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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED CREDIT

IN THE AMOUNT OF SDR 20.9 MILLION
(EUR 24.9 MILLION EQUIVALENT)
(USD 30 MILLION EQUIVALENT)

TO

THE REPUBLIC OF MOLDOVA

FOR THE

ECONOMIC GOVERNANCE DEVELOPMENT POLICY OPERATION

June 6, 2018

Macroeconomics and Fiscal Management Global Practice
Europe and Central Asia

**Republic of Moldova - GOVERNMENT FISCAL YEAR**
January 1 – December 31

**CURRENCY EQUIVALENTS**
(Exchange Rate Effective as of April 30, 2018)

| | |
|---|---|
| Currency Unit = | Moldovan Leu (MDL) |
| MDL 16.51= | US$1 |
| EUR 1 = | 0.83 US$ |

**ABBREVIATIONS AND ACRONYMS**

| | |
|---|---|
| ANRE | National Agency for the Regulation of Energy |
| BEEPS | Business Environment and Enterprise Performance Survey |
| CPF | Country Partnership Framework |
| DPO | Development Policy Operation |
| DSA | Debt Sustainability Analysis |
| ECA | Europe and Central Asia |
| ECF/EFF | Extended Credit Facility/Extended Fund Facility |
| ECS | Energy Community Secretariat |
| EGDPO | Economic Governance Development Policy Operation |
| EU | European Union |
| GDP | Gross Domestic Product |
| IFC | International Finance Corporation |
| IFRS | International Financial Reporting Standards |
| ME | Municipal Enterprise |
| MFA | Macro-Financial Assistance |
| NAS | National Accounting Standards |
| NBM | National Bank of Moldova |
| NIA | National Integrity Authority |
| PEFA | Public Expenditure and Financial Accountability |
| PFM | Public Financial Management |
| PIFC | Public Internal Financial Control |
| SCD | Systematic Country Diagnostic |
| SOE | State-Owned Enterprise |
| StAR | Stolen Asset Recovery Initiative |
| TA | Technical Assistance |
| UBO | Ultimate Beneficial Owner |
| VAT | Value Added Tax |

| | |
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THE REPUBLIC OF MOLDOVA

ECONOMIC GOVERNANCE DEVELOPMENT POLICY OPERATION

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**SUMMARY OF PROPOSED CREDIT AND PROGRAM**

THE REPUBLIC OF MOLDOVA

ECONOMIC GOVERNANCE DEVELOPMENT POLICY OPERATION

| | |
|---|---|
| Borrower | The Republic of Moldova |
| Implementation Agency | Ministry of Finance |
| Financing Data | IDA Credit<br>Amount: EUR 24.9 million |
| Operation Type | Stand-alone |
| Pillars of the Operation and Program Development Objective(s) | The operation supports the Government of Moldova in reducing fiscal risks and leveling the playing field for private sector development. |
| Results Indicators | Average old age pensions replacement rate: Baseline: 24 (2018 - status quo); Target: 26 (2018 - reform)<br>Excise tax collections from tobacco: Baseline: MDL 1.7 billion (2016); Target: Baseline + 12 percent in real terms (2018)<br>Audited financial statements for medium and large MEs and SOEs: Baseline: 38% (2017); Target: 50% (June 2019)<br>Number of asset and interest declarations filed electronically: Baseline: 0 (2016); Target: 60,000 (2018)<br>Number of authorizations (permits and licenses): Baseline: 306 (2016); Target: 153 (2018)<br>Number of plant varieties, types of fertilizers, and pesticides imported: Baseline (2016): Seeds 566; seedlings 90; fertilizers 146; pesticides 754; Target: baseline + 10 percent (June 2019)<br>Number of banks materially complying with the governance provisions in the Law on Banks' Activity and the Regulation on Internal Governance and Risk Management: Baseline: 0 (2016); Target: 5 (June 2019)<br>Share of electricity purchased under published Guidelines (for April–March, 12 months cycle): Baseline: 0 percent (2016); Target: 50 percent (2018) |
| Overall Risk Rating | Moderate |
| Climate and Disaster Risks | No |
| Operation ID | P156963 |

**IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT
TO THE REPUBLIC OF MOLDOVA**

## 1. INTRODUCTION AND COUNTRY CONTEXT

1. **This stand-alone Economic Governance Development Policy Operation (EGDPO) supports reforms to reduce fiscal risks and level the playing field for private sector development in Moldova.** The 2014 banking fraud triggered loss of confidence in the sector, leading to significant interest rate increases, reduced credit to the private sector, and direct public losses from the banking bailout amounting to about 10 percent of 2016 gross domestic product (GDP). The fraud exposed deep-seated structural governance problems that continue to affect both the public sector by revealing weak accountability of public institutions and state-owned enterprises (SOEs) and the private sector, which remains mired in complex regulations. This operation, along with the engagements of other development partners of Moldova (International Monetary Fund [IMF] and European Union [EU]), is designed to remove key economic governance bottlenecks for reducing medium-term fiscal risks and fostering private sector development.

2. **Following the banking fraud, Moldova embarked on a reform program for rebuilding the credibility of its economic governance and policy making, but macroeconomic challenges remain.** The banking bailout, the 2015 recession, and a shortfall in external financing increased fiscal pressures in 2015–2016. To maintain fiscal deficit under control, the Government cut public expenditures, particularly capital outlays. At the same time, Moldova embarked on a series of reforms to reduce the macro-fiscal risks stemming from the financial sector, including by undertaking bank-level diagnostics and by strengthening the supervisory and regulatory frameworks. While these policy actions helped tackle vulnerabilities in the financial sector and maintain fiscal deficits under control (despite the concomitant reduction in fiscal space), preventing fiscal risks stemming from illicit public liabilities and current spending pressures remains a priority in the macroeconomic stability agenda.

3. **In the context of slowing growth over the medium term, addressing the structural impediments to efficient public and private sector governance is paramount for enabling new sources of economic growth, while ensuring macroeconomic stability.** Economic growth is expected to moderate at below 4 percent in the medium term. Growth remains highly reliant on consumption due to sustained remittances and recent increases in public wages. With large share of Moldovans already living and working abroad and the attachment of subsequent-generation migrants to Moldova declining over time, the country needs to enable new drivers of growth. Yet, the large economic governance challenges undermine both public and private sector development. International indicators confirm the severity of the problem. In 2015, according to the Gallup World Poll, 88 percent of Moldovans perceived the business sector and the Government as corrupt (World Bank Systematic Country Diagnostic[1] 2016) and in 2016, Moldova ranked below the bottom 30 percent globally (126 among 176 countries) on the Transparency International corruption perceptions index. Unless addressed, the economic governance challenges will continue to hamstring growth in Moldova.

4. **High exposure to climate shocks have further constrained economic growth and poverty reduction outcomes in Moldova.** Moldova has made considerable progress in reducing poverty, which declined from 26 percent in 2007 to 9.6 percent in 2015. Yet spatial disparities persist with higher poverty rates in rural areas and with the poor largely concentrated in agriculture activities. Agriculture is characterized by high output volatility mainly due to weather shocks, particularly drought, which affects poor households. Moldova faces environmental risks that are only expected to worsen with the projected

[1] Report N. 107502-MD.

climate change impacts, thereby affecting the key economic sectors, including agriculture. The related volatility of households' income streams to weather shocks, coupled with weak job creation constrained by economic governance factors, is a barrier to sustainable poverty reduction and per capita income growth in Moldova.

5. **This operation supports reforms to strengthen economic governance in Moldova linked to the management of public resources to reduce fiscal risks (Pillar A) and to level the playing field for private sector development (Pillar B), including in the core economic sectors of agriculture, banking, and energy.** The authorities are committed to restore investors' and citizens' trust in the integrity of the public sector by developing transparent and stable economic institutions and improving equity in access and use of resources. Reforms under the first pillar focus on reducing fiscal risks by reforming the pensions system, strengthening tax collection by increasing tobacco taxation, pre-empting potential conflicts of interest of high-level public officials, and improving the financial information reliability of state owned enterprises (SOEs) and municipal enterprises (MEs). Reforms under the second pillar aim at removing bottlenecks in obtaining licenses, authorizations, and certificates; in accessing key agriculture inputs (seeds, seedlings, fertilizers, and pesticides); and at improving the governance regime in the banking and energy sectors. Agriculture-related reforms supported by this operation further increase farmers' ability to adapt to climate change.

6. **Risks to the program implementation are moderate.** The highest risks to program implementation are macroeconomic, sector strategies, and technical design risks which are rated as substantial. These risks are partially mitigated by the recent record of Moldova's prudent fiscal policy, the IMF program which serves as a macro-fiscal stability anchor, the stand-alone design of this operation and its focus on adopting key reforms during the non-electoral year 2017 and in early 2018, and the technical assistance (TA) provided by the World Bank Group and other development partners to strengthen the implementation capacity of selected agencies.

## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1 RECENT ECONOMIC DEVELOPMENTS

7. **While Moldova has sustained the recovery from the 2015 contraction, economic growth remains below historical averages and is mainly led by consumption**. Following the banking fraud in 2014 and the subsequent contraction of the economy in 2015, growth rebounded reaching more than four percent in both 2016 and 2017. This was owing to robust private consumption largely driven by remittances and public and private wage increases. Lower interest rates, the stabilization of the financial sector, and the double-digit increase in public investments led to a recovery in gross fixed investments, which reached 5.3 percent year-on-year growth in 2017. Despite robust exports supported by good harvests in the past two years and a stronger leu, imports rapidly increased, resulting in a negative contribution of net exports to growth (−2.7 percentage points) (Table 1). On the production side, growth has been mainly driven by retail and wholesale trade, followed by agriculture and industry. With the recovery, labor market outcomes also improved. In 2017, the unemployment rate fell 0.7 percentage points to 3.5 percent, and the employment rate increased, particularly in rural areas. In line with economic conditions, salaries rose by 5.2 percent in real terms in 2017.

