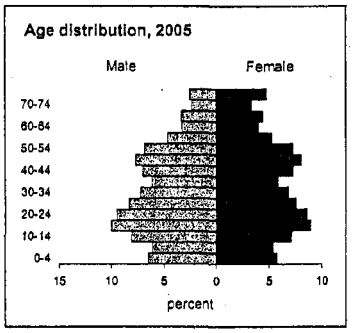
	2003	2004	2005 Est.	2006 Proj.
	(Percent change: unless otherwise indicated)			
Production and Prices				
Nominal GDP (in MDL millions)	27,619	32,032	36,755	42,585
Real GDP growth	6.6	7.4	7.1	6.0
Consumer prices (end of period)	15.7	12.6	10.0	9.0
	(In percent of GDP)			
Public finance (general government)				
Overall balance (cash)	0.2	0.8	1.7	-0.8
Primary balance	2.3	2.7	3.0	0.6
	(Percent change: unless otherwise indicated)			
Money and credit				
Broad money (M3)	30.7	37.7	35.0	29.4
Credit to the economy	44.4	22.2	35.0	25.6
External sector				
Current account balance (in percent of GDP	-6.8	-2.7	-5.6	-5.4
Total external debt (in percent of GDP)	88.7	63.8	54.7	51.3
Total debt service (in percent of exports of goods and services)	19.8	21.3	20.2	14.5
Gross official reserves (in millions of dollars)	302	470	597	750

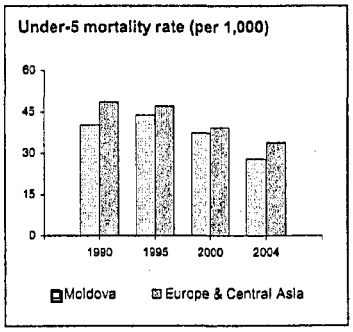
Sources: Moldovan authorities; and Fund staff estimates.

ANNEX 4. Moldova at a glance

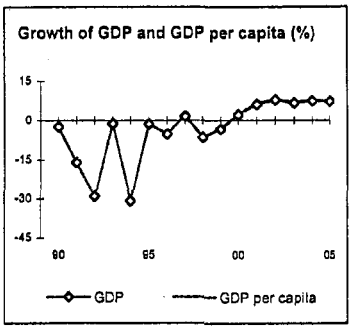
8/17/06

Key Development Indicators (2005)	Moldova	Europe & Central Asia	Lower middle income
Population, mid-year (millions)	4.2	473	2,475
Surface area (thousand sq. km)	34	24,238	39,946
Population growth (%)	-0.3	0.1	1.0
Urban population (% of total population)	46	64	49
GNI (Atlas method, US$ billions)	3.2	1,945	4,746
GNI per capita (Atlas method, US$)	880 [b]	4,113	1,918
GNI per capita (PPP, international $)	2,150	9,142	6,313
GDP growth (%)	7.1	6.0	6.9
GDP per capita growth (%)	7.4	5.9	5.9
(most recent estimate, 2000–2005)			
Poverty headcount ratio at $1 a day (PPP, %)	22	2	..
Poverty headcount ratio at $2 a day (PPP, %)	64	16	..
Life expectancy at birth (years)	68	69	70
Infant mortality (per 1,000 live births)	23	28	33
Child malnutrition (% of children under 5)	..	5	12
Adult literacy, male (% of ages 15 and older)	99	99	93
Adult literacy, female (% of ages 15 and older)	98	96	85
Gross primary enrollment, male (% of age group)	95	105	115
Gross primary enrollment, female (% of age group)	94	102	113
Access to an improved water source (% of population)	92	92	82
Access to improved sanitation facilities (% of population)	68	85	57





Net Aid Flows	1980	1990	2000	2005 [a]
(US$ millions)				
Net ODA and official aid	..	*10*	123	118
Top 3 donors (in 2004):				
United States	..	*9*	35	33
Sweden	..	*0*	2	7
Germany	..	*0*	2	6
Aid (% of GNI)	..	*0.4*	9.4	4.0
Aid per capita (US$)	..	*2*	29	28



Long-Term Economic Trends	1980	1990	2000	2005 [a]	1980–90	1990–2000	2000–05
					(average annual growth %)		
Consumer prices (annual % change)	..	..	31.3	13.1			
GDP implicit deflator (annual % change)	..	13.5	27.3	7.3			
Exchange rate (annual average, local per US$)	..	0.0	12.4	12.6			
Terms of trade index (2000 = 100)	..	..	100	115			
Population, mid-year (millions)	4.0	4.4	4.3	4.2	0.8	-0.2	-0.3
GDP (US$ millions)	..	3,593	1,288	2,917	2.7	-9.6	7.1
		(% of GDP)					
Agriculture	..	36.1	29.0	17.0	..	*-11.2*	1.4
Industry	..	36.7	21.7	24.5	..	*-13.6*	8.9
Manufacturing	..	*36.0*	16.3	17.3	..	*-7.1*	7.7
Services	..	27.2	49.2	58.5	..	*0.7*	6.4
Household final consumption expenditure	..	*57.5*	91.4	91.6	..	*9.9*	10.2
General gov't final consumption expenditure	..	*15.1*	10.3	15.5	..	*-12.4*	7.0
Gross capital formation	..	24.9	23.9	29.8	..	*-15.5*	8.4
Exports of goods and services	..	48.2	49.8	52.4	..	*0.7*	16.1
Imports of goods and services	..	50.6	75.4	93.9	..	*5.6*	16.3
Gross savings	..	*58.1*	16.3	24.7	..	..	..

Note: Figures in italics are for years other than those specified. 2005 data are preliminary estimates. .. indicates data are not available.
a. Aid data are for 2004. b. GNI per capita excludes Transnistria.

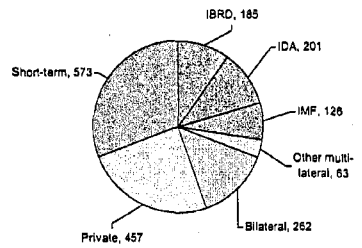
Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade	2000	2005
(US$ millions)		
Total merchandise exports (fob)	477	996
Total merchandise imports (cif)	793	1,817
Net trade in goods and services	-331	-1,211
Workers' remittances and compensation of employees (receipts)	179	920
Current account balance	-98	-285
as a % of GDP	-7.6	-9.8
Reserves, including gold	218	597

Central Government Finance		
(% of GDP)		
Revenue	27.4	*29.3*
Tax revenue	14.7	*16.4*
Expense	28.9	*27.1*
Cash surplus/deficit	-1.5	*0.4*
Highest marginal tax rate (%)		
Individual	..	..
Corporate	..	..

External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	1,693	*1,868*
Total debt service	151	*248*
HIPC and MDRI debt relief (expected; flow)	–	–
Total debt (% of GDP)	131.4	*72.0*
Total debt service (% of exports)	18.1	*12.2*
Foreign direct investment (net inflows)	127	*81*
Portfolio equity (net inflows)	3	*-2*

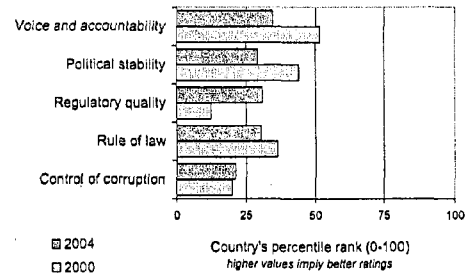
Composition of total external debt, 2004



US$ millions

Private Sector Development	2000	2005
Time required to start a business (days)	–	30
Cost to start a business (% of GNI per capita)	–	17.1
Time required to register property (days)	–	48
Ranked as a major constraint to business (% of managers surveyed who agreed)		
Cost of financing	..	41.3
Tax rates	..	37.8
Stock market capitalization (% of GDP)	30.4	*22.1*
Bank branches (per 100,000 people)	..	..