8. **The current account deficit has widened as imports outpaced exports growth.** In 2017, supported by a stronger leu, imports rebounded fast, increasing at +20.2 percent in U.S. dollar nominal terms, year-on-year. Thus, the current account deficit kept widening by about 3.4 percentage points,

reaching 7.6 percent of GDP in 2017. Favorable exchange rate conditions helped the National Bank of Moldova (NBM) rebuild foreign reserves. By end-April 2018, reserves reached a record level of US$2.9 billion, equivalent to almost 6 months of imports. Foreign direct investment covered about a third of the current account deficit.

**Table 1. Key Macroeconomic Indicators**

| | 2015 | 2016 | 2017 | 2018f | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|---|---|
| **Real economy** | | | | | | | |
| Nominal GDP (MDL, billion) | 122.6 | 135.4 | 150.9 | 163.9 | 178.0 | 193.4 | 201.2 |
| Real GDP (percent change) | -0.4 | 4.3 | 4.5 | 3.8 | 3.7 | 3.6 | 3.5 |
| Per Capita GDP (US$, Atlas Method) | 2,230 | 2,110 | 2,180 | | | | |
| **Contributions:** | | | | | | | |
| *Consumption (percent points of GDP)* | *-2.1* | *3.5* | *4.3* | *3.9* | *3.7* | *3.5* | *3.4* |
| *Investment (percent points of GDP)* | *-3.3* | *0.9* | *2.9* | *1.1* | *1.0* | *1.1* | *1.3* |
| *Net exports (percent points of GDP)* | *4.9* | *-0.1* | *-2.7* | *-1.2* | *-1.0* | *-1.1* | *-1.2* |
| Imports (percent volume change) | -5.2 | 5.9 | 11.4 | 5.3 | 4.4 | 4.9 | 5.0 |
| Exports (percent volume change) | 2.9 | 9.3 | 12.7 | 5.1 | 4.3 | 4.7 | 4.8 |
| Unemployment rate (ILO definition) (percent) | 4.9 | 4.2 | 3.5 | | | | |
| GDP deflator (percent change) | 9.9 | 5.7 | 6.6 | 4.2 | 5.2 | 5.1 | 5.0 |
| Consumer price index (CPI) (eop) (percent change) | 13.6 | 2.4 | 7.3 | 3.8 | 4.9 | 5.0 | 5.0 |
| **Fiscal Accounts** | | | | | | | |
| Expenditures (percentage of GDP) | 37.9 | 35.8 | 36.3 | 37.3 | 36.3 | 35.8 | 35.1 |
| Revenues (percentage of GDP) | 35.6 | 33.9 | 35.5 | 34.3 | 33.8 | 33.5 | 33.2 |
| General government balance (percentage of GDP) | -2.2 | -1.7 | -0.8 | -3.0 | -2.5 | -2.2 | -1.9 |
| Public and publicly guaranteed debt[1] (eop) (percentage of GDP) | 35.2 | 43.8 | 38.9 | 39.2 | 38.7 | 38.1 | 37.5 |
| **Selected Monetary Accounts** | | | | | | | |
| Base money (M1, percentage change) | 24.1 | 19.2 | 23.1 | | | | |
| Credit to non-government (percentage change) | 3.5 | -7.6 | -3.4 | | | | |
| Interest (key policy interest rate) (percentage) | 19.5 | 9.5 | 6.5 | | | | |
| **Balance of Payments** | | | | | | | |
| Current account balance[2] (percentage of GDP) | -7.2 | -4.2 | -7.6 | -4.9 | -5.1 | -5.6 | -5.8 |
| Imports (percentage of GDP) | 66.1 | 65.9 | 66.8 | | | | |
| Exports (percentage of GDP) | 36.6 | 38.3 | 39.1 | | | | |
| FDI (percentage of GDP) | 3.3 | 1.3 | 2.6 | 2.7 | 3.3 | 3.5 | 3.7 |
| Remittances (percentage of GDP) | 22.3 | 20.3 | 19.3 | 18.7 | 18.5 | 18.3 | 18.1 |
| Gross reserves[3] (US$, millions) eop | 1,757 | 2,206 | 2,803 | | | | |
| In months of next year's imports | 4.7 | 5.9 | 6.1 | | | | |
| Percentage of short-term external debt | 140.6 | 158.9 | 160.0 | | | | |
| External debt (percentage of GDP) | 93.7 | 91.8 | 85.8 | | | | |
| Terms of trade (percentage change) | 7.4 | -3.4 | -1.1 | | | | |
| Exchange rate (MDL/US$, average) | 18.8 | 19.9 | 18.5 | | | | |
| Nominal GDP (US$, millions) | 6,514 | 6,796 | 8,121 | | | | |

*Source:* National authorities, World Bank staff calculations.
*Note:* ILO = International Labour Organization; eop = End of Period.
1. Includes the state debt, debt of national bank, debt of administrative-territorial units, debt of public sector entities, debt of majority state-owned companies; does not include short-term domestic arrears (0.4 percent of estimated GDP, September 2016).
2. According to IMF's Balance of Payments Manual, 6th edition, the definition of current account is based on standard representation of current account. Standard representation of current account, compared with analytical one, includes current official transfers to/from the Government;
3. Gross reserves in months of next year's imports is the ratio of total gross reserves to next year's estimated average monthly import.

9. **After a sharp deceleration in 2016, inflation has been above the upper bound of the central bank target corridor through most of 2017.** Increases in regulated prices at the beginning of 2017, unfavorable weather conditions in the spring affecting locally sold agriculture outputs, and stronger internal demand accelerated inflation, which peaked at 7.9 percent in October 2017 and declined thereafter.

10. **Monetary policy was geared toward supporting lending activity but was hampered by continued excess liquidity.** Throughout 2017, the NBM gradually reduced the base interest rate (from 9 percent to 6.5 percent) while increasing the reserve requirement ratio of deposits in national currency to a record high of 40 percent to shore up liquidity. However, the recovery in deposits and forex market interventions conducted by the NBM contributed to persistent excess liquidity, which had first appeared following the banking fraud. Due also to the resulting limited pass-through from base to lending rates, credit remained subdued.

11. **Financial sector stability improved since the 2014 fraud, but risks remain.** After initiating the liquidation of the three defrauded banks, the NBM installed special supervision and conducted special diagnostic audits of the next three largest banks, revealing governance issues and balance sheet weaknesses. Overall, commercial banks' assets are over 50 percent of GDP, with liquid assets representing over 50 percent of total assets. Credit growth to the private sector remains negative (−3.4 percent in 2017), reflecting low investor confidence, limited pass-through of the monetary policy stance to commercial interest rates, and tighter prudential standards in the banking sector. In January 2018, due to more prudent loan classification under the supervision regime and cleansing of the loans in the three major banks, the reported share of non-performing loans in total loans increased to a record high of 18.3 percent. The reported capital adequacy ratio in the banking system remains high, at more than 30 percent (compared to the prudential requirement of 16 percent).

12. **Due to the guarantees to failed banks, public and publicly guaranteed external debt increased.** In 2016, a special law converted the public guarantees on the emergency loans to the banking sector into state securities worth MDL 13.6 billion (about 10 percent of 2016 GDP) for 25 years with a 5 percent average interest rate. On average, more than 55 percent of the general government debt is denominated in foreign currency and is mostly financed by medium- and long-term credits from multilaterals. Most government domestic debt has a short-term maturity and the Government has refinanced it by issuing government T-bills with variable rates.

13. **Following two years of tight fiscal policies, 2017 registered a lower than expected fiscal deficit.** The recession of 2015 combined with lower than expected external financing led the Government to cut spending in 2016, except for social spending. In 2015 and 2016, the pace of revenue collection declined. In 2017, mainly because of better compliance at the customs, government fiscal revenues registered a double-digit nominal year-on-year increase. Buoyant foreign trade is also reflected in strong collections of value added tax (VAT) (about +16 percent) and excises (about +31 percent). The fiscal deficit reached 0.8 percent in 2017, lower than the deficit forecasted at budget stage.

**Table 2. External Debt Level and Structure**

| | 2009 | | | 2017 | | |
|---|---|---|---|---|---|---|
| | US$ (million) | Share of total (%) | Percentage of GDP | US$ (million) | Share of total (%) | Percentage of GDP |
| Monetary authorities | 153.3 | 3.5 | 2.8 | 264.3 | 3.8 | 3.2 |
| General Government | 957.5 | 22.1 | 17.6 | 1722.5 | 24.7 | 21.2 |
| Banks | 457.6 | 10.6 | 8.4 | 440.4 | 6.3 | 5.4 |
| Other sectors | 2758.7 | 63.8 | 50.7 | 4546.4 | 65.2 | 55.9 |
| *of which intercompany lending* | 853.2 | 19.7 | 15.7 | 1838.9 | 26.4 | 22.6 |
| **Total external debt** | **4,327.10** | **100** | **79.6** | **6973.7** | **100** | **85.8** |
| Long-term external debt | 2,999.10 | 69.3 | 55.1 | 5226 | 75 | 64.3 |
| Short-term external debt | 1,328 | 30.7 | 24.4 | 1747.7 | 25.1 | 21.5 |

*Source:* NBM.

## 2.2 MACROECONOMIC OUTLOOK, DEBT SUSTAINABILITY AND RISKS

14. **In the medium term, growth is expected to remain robust but below historical averages.** Real GDP is projected to reach 3.8 percent and 3.7 percent in 2018 and 2019, respectively. Favorable external conditions will support the ongoing recovery in remittances, further sustaining private consumption, which will remain the main driver of growth. Increased contribution of exports and investment to growth is expected with improvements in the governance of the financial sector and in the business environment. Real growth in public transfers and the ongoing recovery in capital spending will help support growth in the medium term, particularly in the 2018 electoral year.

15. **The reforms supported under this operation are critical to sustaining medium-term growth.** The simplification and increased transparency in the issuance of business authorizations, licenses, and permits and in the procurement of electricity will lower costs for businesses, increasing the potential firm entry and creation, and improving competition. Increased access to selected agriculture inputs will improve farmers' productivity and their ability to adapt to adverse climate change events. Finally, strengthening the banking sector governance will help reduce excessive risk taking by banks and ensure that the banking system can effectively intermediate funds to productive investments. These reforms complement IMF's ongoing support focused on the identification of ultimate beneficial owners (UBOs) of all qualified shareholders (>1 percent) in the banking sector, the application of appropriate supervisory actions to shareholders with unidentified UBOs, and the adoption of appropriate enforcement and corrective supervisory actions for breaches of banking regulations, including those related to Anti-Money Laundering and Combating the Financing of Terrorism.

16. **As consumption and imports remain robust, the current account deficit is expected to gradually increase but to remain below its historical average**. The current account deficit is projected to improve and reach 4.9 percent in 2018 supported by a good harvest, widening thereafter. By 2019, supported by progress in reforms, foreign direct investment is expected to increase above historical averages. The bulk of net financing for the public sector will be covered by disbursements from the European Commission, IMF, Romania, and the World Bank. The IMF program is expected to continue its support for the gradual buildup in foreign exchange reserves (Table 3).

**Table 3. Balance of Payments Financing Requirements and Sources**

| (US$, millions) | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| **Gross external financing requirements** | **640** | **1064** | **1734** | **1298** | **1220** | **1186** |
| Current account deficit and errors and missions | 286 | 616 | 469 | 540 | 647 | 664 |
| Debt amortization and other investments (outflows) | 354 | 448 | 1265 | 758 | 573 | 522 |
| **Gross external financing sources** | **640** | **1064** | **1734** | **1298** | **1220** | **1186** |
| FDI and portfolio investments (net) | 75 | 206 | 261 | 340 | 386 | 423 |
| Change in gross reserves (-increase) | -531 | -531 | -95 | -65 | 25 | 30 |
| Debt disbursements and other investments (inflows | 1117 | 1417 | 1582 | 1037 | 822 | 744 |
| Capital account | -21 | -30 | -15 | -14 | -13 | -11 |

*Source:* IMF, NBM, World Bank.

17. **Monetary policy is expected to remain adequate with inflation expected to be within the target range of 5 percent (±1.5 percent).** In the short term, relatively low energy prices in national currency are expected to decelerate the inflation rate, which recorded 5 percent in February 2018. In the medium term, potential increases in regulated prices will slightly increase the inflation rate, which is expected to remain in the target corridor. Monetary policy will continue to be implemented through an inflation targeting framework with a flexible exchange rate and interventions focused on managing excess currency volatility while gradually building up foreign exchange reserves.

18. **Moldova has managed to keep fiscal deficits under control in the past 16 years.** In 2018–2019, fiscal deficits are projected to remain below 3 percent of GDP ensuring fiscal sustainability. Nonetheless, due to mandated indexation and valorization of pensions, wage increases, and additional public capital investments, a spike in expenditures is envisaged, resulting in fiscal deficit equivalent to 3 percent of GDP in the electoral year 2018, with subsequent decrease to 2.5 percent of GDP in 2019. In the medium term, the Government is expected to gradually reduce recurrent spending to create space for public investment. On the revenue side, Moldova will need to find substitutes for gradually declining official development assistance. Reforms under this operation help reduce key fiscal risks by improving the sustainability of the pension system, increasing revenue collection through an increase in tobacco taxation, and improving the reliability of the financial statements of state-owned and municipal enterprises and the effectiveness of the asset declaration regime of high-level public officials to preempt potential conflict of interests. While improvements in the overall tax and customs administration are ongoing, more efforts are needed to fight VAT fraud, reduce tax exemptions, increase collections from immovable property, and enhance collection mechanisms of taxes, especially for high-wealth individuals.

19. **According to the Joint IMF-World Bank Debt Sustainability Analysis (DSA), Moldova's public debt is expected to remain sustainable but some risks for private sector external debt persist in the near term.** By end-2017, as the economy grew faster, external debt decreased to 85.8 percent of GDP, from 93.7 percent in 2015. About 70 percent of total external debt is private. About half of the latter is short term, posing therefore rollover risks. Meanwhile, on the back of appreciation, public debt and guarantees are estimated to have decreased to 38.9 percent in 2017, from 43.8 percent in 2016. Moldova's public debt dynamics are projected to remain on a sustainable path under all stress scenarios, except for a permanent lower GDP growth scenario that potentially raises external public debt level above the threshold in the longer run (by 2037). While the present value of debt-to-GDP remains below the indicative thresholds, it is more sensitive to exchange rate depreciation and ad hoc increases due to debt creating flows (including a potential increase in contingencies that may arise in the banking system or for accumulated energy sector arrears). The DSA emphasizes the importance of prudent fiscal and borrowing

policies. It also notes that advancing structural reforms continues to be necessary to ensure debt sustainability.

**Table 4. Key Fiscal Indicators, Percentage of GDP**

| | 2015 | 2016 | 2017 | 2018f | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|---|---|
| **Overall balance** | **-2.2** | **-1.8** | **-0.8** | **-3** | **-2.5** | **-2.2** | **-1.9** |
| **Primary balance** | **-1.3** | **-0.5** | **0.5** | **-1.6** | **-1.3** | **-1.1** | **-0.9** |
| **Total revenues (and grants)** | **35.6** | **33.9** | **35.5** | **34.3** | **33.8** | **33.5** | **33.2** |
| Tax revenues | 30.3 | 27.1 | 30.5 | 30.8 | 30.5 | 30.5 | 30.7 |
| Corporate income tax | 2.3 | 2.2 | 2.7 | 2.8 | 2.6 | 2.6 | 2.7 |
| Personal income tax | 2.2 | 2.1 | 2.4 | 2.6 | 2.6 | 2.5 | 2.6 |
| Value added tax | 11.2 | 9.7 | 9.7 | 9.8 | 10.2 | 10.1 | 10 |
| Excises | 3.1 | 3 | 4 | 4.2 | 4.3 | 4.3 | 4.2 |
| Taxes on international trade | 1.1 | 1 | 1.1 | 1 | 1.1 | 1.1 | 1.1 |
| Social benefits | 9.9 | 8.8 | 10.3 | 10.2 | 9.6 | 9.7 | 9.8 |
| Non-tax revenues and other reve | 2.7 | 2.5 | 1.6 | 2.5 | 2.4 | 2.4 | 2.5 |
| Grants | 1.7 | 0.9 | 0.7 | 1.2 | 1 | 0.8 | 0.6 |
| **Expenditures (economic classifi** | **37.9** | **35.8** | **36.3** | **37.3** | **36.3** | **35.8** | **35.1** |
| Current expenditures | | | | | | | |
| Wages and compensation | 8.6 | 8.1 | 8.3 | 8.4 | 8.2 | 8.1 | 8.0 |
| Goods and services | 8.3 | 7 | 7 | 7.3 | 7.2 | 7.0 | 7.1 |
| Interest payments | 0.9 | 1.3 | 1.3 | 1.4 | 1.2 | 1.1 | 1.0 |
| Social benefits | 12.2 | 12.1 | 11.9 | 12.2 | 12 | 11.8 | 11.6 |
| Capital expenditures | | | | | | | |
| Nonfinancial assets | 4.8 | 4 | 4.1 | 4.9 | 4.2 | 4.3 | 4.5 |
| **General Government Financing** | **2.2** | **1.8** | **0.8** | **3** | **2.5** | **2.2** | **1.9** |
| External (net) | 1.5 | 2.3 | 1.6 | 2.5 | 1.1 | 0.7 | 0.6 |
| Domestic (net) | 0.7 | -0.5 | -0.8 | 0.5 | 1.4 | 1.5 | 1.3 |
| of which privatization | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 | 0.3 |
| **Expenditures (functional classification)** | | | | | | | |
| General services | 1.8 | 3.4 | 3.8 | 4 | 3.9 | 3.9 | 3.8 |
| Public order, security and defens | 2.3 | 2.6 | 3.1 | 3 | 2.9 | 2.7 | 2.6 |
| Economic affairs | 3.3 | 3.8 | 4.5 | 4.6 | 4.5 | 4.6 | 4.5 |
| Health | 5.3 | 4.3 | 4.8 | 4.9 | 4.8 | 4.7 | 4.6 |
| Education | 6.9 | 5.7 | 6.4 | 6.5 | 6.4 | 6.4 | 6.2 |
| Cultural, sports, recreational, reli | 0.9 | 0.8 | 0.9 | 1.2 | 1 | 0.9 | 0.9 |
| Social protection | 12.8 | 11.5 | 12.7 | 13.1 | 12.8 | 12.6 | 12.5 |

*Source:* National authorities, World Bank staff calculations.

**Figure 1. Public and Publicly Guaranteed Debt Dynamics as a Share of GDP**

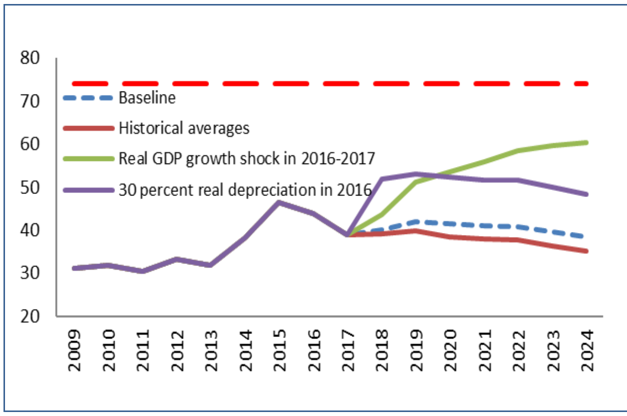
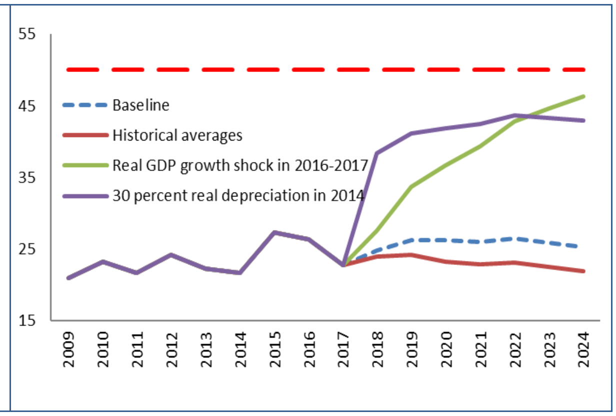



**Figure 2. External Public and Publicly Guaranteed Debt Dynamics as a Share of GDP**




*Source:* Joint IMF and World Bank DSA, 2017.
*Note:* Threshold represented by long-dashed red line.