Governance Indicators, 2000 and 2004



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	2000	2004
Paved roads (% of total)	86.1	*86.2*
Fixed line and mobile phone subscribers (per 1,000 people)	169	391
High technology exports (% of manufactured exports)	4.1	3.7

Environment		
Agricultural land (% of land area)	77	*77*
Forest area (% of land area, 2000 and 2005)	9.9	10.0
Nationally protected areas (% of land area)	..	1.4
Freshwater resources per capita (cu. meters)	..	237
Freshwater withdrawal (% of internal resources)	..	*231.0*
CO2 emissions per capita (mt)	1.5	*1.6*
GDP per unit of energy use (2000 PPP $ per kg of oil equivalent)	2.0	*1.9*
Energy use per capita (kg of oil equivalent)	672	*772*

World Bank Group portfolio	2000	2005
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	191	161
Disbursements	6	0
Principal repayments	5	13
Interest payments	11	6
IDA		
Total debt outstanding and disbursed	103	209
Disbursements	30	24
Total debt service	1	2
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	35	*63*
of which IFC own account	19	*50*
Disbursements for IFC own account	1	*16*
Portfolio sales, prepayments and repayments for IFC own account	0	*4*
MIGA		
Gross exposure	3	62
New guarantees	3	0

Note: Figures in italics are for years other than those specified. 2005 data are preliminary estimates.
.. indicates data are not available. – indicates observation is not applicable.

8/11/06

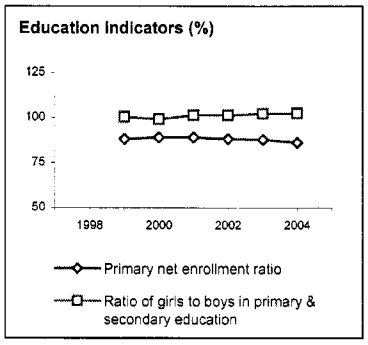
Development Economics, Development Data Group (DECDG).

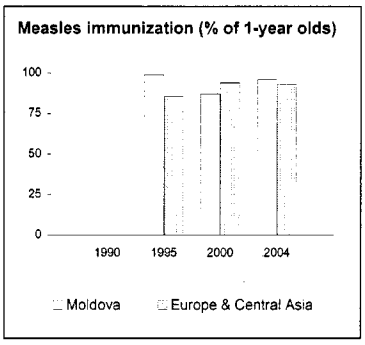
Millennium Development Goals

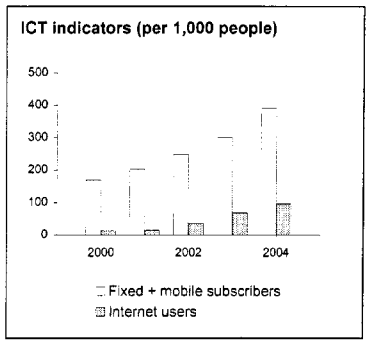
Moldova

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Moldova			
Goal 1: halve the rates for $1 a day poverty and malnutrition	**1990**	**1995**	**2000**	**2004**
Poverty headcount ratio at $1 a day (PPP, % of population)	*7.3*	<2	*21.8*	..
Poverty headcount ratio at national poverty line (% of population)	..	..	*62.4*	*48.5*
Share of income or consumption to the poorest qunitile (%)	..	..	..	*7.8*
Prevalence of malnutrition (% of children under 5)	..	*3*	..	..
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	*89*	..	89	86
Primary completion rate (% of relevant age group)	..	94	90	91
Secondary school enrollment (gross, %)	*80*	..	83	83
Youth literacy rate (% of people ages 15-24)	100	..	..	100
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	*105*	..	99	102
Women employed in the nonagricultural sector (% of nonagricultural employment)	49	51	53	*55*
Proportion of seats held by women in national parliament (%)	..	*5*	9	*22*
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	40	44	37	28
Infant mortality rate (per 1,000 live births)	30	34	29	23
Measles immunization (proportion of one-year olds immunized, %)	*92*	99	87	96
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	36	..
Births attended by skilled health staff (% of total)	..	*99*	..	..
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	*1.1*
Contraceptive prevalence (% of women ages 15-49)	..	*74*	62	..
Incidence of tuberculosis (per 100,000 people)	64	..	..	138
Tuberculosis cases detected under DOTS (%)	..	..	*40*	59
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	..	..	..	92
Access to improved sanitation facilities (% of population)	..	..	..	68
Forest area (% of total land area)	..	..	9.9	*10.0*
Nationally protected areas (% of total land area)	..	..	..	1.4
CO2 emissions (metric tons per capita)	5.5	2.6	1.5	*1.6*
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	2.2	1.5	2.0	*1.9*
Goal 8: develop a global partnership for development				
Fixed line and mobile phone subscribers (per 1,000 people)	106	131	169	391
Internet users (per 1,000 people)	0	0	12	96
Personal computers (per 1,000 people)	..	2	15	*27*
Youth unemployment (% of total labor force ages 15-24)	..	..	..	*15.2*