20. **Macroeconomic risks are substantial.** First, agriculture remains vulnerable to extreme weather conditions and in recent years, the sector has posted double-digit fluctuations of output affecting GDP growth rates. Extreme weather events and droughts have lowered economic performance in the past decade, with annual economic losses caused by natural disasters ranging between 3.5 percent and 7 percent of GDP. With estimates suggesting significant increases in temperature (ranging from +1.3ºC to +4.6ºC by 2100 depending on the model used) coupled with the expected decrease in precipitation, the agriculture sector in Moldova experiences a high degree of vulnerability to extreme weather. Second, the banking sector poses risks in terms of credit quality, liquidity, and capital adequacy of selected banks. Moreover, poor governance throughout the financial system and lack of shareholder transparency compound the risks in the sector. Consequently, increased demand observed for the unregulated and poorly monitored nonbanking financial intermediation sector raises concerns.[2] Third, weaker growth of key trade partners and potential changes in international trade and migration relations could undermine exports and remittances flows. Fourth, the Parliamentary elections in 2018 may derail fiscal discipline and undermine sustainability. The risk is partially mitigated by the ongoing IMF program which serves as a macro-fiscal stability anchor. While the authorities have made efforts to reduce macroeconomic risks, some of them are inherent to the economic structure of Moldova and may not be fully mitigated in the short to medium term.

21. **The macroeconomic framework is considered adequate for policy lending.** Monetary policy is focused on the inflation objective, and fiscal deficits are expected to be on a declining path, maintaining debt sustainability. The authorities are taking measures to reduce the macro-fiscal risks stemming from the financial sector. The macroeconomic framework is being supported by the ongoing IMF program.

### 2.3 IMF RELATIONS

22. **In December 2017, the IMF Board approved the second review of the three-year extended credit facility/extended fund facility (ECF/EFF) blended arrangement with access of SDR 129.4 million (75 percent of quota, US$182.7 million).** The program, approved in November 2016, has four objectives: (a) strengthen financial sector, (b) safeguard fiscal sustainability, (c) maintain prudent monetary policy, and

[2] In the first half of the year, total loans given through the nonbanking sector increased by 29 percent, totaling 0.4 percent of GDP.

(d) advance structural reforms. Financial sector policies focus on four key areas: (a) taking enforcement actions to address already identified breaches of NBM regulations; (b) identifying Ultimate Beneficial Owners (UBOs) and related parties, unwinding related-party lending and enhancing governance in the banking sector; (c) revamping the resolution framework, preparing contingency plans, and restructuring banks; and (d) improving the NBM's governance and resources. In addition, the program sets out structural benchmarks for the energy sector, including the adoption of a new tariff-setting methodology to ensure transparency and cost recovery in the sector. The second review provided access to the equivalent of SDR 15.7 million, bringing the total disbursements and purchases under the Extended Credit Facility and Extended Fund Facility to the equivalent of SDR 57.4 million. It concluded that the program was broadly on track, but continued reform efforts were needed to accelerate growth and improve living standards.[3] The preliminary findings of the third review visit concluded that "authorities have made progress in strengthening economic policies and addressing vulnerabilities in the financial sector" and that "implementation of the 2017 budget and the authorities' fiscal policy commitments for 2018 are in line with program objectives and support growth-friendly measures." The completion of the third review, which will make available SDR 24.0 million (about US$34.9 million), is subject to approval by IMF management and the Executive Board. Approval could happen in June 2018, following the authorities' implementation of certain prior actions.

## 3. THE GOVERNMENT'S PROGRAM

23. **The Government's medium-term strategy is reflected in the National Development Strategy - Moldova 2020,** which calls for a shift from the current consumption-based growth model toward a growth model based on raising investments, increasing productivity and competitiveness, developing export industries, and promoting a knowledge-based society. The strategy currently identifies eight national development priorities, with the objectives of "ensuring qualitative economic growth and, implicitly, poverty reduction." These include:

(1) Aligning the education system to labor market needs to enhance labor productivity and increase employment in the economy;

(2) Increasing public investment in national and local road infrastructure to reduce transportation costs and increase speed of access;

(3) Reducing financing costs by increasing competition in the financial sector and developing risk management tools;

(4) Improving the business climate, promoting competition policies, streamlining the regulatory framework, and applying information technologies in public services for businesses and citizens;

(5) Reducing energy consumption by increasing energy efficiency and using renewable energy sources;

[3] Key performance criteria met included facilitating ownership transfer of the largest bank to fit and proper investors and streamlining the shareholder removal process, as well as adoption of a 2017 budget amendment and of 2018 budget consistent with program targets. Several structural benchmarks have been reset in relation to program priorities and given the complexity of financial sector reforms.

(6) Ensuring financial sustainability of the pension system to secure an appropriate rate of wage replacement;

(7) Increasing quality and efficiency of justice and fighting corruption to ensure equitable access to public goods for all citizens; and

(8) Ensuring competitiveness of agro-food products and sustainable rural development. The Government is currently reviewing the strategy and plans to extend it to 2030.

## 4. THE PROPOSED OPERATION

### 4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. **The reforms supported by this program are aligned with specific priorities identified in the National Development Strategy - Moldova 2020.** Pillar A focuses on reducing fiscal risks by strengthening oversight mechanisms which also contribute to the fight against corruption and supporting reforms to the pension system and tobacco taxation. These actions are directly connected to Priority Number 6 (ensuring financial sustainability of the pension system to secure an appropriate rate of wage replacement) and Priority Number 7 (Increasing quality and efficiency of justice and fighting corruption to ensure equitable access to public goods for all citizens), as identified by the National Development Strategy - Moldova 2020. Pillar B of this operation supports reforms that promote an improved business climate across the economy and in core economic sectors (banking, energy, and agriculture). These reforms are directly linked to Priority Number 4 (improving the business climate, promoting competition policies, streamlining the regulatory framework, and applying information technologies in public services for businesses and citizens) and Priority Number 8 (ensuring competitiveness of agro-food products and sustainable rural development).

25. **The design of the operation reflects lessons learned in the implementation of previous operations, as also reported in the 2017 World Bank Country Partnership Framework (CPF).**[4] Among others, the FY14–17 Country Partnership Strategy Completion and Learning Review[5] suggested that politically difficult structural reforms should be supported mainly through Development Policy Operations (DPOs) and/or Advisory Services and Analytics Operations, reducing the risk of delayed investment projects, and that coordination among development partners providing budget support is essential for effective leverage over key policy, especially governance, issues (World Bank, 2017 Country Partnership Framework for FY18–21). The operation, which focuses on economic governance, complements the World Bank's specific investment projects and technical assistance services (section 4.3) as well as reforms supported by ongoing budget support provided by development partners (section 4.4). Moreover, in line with Moldova DPO 2, the operation's design is selective and adjusted to the country's administrative capacity, with fewer policy areas than in earlier operations. Also, where legislative amendments are required to implement reforms, prior actions involve both government and parliamentary adoption.

### 4.2 PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

26. **By tackling economic governance challenges, the reforms supported by the program aim at lowering fiscal risks and leveling the playing field for private sector development**. The pension reform aims at ensuring sustainability of the public sector, while halting the declining trend in the replacement

[4] Report N. 115716-MD.

[5] *Ibid.*

rate (the level of pensions relative to wages) and removing special pension benefits considered unequal. Reforms under the first pillar are also expected to boost revenue from tobacco taxes in a country characterized by high smoking prevalence and related deaths. These reforms will expand fiscal space by increasing revenues in the short term and reducing health-related expenses in the longer term. Improving the ability to oversee the financial statements of SOEs and monitor assets owned by high-level public officials will help relieve the buildup of implicit liabilities and potentially preempt conflict of interests in the public sector. Reforms under the second pillar promote private sector growth by streamlining and clarifying what at times used to be a bureaucratic and cumbersome application process for authorizations, licenses, and permits; removing cumbersome and costly domestic testing for seeds, seedlings, pesticides, and fertilizers already part of the respective EU lists and catalogues; supporting reforms to strengthen the corporate governance of the banking sector, shaken by the 2014 banking fraud; and supporting guidelines to strengthen the transparency in the electricity procurement process, which had been characterized by an opaque procedure.

**Pillar A: Reducing fiscal risks**

27. **Restoring citizens' trust in the integrity of public institutions requires strengthening their economic governance for reducing fiscal risks**. Despite high social spending, the provision of social services has been inadequate. Before the reform, the public pension system was characterized by a low retirement age, inadequate valorization of past earnings in the pension formula, and the provision of special pension benefits for civil servants. As a result, in 2013, pension outlays constituted about 8.5 percent of GDP but failed to provide adequate benefits for the elderly. The replacement rate (the level of pensions relative to wages) in that year was 27 percent, among the lowest gross replacement rates in the region, and was projected to fall to 14 percent by 2050. During 2000–2014, public expenditures in health averaged 4.7 percent of GDP compared to the Europe and Central Asia average of 3.5 percent. The burden of disease in Moldova is substantial, with circulatory and respiratory diseases accounting for most of the high morbidity rate (World Bank Systematic Country Diagnostic 2016), while smoking prevalence remaining high. Yet in 2015, tobacco taxes averaged EUR 16 per 1,000 cigarettes, one of the lowest values in Europe. Sustainable and efficient public spending needs to be supported by transparent allocation of public resources. This is important in Moldova because SOEs employ 13 percent of the working population, their assets account for one-third of GDP and they are engaged in key activities such as gas import and distribution, electricity networks, telecommunications, railways, and transport.[6] While SOEs do not receive debt guarantees, their large participation in key utilities creates an implicit liability for the Government, driven by moral aspects or public expectations and pressures.[7] Before the reforms supported by this operation, the legislative framework provided for a limited oversight of the SOEs' financial performance, which may have led to a limited ability to undertake sound economic decisions, exacerbating fiscal risks. At the time of the identification of the operation, Moldova lacked a modern framework for asset declaration by high-level public officials, weakening the ability to monitor potential conflict of interests in public sector-related decision making. The operation supports reforms to tackle these challenges, promoting a transparent and both fiscally and socially sustainable public sector. It further continues the reform agenda supported by the previous DPO series which focused on reforms aimed at increasing the efficiency of public investment management system and the efficiency and targeting of the agricultural investment subsidies and of the social safety net.

[6] World Bank, Moldova support to the SOE preliminary diagnostic and reform assessment.
[7] Ibid.

**Prior Action 1. Enacted amendments to its public pension legislation by introducing a new benefit formula and indexation, increasing the retirement age, and streamlining the special pension regimes.**

28. Short-term fiscal imbalances and lack of long-term social sustainability were two key features of the public pension system in Moldova. Lack of pension valorization after 1999 weakened the link between contributions and benefits, creating incentives for contribution evasion.[8] Without changes, the average replacement rate for all pensioners was projected to drop from 25 percent in 2016 to 14 percent by 2050—a socially unacceptable level. In addition, different retirement age for men and women led to differences in benefits. In 2016, the average old age pension for women was 12 percent lower than for men.

29. **Prior Action 1** supports parametric reforms which entered into force during 2017, including changes to the pension formula and the increase in the retirement age. The new benefit formula, whose implementation started in April 2017, reinstalled valorization of wage used for calculation of the pension benefit at retirement and adjusted the accrual rate and benefits indexation to balance the relatively high cost of valorization. The new benefit formula strengthened the link between contributions and improved the adequacy of pension benefits. The retirement age, which started to increase in July 2017, is expected to increase gradually to reach 63 by 2019 for men and by 2028 for women. In addition, the reform eliminated special pension benefits of civil servants and thus, improved equity in the system. The formula and retirement age changes combined allow for achieving two outcomes in the medium term: (a) elimination of the pension deficit, which, during 2015–2017, stood on average at 1 percent of GDP and (b) maintenance of the replacement rate at least at about 25 percent over the medium run. The pension reform law also introduced retroactive valorization whereby the pensions of existing pensioners were recalculated based on revalued wage base. This measure aimed to restore social fairness towards those who retired when there was no valorization factor in the benefit formula. Therefore, existing projections suggest that the pension deficit will be likely eliminated around 2030.

30. **The expected result** is an increase in the replacement rate by 2 percentage points in 2018, compared to the 'no reform' (status quo) scenario[9] while maintaining the same cash balance of the pension system. Specifically, it is expected that the replacement rate will be above 25 percent in 2018 compared to below in the non-reform scenario. Over the medium term, the replacement rate will remain at around 25 percent (rather than decline) and the system deficit will be eliminated in about 15 years. To ensure longer term fiscal sustainability, the Authorities would need to keep on reassessing the system against the demographic changes.

**Prior Action 2. Enacted legislation to increase specific excise taxes on cigarettes.**

31. Fiscal revenue from tobacco is low despite the high prevalence of smoking, which contributes to high rates of tobacco-related diseases in Moldova. In 2009, Moldova signed the World Health Organization Framework Convention on Tobacco Control Agreement followed by the EU Association Agreement (2014). In 2015, the average tax on tobacco in Moldova was EUR 16 per 1,000 cigarettes, while the target for 2025, specified by the EU Association Agreement was EUR 90 per 1,000 cigarettes. According to the 2013 Skills towards Employment and Productivity survey, adult smoking prevalence in Moldova is 43.6 percent

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[8] Since 1999, the number of contributors in the system has shrunk by more than 40 percent.

[9] Since the replacement rate declines in the 'no reform' (status quo) scenario, comparing the 'reform' scenario to the 'no reform' scenario in 2018 would show the impact of reform better than comparing the 'reform' scenario in 2018 to the actual data for 2016.

among men and 5.6 percent among women.[10] Half of the youth start smoking by the age of 10 years. The higher smoking prevalence among men may also explain a 20 percent higher mortality rate among men than women.

32. **Prior Action 2** supports the increase in tobacco taxes in 2017–2019, thus increasing the fiscal revenue from tobacco excise and making cigarettes less affordable to the population.[11] The first amendments to the Tax and Custom Codes were adopted in 2017 and foresaw an increase in the average tax on tobacco to EUR 22 per 1,000 cigarettes compared to EUR 20 per 1,000 cigarettes in 2016. This operation supported the additional amendments adopted in December 2017, according to which in 2018 specific tobacco excise taxes for filtered cigarette were increased by 13 percent and more than doubled those for unfiltered cigarettes, which further foresaw the introduction of an ad-valorem tax of three percent. These increases are expected to generate, in 2018, a 22 percent increase in revenues from tobacco taxes in nominal terms compared to 2016.[12]

33. The **expected result** is an increase of the excise tax collections from tobacco by 12 percent in real term in 2018 compared to the baseline in 2016, while ultimately the reform is expected to improve public health outcomes.

**Prior Action 3. Enhanced transparency and oversight of SOEs by enacting legislation that: (a) mandates the auditing of the annual financial statements of state/municipal enterprises which are part of the medium, large, or public interest category; (b) classifies Large SOEs as public interest entities and obligates them to prepare financial statements under IFRS; and (c) establishes improved institutional and funding arrangements for an audit oversight system.**

34. SOEs play a significant role in the economy, but the lack of reliable and published financial data has limited the ability to assess accurately their overall performance, contributing to poor governance of SOEs and increasing associated fiscal risks. SOEs in Moldova are present in essential services and industries including utilities, health care, transport, and energy and in the delivery of administrative functions. SOEs employ 13 percent of the working population and their assets account for one-third of GDP. According to the latest available data, despite receiving 4 percent of GDP in direct state aid, SOEs receive significant indirect state support: exemptions, rebates, deferrals, or rescheduling of the payment of taxes accounted for 79 percent of state aid. SOEs have an overall positive net financial position, but its long-term debt and negative profitability trends indicate a deteriorating financial performance. In 2015, overall losses by SOEs were estimated at 1 percent of GDP. Moreover, before the reform supported by this operation, Municipal Enterprises (MEs) were not subject to auditing requirements, while large and economically significant SOEs were subject to the National Accounting Standards (NAS) rather than the more demanding International Financial Reporting Standards (IFRS).[13] The oversight and quality assurance of the audit

[10] Smoking prevalence among men is thus much higher than in the Europe and Central Asia Region (38 percent) or the EU (30 percent), although female smoking prevalence is higher in the region in comparison with Moldova (20 percent in Europe and Central Asia and 24 percent in the EU, respectively). Europe and Central Asia and EU averages from World Development Indicators database.

[11] The tobacco excise increase is supported by the World Bank Group Global Tobacco Control Program that is assisting countries in the region (Ukraine, Moldova, Belarus, Armenia, and Russia, among others) to coordinate and combine efforts in tobacco taxation for additional revenue generation and curbing of smoking prevalence to improve health outcomes.

[12] Based on the medium-bound elasticity calculated in Fuchs, Alan, and Francisco Meneses. 2018. "Tobacco Price Elasticity and Tax Progressivity in Moldova." World Bank, Washington, DC.

[13] Compared to IFRS, NAS contain simplified valuation rules for assets and liabilities and fewer disclosures compare to IFRS, which is adequate for medium-size and smaller companies but not for companies of public interest.

profession are also at an early stage leading to uneven quality of audits and therefore limited reliability of SOEs' audited financial information. Therefore, the presentation of the assets in the financial statements of SOEs and MEs has been of weak quality, with negative implications for economic decisions and higher potential opportunity for asset stripping. Furthermore, the absence of enforcement for SOEs to publish their financial statements on their corporate websites has limited the oversight by all relevant stakeholders. This undermines the trust in the public institutions in a context of low customer satisfaction for SOEs' services and business-related concerns in the sectors in which SOEs are active.

35. **Prior Action 3** supports legislative provisions adopted toward the end of 2017[14] which aim at strengthening the reliability of SOEs' and MEs' financial information. Specifically, these legislative provisions provide for mandatory auditing of annual financial statements of both SOEs and MEs classified as medium, large, or of public interest according to the recently enacted Accounting Law[15] and oblige them to submit the auditor's report to the Public Property Agency, the agency responsible for ownership function of SOEs, for publication on its official website. The prior action also promotes recent legislative amendments[16] that classify large SOEs as public interest entities, obliging them to be subject to more demanding and transparent IFRS financial reporting standards starting from January 1, 2019, the date of entry into force of the new Accounting Law. Finally, it supports the establishment of the improved institutional and funding arrangements for the audit oversight system, which will also promote the independence and enhanced quality of SOE audits. This prior action has been complemented by ongoing technical assistance in partnership with the UK Good Governance Fund. The technical assistance focused on (a) a comprehensive diagnostic of the Moldova's SOE sector on the basis of international benchmarks, which highlighted key challenges and reform areas for future focus by policy makers, and (b) limited capacity-building activities for SOEs' Board Members, who represent the Ministry of Finance. Assistance funded by the European Union mainly focuses on improving capacity of relevant national institutions and SOEs to govern, regulate, enforce, and disseminate high-quality SOEs governance practices, including accountability of SOEs through enforcing sound financial reporting and auditing standards.[17]

36. **The expected result** is that in 2019, at least 50 percent of the total number of existing SOEs and MEs will submit 2018 audited financial statements to the competent national authority. This will strengthen the quality of financial data and the ability to undertake sound economic decisions and base assessment of fiscal risks of SOEs on more rigorous and credible data. Moreover, the publication of the audited financial statements for large and medium SOEs and MEs and the publication of the annual analysis on their economic-financial status is expected to strengthen the transparency and accountability in the use of public resources.