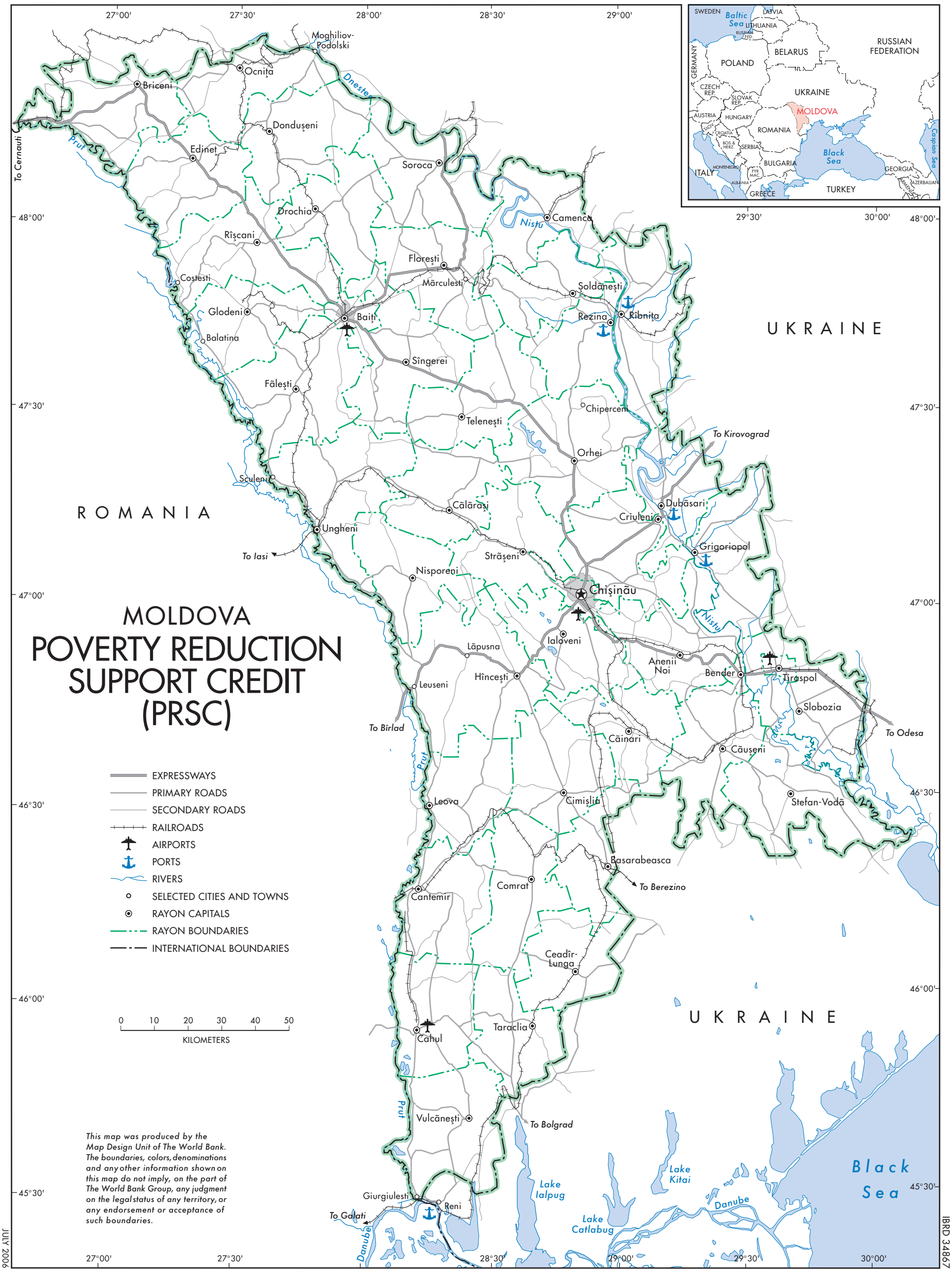




Note: Figures in italics are for years other than those specified. .. indicates data are not available.

8/11/06

Development Economics, Development Data Group (DECDG).



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