**Prior Action 4. Strengthened its asset declaration regime by (a) enacting amendments to the NIA Law, the Law on Declaration of Assets and Interests, the Criminal Code, and the Contravention Code; (b) adopting a regulation on the methodology for verification of asset declarations and conflicts of interests; and (c) launching the NIA's electronic asset declaration and verification system online.**

37. Lack of effective system for declaring and verifying assets and interests of public officials reduces the strength of the fight against corruption and available tools for its prevention. Since 2013, public

[14] Chapter III, Article 11, and Chapter IV, Article 18 of the Law on State enterprise and Municipal Enterprise No. 246 dated November 11, 2017, lay down provisions for auditing and disclosure of SOEs' and MEs' financial information.
[15] The new Accounting Law will enter into force in 2019 (see later); however, the recent amendments to the Law on State-Owned and Municipal Enterprises require that the same size criteria are already used starting from 2018 audits.
[16] Chapter 1, Article 3 of the Law on Accounting and Financial Reporting No. 287, dated December 15, 2017.
[17] The EU assistance is estimated to commence mid-2018.

officials have been declaring their assets and interests to the National Integrity Commission, which was responsible for checking the accuracy of the information in declarations and playing a leading role in sanctioning officials for false statements and actual conflicts of interest. However, as the legal and institutional framework for asset declarations failed to have a substantial impact on preventing and fighting corruption, a new law was enacted in June 2016. This new legislation foresaw the transition to a new institutional model (from the National Integrity Commission to the National Integrity Authority[NIA]) and the launch of the electronic filing and verification system.

38. **Prior Action 4** aims at improving the effectiveness of this tool in the prevention and fight against corruption. The authorities worked with the Stolen Asset Recovery Initiative (StAR) on a number of technical legislative amendments to improve the legal framework, in particular, on sanctions, verification process, and strengthening of the asset declaration form to systematically include the declaration of assets held by officials as beneficial owners. While the legislative amendments supported by this Prior Action are a notable achievement toward strengthening the effectiveness of the system for preempting conflict of interests in public decisions, going forward certain sections of the recently enacted form for the declaration of assets and interests could be further improved to ensure consistency throughout the whole form while other sections could be further strengthened. The electronic system for filing and verifying asset declarations was launched on January 1, 2018. StAR also provided advice on the development of the methodology for the verification of asset declarations, which was formally approved by the Acting Chairperson Head in early January 2018. StAR continues to help the authorities in developing detailed guidelines for filers based on the newly adopted amendments and to further increase the capacity of the technical staff of the NIA.

39. **The expected result** is that at least 60,000 declarations of high-level officials are filed electronically and undergo automatic cross-checks with public registries (property, company, and vehicle registries) in 2018 compared to none in 2016. This will increase the incentive for filers to disclose accurate information and play a dissuasive role for those considering engaging in corrupt acts and conflicts of interest. This new electronic system will also increase the ability of the public and civil society to monitor the information filed, with most of the content of disclosures available online in a format that allows analysis of bulk data.

**Pillar B: Leveling the playing field for private sector development**

40. **This pillar supports private sector development through leveling the playing field in access to business opportunities and resources in the overall economy and in its core sectors (agriculture, banking, and energy).[18]** Enterprise surveys confirm that economic governance bottlenecks hamper the ability of conducting business in the country. In 2013, about 30 percent of the Business Environment and Enterprise Performance Survey (BEEPS) respondents indicated that unofficial payments/gifts, private payments, or other benefits to public officials had a moderate, major, or decisive impact to gain advantage in the drafting of laws, decrees, regulations, and other binding government decisions. At the same time, Moldovan businesses have been subject to cumbersome, multiplicative, and time-consuming processes related to obtaining permits or licenses, discouraging business entry. Farmers in the agriculture sector, which accounts for 14 percent of GDP and employs 25 percent of the labor force,[19] face limited access to

[18] Looking forward, structural reforms in the agriculture sector will need to concentrate on land reforms. In addition, further analytical work is needed to better understand the extent of the restrictiveness and the impact of various product market regulations in Moldova. Analytical work is currently ongoing in this area as part of the forthcoming Country Economic Memorandum, which will provide recommendations in this area.

[19] World Bank. 2015. *Moldova Public Expenditure Review: Agriculture*. World Bank: Washington, DC.

high-quality inputs. This harms the ability of firms in the sector to adjust to weather and market shocks and places them at a disadvantage compared to peers in the EU that possess more advanced inputs and technologies. Moldova's banking fraud of 2014 exposed prevalent weaknesses in banking sector governance. Strengthening the internal governance arrangements of banks ensures that the banking system can effectively intermediate funds to productive investments and therefore foster economic development and growth. In the energy sector, Moldova satisfies 96 percent of its needs through imports. Its electricity imports have been governed by a nontransparent agreement between two intermediary companies. Strengthening the transparency of the procurement process can therefore contribute to leveling the playing field among participating bidders.

**Prior Action 5. Enacted amendments to its legislation on the regulation of entrepreneurial activity to streamline requirements for application and the procedure for receiving authorizations, including mandating the use of a one-stop-shop, and to reduce the list of required licenses, authorizations, and certificates.**

41. Moldova suffers from the problem of multiple, duplicative, and burdensome procedures for obtaining licenses, authorizations, and certificates that represent a heavy burden for business development and increase corruption opportunities. In 2016, licenses, authorizations, and certificates were regulated by both the main Law 160 and by a series of unrelated laws and regulations, adding to the complexity of the system. The latest Business Environment and Enterprise Performance Survey (BEEPS) in 2013 indicated that every fifth firm was expected to make informal gifts/payments to obtain an operating license in Moldova. Yet, according to the Systematic Country Diagnostic, firms that allegedly relied on bribes in their applications for a business license were 50 percent less productive than counterparts. The complexity of the system and the potentially associated rent-seeking opportunities deterred efficient allocation of resources across businesses and further acted as a constraint for business entry, competition and private sector growth.

42. **Prior Action 5** supports legislative amendments for streamlining the issuance procedures of the authorizations and reducing the number of licensees, authorizations, and certificates. By reducing barriers to business activities, it therefore fosters competition and facilitates firm creation.[20] The legislative amendments streamline the application process by introducing a clearer and transparent procedures for receiving the application, suspending the term of examination,[21] introducing tacit approval mechanism, and establishing the predictability and transparency of costs for obtaining permits and licenses. The legislative amendments further mandate that licenses, authorizations, and certificates could be invoked

[20] Specifically, with technical assistance from the IFC Business Climate Team, Moldova enacted Organic Law No. 181 of July 22, 2016, which amended Law No.160/2011 and 10 other laws, and Organic Law No. 185 of September 21, 2017, which amended Law No. 160/2011 and reorganized and amended about 108 other laws.

[21] For example, Article $6^1$ provides that upon receipt of the request, if it is found to be incomplete, the issuing authority has the right to suspend the expiry of the time limit set by the law for the issuance/extension of the permissive act requested, being obliged to immediately notify the applicant on the suspension and to indicate expressly what the applicant must present and/or carry out for the application to be processed. If the issuing authority indicates the need to present the acts/information or to carry out actions not expressly provided for by law, the decision to suspend the term is null and void. The nullity (total or partial) is to be invoked by the applicant by notifying the authority in written form. Suspension cannot be applied for more than 30 calendar days from the date of notification. Upon the expiration of the time limit set for the suspension or until the expiration of the period stipulated by the law for issuance of the permissive act, the issuing authority shall be obliged to issue the permissive act or to refuse its issuance if the conditions set by the law are not met. Otherwise, the principle of tacit approval will occur.

or requested only after their inclusion in the Nomenclature of Permissive Acts[22] and in the Single Governmental Public Service Portal.[23] Relatedly, the authorities are developing secondary legislation and internal regulations that provide for the functions and attributions to act as one stop shop, including developing instructions and guides regarding new procedure of tacit approval. The information system platform of the one stop shop was presented in October 2017 and will be piloted in May 2018. [24] With assistance from the World Bank and the International Finance Corporation, the final version of the one-stop-shop information system with all 149 permits digitized will be released toward the end of 2018. Moreover, the reduction in the number of licenses, authorizations, and certificates is based on removing duplicative ones and those for which there are already similar regulatory mechanisms or those that tend to cover public risks in excess to what would be necessary to achieve its objective.[25]

43. **The expected result** is that the number of licenses, authorizations, and certificates for business activity will be halved by end-2018 compared to baseline of 2016. IFC estimates suggest that annual direct compliance cost savings for the private business are likely to reach around US$12 million (0.2 percent of GDP), while the more transparent procedures and reduced face-to-face interactions between the businesses and the inspection bodies are expected to limit opportunities for corruption.

**Prior Action 6. Enacted amendments to its legislation to improve farmers' access to agricultural inputs (seeds, seedlings, fertilizers, and pesticides) by simplifying the domestic mandatory requirements for testing and registration for European Union-registered inputs.**

44. Despite low productivity and high volatility of agricultural output, Moldovan farmers face inadequate access to inputs**.** While agricultural sector employs a third of the population, its productivity is 40 percent lower than the national average. As a result, agricultural incomes remain modest, leading to much higher poverty incidence in the rural areas compared to urban areas.[26] In addition, climate-related events have increased the volatility of agricultural output directly affecting the vulnerability of the income of poor households. Yet, Moldovan farmers can access only a small fraction of plant varieties and types of fertilizers and pesticides compared to EU farmers. Only inputs listed in the national catalogues of Moldova can be sold in the domestic market, while new inputs are subject to lengthy and costly domestic testing procedures (Box 1). While domestic testing procedures for EU-registered seeds, seedlings, fertilizers, and pesticides are somewhat shorter compared to similar products from other countries, it is still costly, nontransparent, and unreliable. The costly and lengthy registration procedures and the relatively small size of the domestic market for inputs discourage importers to bring new products into the country. This governance arrangement for the sector reduces productivity and competitiveness of domestic agricultural producers, affecting also their export potential. This is a bottleneck that prevents Moldova from increasing agricultural exports to the EU under the Association Agreement and the Deep and Comprehensive Free Trade Area. In addition, anecdotal evidence suggests an ongoing smuggling of agricultural inputs from the EU, fueling corruption, distorting statistics, and posing serious phytosanitary risks. The agriculture sector is inextricably tied to climate change, making it the most climate sensitive of all economic sectors. The Nationally Determined Contribution and the Climate Change Adaptation Strategy of Moldova promote

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[22] Before 2016, there was a single list of permissive documents in Law 2016. However, there was no rule that other non-listed permits should not be requested/issued.
[23] Law No. 160/22.07.2011, Art. 4 para. (3) (as amended by Law 181 as of July 22, 2016).
[24] http://www.gov.md/en/content/issuance-permissive-acts-be-integrated-single-window-moldova.
[25] Law No. 181 eliminated 111 and Law No. 185 additional 151 licenses, permits, and authorizations.
[26] World Bank. 2015. *Moldova Public Expenditure Review: Agriculture*. World Bank: Washington, DC.

climate actions in agriculture, including the need to increase the use of crop varieties that are better suited to the new climate conditions and, therefore, more resilient to the anticipated climate impacts.

45. **Prior Action 6** supports legislative amendments to simplify these domestic requirements for EU-listed inputs and indirectly recognize the respective EU catalogues/lists. Specifically, it supports legislative amendments which foresee the unconditional recognition of the list of active substances approved by the EU, a shorter time frame (40 working days rather than one year), and a simplified procedure for the approval of plant protection products authorized in one of the member states of the EU.[27] It also provides for the free introduction and circulation in the market of the fertilizer marked 'EC fertilizer' without state testing—and without registration in the State Register of Phytosanitary Products and Fertilizers.[28] Similarly, it supports recent legislative amendments which allow seeds and seedling registered in the EU Common Catalogues to be imported and marketed without having to undertake prior domestic testing. IFC continues to provide technical assistance to the authorities on developing the related secondary legislation for timely and efficient implementation of the primary laws supported by this prior action.

**Box 1 . Official Costs of Testing Agricultural Inputs that Are Not Registered Domestically**

Seeds and seedlings - one-year testing/EUR 500, registration fees of EUR 100–250, annual costs for keeping varieties in the register/EUR 60–120. EU seeds are tested for at least one year, seedlings are tested for at least 5 years, and therefore, the related costs are incrementally higher.

Fertilizers and pesticides - one-year testing/EUR 500, registration fees of EUR 300–4,000. EU pesticides are tested for at least 1 year while EU fertilizers are subject to a short recognition procedure of 30 days.

*Source:* ABG GmbH. 2017. *Moldova Regulatory Assessment of Agricultural Input Markets*. Report commissioned by the World Bank Group and Government of Sweden and implemented by Moldova Investment Climate Reform Project.

46. **The expected result,** which is measured with an increase in the number of imported varieties of seeds and seedlings, as well as the types of fertilizers and pesticides (10 percent in 2019 compared to 2017), is a larger access of Moldovan farmers to agricultural inputs developed in the EU over the medium term. The larger access is expected to help farmers to improve crop productivity, competitiveness, and market access. Furthermore, by sourcing drought-resilient varieties of seeds and seedlings, vulnerability to climate change in the sector will be partly addressed with the improved adaptive capacity in the sector, thereby helping ensure long-term food security in the country.

**Prior Action 7. The National Bank of Moldova initiated evaluation of compliance by three banks in accordance with the bank governance provisions of the new Law on Banks' Activity and the new Regulation on Internal Governance and Risk Management in Banks through its on-site and off-site monitoring systems.**

47. Poor corporate governance in Moldova's banks and weak supervisory response by the NBM was at the heart of the 2014 banking fraud and hindered the proper functioning of the banking system, including its role of providing loans to productive investments for private sector development. Adequate regulations and processes were not in place, and those tools available were not rigorously employed, to identify banks' ultimate beneficial owners (UBOs) and their direct and indirect interests. Thus, transactions with such parties were difficult to identify, track, and address. Lack of sufficient information

[27] Including for fertilizers meeting the essential requirements established by the Government and for fertilizers registered in accordance with the national requirements of a member state of the European Union.
[28] Amendments to Article 10 ($3^1$), 10 ($3^2$) and Article 12(a) of Law No. 119, June, 22, 2004, as enacted in January 2017.

on insider parties, including, but not limited to, the UBOs and their interests, also encumbered efforts to clearly identify and disclose the range of nontransparent actors in the sector. Consequently, changes in the control of banks (often through 'raider attacks') escaped the 'fit and proper' vetting and supervisory response by the NBM, allowing undisclosed parties to operate in the country's financial sector with unclear and dubious intentions. Because of the skewed incentives in such governance structure, insufficient attention was paid to the control environment, as evidenced by the underdevelopment of critical risk control and internal audit functions of banks.

48. **Prior Action 7** is part of the Government's and NBM's strategy to address the issues that led to the banking fraud and to prevent its recurrence.[29] This prior action specifically supports ongoing improvements in bank governance. The enacted new 'Law on Banks' Activity' includes improved provisions on bank governance. In addition, the NBM has issued a new bank governance and risk management regulation. The regulation and governance articles of the law include provisions to strengthen bank oversight by the supervisory board and senior management (the 'executive body'); strengthen the internal control environment (including internal audit, risk management, and compliance functions); and require banks to establish comprehensive internal governance, risk management, and conflict-of-interest policies and processes. The new provisions ensure that the supervisory board focuses on organizational structure, policy setting, and strategy direction of the bank while leaving day-to-day management and implementation of board decisions to the executive body. Internal audit, compliance, and risk management functions must now report to the supervisory board, rather than to management, to maintain their independent status. The board must approve a corporate governance code, which must also be approved by the supervisory board and by the NBM. The board and the NBM will monitor compliance. Importantly, the new legal provisions shift the burden to a potential bank acquirer to demonstrate otherwise when NBM suspects that the ultimate beneficial owner is different from the stated acquirer.

49. **The expected result** is that five banks will be materially compliant with the new corporate governance legal and regulatory framework by mid-2019. This prior action builds upon the previous DPO series which, among others, supported legislative amendments to strengthen the supervisors' independence and the launch of the special audits for the three largest banks (Victoria Bank, Moldinconbank, and Agroindbank).

**Prior Action 8. Taken steps to improve the transparency and competition in the wholesale electricity market by i) the approval of the Guidelines for Annual Procurement of Electricity for the purchase of electricity on the wholesale market (excluding regulated purchase of domestic power generation, power reserves, and emergency supply); and by ii) the involvement of the Group of Observers in the monitoring of the tender-related process.**

50. In 2016, in its review of the National Energy Regulation in Moldova, the Energy Community Secretariat (ECS) noted that the annual power purchase contracts were concluded "following a rather opaque bidding process," and that "ANRE (energy regulator) so far has failed to remedy that situation or to add transparency and fairness by acting as an independent authority." Following this diagnosis, the ECS, the National Agency for the Regulation of Energy (ANRE), and the Deputy Prime Minister signed an

[29] Other initiatives supported by the IMF, EU, and World Bank, include identifying and requiring the disclosure of ultimate beneficial owners (UBOs), putting three banks with weak governance under special administration, freezing the shares of shareholders acting in concert without proper notification to the NBM, finding strategic investors to buy those shares, and creating a central securities depository in the NBM where shares in banks and other public intertest entities must be registered (rather than in the smaller, private registries that were used in the raider attacks).

action plan to provide all necessary mechanisms and ensure full transparency for imported electricity purchases by the next contracting period. On this basis, the ECS and the Government developed annual electricity procurement guidelines, designed to improve the transparency and competition of electricity procurement while maintaining security of supply.

51. **Prior Action 8** supports the adoption for the first time of a set of guidelines to drive the annual procurement process for electricity for the 12-month cycle starting on April 1, 2017, and the monitoring of the tender-related process by a dedicated Group of Observers to identify ways to further strengthen the process if needed.[30] In its report of 2017, the Group of Observers noted that, compared to the previous years, the procurement procedure that started in March 2017 and resulted in the selection of Energocom (an SOE) to supply Moldova (through a supply contract with the Ukrainian generator DTEK) "has shown significant steps forward made by both the state authorities and the companies. At the same time, there is significant room for improvement." [31] In May 2017, after the completion of the tender-related procedure, Energocom signed a new supply contract with MGRES, which had previously participated as a competitor in the tender procedure and lost during price negotiations. Such a situation was concomitant with the interruption of anthracite supply from Donbass and the issuance by the Ministry of Energy of Ukraine of new export quota which reduced the allowed electricity export from Ukraine to Moldova. Thus, since May 2017, Moldova (through Energocom) sourced 70 percent of all 'imports' from MGRES and 30 percent from DTEK. The contractual supply price agreed in this new contract with MGRES (US$45 per MWh) turned lower than the price offered by DTEK (US$50.2 per MWh) and the price initially offered by MGRES during the March 2017 tender process (US$58.5 per MWh in the first round and US$54.4 per MWh in the second).

52. Based on the 2017 experience, the Moldovan authorities, the Energy Community Secretariat, the EU Delegation, and the EU High-Level Adviser for Energy Policy worked on a list of amendments and revised the 2017 Guidelines (adopting the 2018 Guidelines) for clearer provisions and requirements to further improve the transparency of the procurement process. The 2018 procurement of electricity in Moldova ended with the win of the state-owned company Energocom, with a final price of US$52.8 per MWh (average). According to the Group of Observers monitoring Report of April 2018,[32] the 2018 tender process showed limited progress compared to the 2017 one. There is a need to further strengthen the guidelines for future tender processes, including in relation to the participation of Energocom at the place of direct contracts by the Moldovan energy companies.

53. **The expected result** is that 50 percent of all electricity is purchased following the guidelines. Looking forward, further progress and the sustainability of a more transparent tender process compared to 2016 risks to halt. The risk is partially mitigated by ongoing and planned engagements to support reform of the Moldovan energy sector by the EU and the World Bank (the prior action is complementary to the planned Transparent Power Market Project and to long-term support to the energy sector regulator).

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[30] The Group of Observers comprises representatives of the Moldovan Energy Regulator ANRE, the Ministry of Economy in Moldova, the Energy Community Secretariat, the EU delegation in Moldova, and the EU High-Level Adviser for Energy Policy.

[31] Among others, this includes the participation of SOEs (such as Energocom), which may be at a significant advantage in relation to other competitors in a tender procedure largely organized, influenced, and monitored by the state and the fact that intermediaries such as Energocom and their electricity acquisition and contracts were not subject to the Group of Observers monitoring. Similarly, the guidelines do not foresee the publication of information related to the electricity acquisition and contracts for intermediaries such as Energocom but only for regulated suppliers (that is, suppliers for which the retail prices are regulated by ANRE) and buyers (that is, transmission and distribution companies).

[32] Available at https://www.energy-community.org/news/Energy-Community-News/2018/04/05.html.

## Analytical Underpinnings

54. **The operation builds on the SCD, which identifies six priorities for making progress toward the twin goals of reducing poverty and boosting shared prosperity in a sustainable manner**. This includes three top priorities: (a) strengthening the rule of law and the accountability of institutions; (b) improving the efficiency of and equity in service delivery; and (c) increasing the quality, equity, and relevance of education and training systems, so that firms may increase productivity and households may increase economic opportunities. In addition, supporting priorities include (d) improving the business regulatory framework; (e) ensuring sound macroeconomic and fiscal management; and (f) reforming the social protection system, particularly pensions. The reforms of the operation are mainly directly linked to top priority (a) and to two supporting priorities: (d) and (e). The reforms are further supported by dedicated analytical underpinning (Table 5).

**Table 5: DPO Prior Actions and Analytical Underpinnings**

| Prior Actions | Analytical Underpinnings |
|---|---|
| **Pillar A. Reducing fiscal risks** | |
| Prior Action 1. Enacted amendments to its public pension legislation by introducing a new benefit formula and indexation, increasing the retirement age, and streamlining the special pension regimes. | World Bank SCD (2016) identifies “reforming the social protection system, particularly pensions” among the six priorities for achieving progress toward the twin goals. SCD (2016) suggests reforming pensions by (a) introducing the valorization of past earnings in the pension formula, along with an adequate indexation pattern and lower accrual rate, and (b) gradually equalizing the retirement age at 62 and then increasing it for both genders to 65. |
| Prior Action 2. Enacted legislation to increase specific excise taxes on cigarettes. | World Bank SCD (2016) identifies “improving efficiency and equity in service delivery,” including improving the efficiency of public spending particularly in health as a key priority for making progresses towards the twin goals. |
| Prior Action 3. Enhanced transparency and oversight of SOEs by enacting legislation that: (a) mandates the auditing of the annual financial statements of state/municipal enterprises which are part of the medium, large, or public interest category; (b) classifies Large SOEs as public interest entities and obligates them to prepare financial statements under IFRS; and (c) establishes improved institutional and funding arrangements for an audit oversight system. | World Bank SCD (2016) recommends “aligning SOE governance with OECD Guidelines on Corporate Governance to improve efficiency, accountability, and transparency” as one of the key actions needed for strengthening the rule of law and the accountability of institutions. |
| Prior Action 4. Strengthened its asset declaration regime by (a) enacting amendments to the NIA Law, the Law on Declaration of Assets and Interests, the Criminal Code, and the Contravention Code; (b) adopting a regulation on the methodology for verification of asset declarations and conflicts of interests; and (c) launching the NIA’s electronic asset declaration and verification system online. | World Bank SCD (2016) identifies strengthening the rule of law and the accountability of institutions as a top priority for making progress toward the twin goals.<br>International evidence supported by the StAR Initiative highlights the importance of a modern asset declaration framework to fight corruption. |
| **Pillar B. Leveling the playing field for private sector development** | |
| Prior Action 5. Enacted amendments to its legislation on the regulation of entrepreneurial activity to streamline requirements for application and the | World Bank SCD (2016) suggests as potential policy option “reducing unjustifiable regulatory compliance costs carried by businesses, particularly those related |

| Prior Actions | Analytical Underpinnings |
| --- | --- |
| procedure for receiving authorizations, including mandating the use of a one-stop-shop, and to reduce the list of required licenses, authorizations, and certificates. | to excessive numbers of licenses, permits, authorizations, certifications, and acts of registration" for improving the business regulatory framework, a priority identified for making progresses toward achieving the twin goals. Technical assistance reports financed under IFC Business Climate operations analyzed the existing set of licenses and permits to identify ways for streamlining and simplifying the process and the feasibility and options for introducing a one-stop shop for licenses and permits. |
| Prior Action 6. Enacted amendments to its legislation to improve farmers' access to agricultural inputs (seeds, seedlings, fertilizers, and pesticides) by simplifying the domestic mandatory requirements for testing and registration for European Union-registered inputs. | World Bank SCD (2016) identifies improving the business regulatory framework, a priority identified for making progresses towards achieving the twin goals.<br>ABG GmbH (2017) "Moldova Regulatory Assessment of Agricultural Input Markets report commissioned by the World Bank Group and Government of Sweden Moldova Investment Climate Reform Project recommends verifying the possibility to "simplifying acceptance of seed varieties that are listed in the EU common catalogues in Moldova, where up to now these seed varieties still have to undergo one year of testing in the field." Similarly, to improve access to fertilizers, the report suggests looking at the possibility for "homologation under the recognition procedure of PPPs that were authorized in one of EU member states of the central zone (e.g. Romania) without additional testing for biological effectiveness would make PPPs that have already proven their safety and effectiveness in similar agricultural conditions." Regarding "fertilizers which are already recognized without further testing when coming from the EU, Moldova might consider going one step further and allow free marketing of EC designated fertilizers without prior homologation." |
| Prior Action 7. The National Bank of Moldova initiated evaluation of compliance by three banks in accordance with the bank governance provisions of the new Law on Banks' Activity and the new Regulation on Internal Governance and Risk Management in Banks through its on-site and off-site monitoring systems. | World Bank SCD (2016) recommends "strengthening the independence, powers, and supervision capacity of the NBM; in addition, ensuring shareholder transparency and good corporate governance in financial institutions" as one of the key action for strengthening the rule of law and the accountability of institutions. |
| Prior Action 8. Taken steps to improve the transparency and competition in the wholesale electricity market by i) the approval of the Guidelines for Annual Procurement of Electricity for the purchase of electricity on the wholesale market (excluding regulated purchase of domestic power generation, power reserves, and emergency supply); | World Bank SCD (2016) identifies "improving efficiency and equity in service delivery," including providing good-quality services in energy as a key priority for making progress toward the twin goals.<br>In 2016, in its review of the National Energy Regulation in Moldova, the Energy Community Secretariat (ECS) noted that the annual power purchase contracts were concluded "following a |

| Prior Actions | Analytical Underpinnings |
|---|---|
| and by ii) the involvement of the Group of Observers in the monitoring of the tender-related process. | rather opaque bidding process" and that "ANRE (energy regulator) so far has failed to remedy that situation or to add transparency and fairness by acting as an independent authority." |

### 4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

55. **The EGDPO is an integral part of the FY18–21 Country Partnership Framework and builds on the previous Moldova DPO series.** The Moldova DPO2, approved by the Board in December 2016, emphasized financial sector stability after the 2014 banking fraud, in addition to reforms which aimed at increasing the efficiency of public investment management system and the efficiency and the targeting of the agricultural investment subsidies and of the social safety net. The operation focuses instead on the latter dimensions. The FY18–21 Country Partnership Framework is at the intersection of the National Development Strategy and SCD priorities and the World Bank Group's comparative advantage and supports Moldova's transition toward a new, more sustainable, and inclusive development and growth model, with priorities focused on economic governance, service governance, and skills development. This operation is directly connected to the economic governance pillar of the FY18–21 Country Partnership Framework, which emphasized three priorities: (a) business-friendly policies to foster private sector development and job creation, (b) better accountability in selected economic institutions, that is, government agencies and ministries and state-owned enterprises (SOEs); and (c) improved governance of financial institutions.

56. **The reform program supported by this operation builds on strong complementarity with other World Bank Group instruments in Moldova, including investment projects and analytical and advisory activities.** The fiscal dialogue was supported by the Public Finance Review and pension reforms benefitted from dedicated technical assistance by the Social Protection team (Prior Action 1), while programmatic Technical Assistance by the Financial Sector and Energy Sector teams has been provided and informed the policy reforms related to the banking and energy sector, respectively (Prior Action 7 and 8). Energy sector reforms are further complementary to the planned Transparent Power Market Project and to long-term support to the energy sector regulator. Reforms supported by the operation have been informed by technical assistance by the StAR Initiative (Prior Action 4), and the ongoing Technical Assistance for SOE Governance as part of the Economic Rule of Law Project (Prior Action 3). Reforms related to business climate have been informed by the Technical Assistance provided by the Competitiveness team as part of IFC's Investment Climate Reform Project and the World Bank Competitiveness Enhancement Project, which support regulatory reforms to de-risk investment by reducing the administrative burden of inspections, licenses, and permits on private businesses and increase farmers' access to key inputs (Prior Actions 5 and 6).

### 4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

57. **The EGDPO contributes to the coordinated set of policy-based support by development partners to Moldova.** The policy-based support from the IMF and the EU complements the priorities identified under the CPF, including this EGDPO. The IMF program, approved in November 2016, focuses on strengthening the financial sector, by supporting reforms to foster the regulatory and supervisory environment of the banking sector; maintaining prudent monetary policy; safeguarding fiscal sustainability; and advancing structural reforms, with a focus on improving the transparency and financial viability of the energy sector. The EU Macro-Financial Assistance (MFA) is expected to focus on financial sector and public sector governance, the fight against corruption and money laundering, energy sector

and business climate reforms, and the Deep and Comprehensive Trade Agreement implementation. While the MFA has been approved by the European Parliament and signed by the European Commission, the program is uncertain and will also depend on the impact of the recently adopted electoral law on democratic mechanisms. The next general elections are expected to take place in November 2018.

58. **Reforms supported by the program benefitted from wide citizen engagement.** Several laws[33] were presented for public discussion before entering the Parliamentary debate. Moreover, key analytical underpinning that informed specific actions were discussed in public fora. The SOEs' diagnostic assessment that informed the reforms supported by Prior Action 3 was discussed among over 60 stakeholders, including high-level officials, policy makers, representatives of relevant ministries and agencies, regulators, and representatives of SOEs.[34] The Economic Council, a public-private dialogue platform,[35] hosted multiple consultations on the reforms related to authorizations, licenses, and permits (Prior Action 5). The report underlying Prior Action 6 was publicly discussed in a stakeholder workshop held in June 2017 involving participants from government institutions, donor organizations, farmers' associations, and private input suppliers. Furthermore, in the process of developing the secondary legislation and to ensure efficient implementation of the enacted reforms, the team will engage and leverage the Prime Minister's Economic Council, which acts as a public-private dialogue platform proactively promoting business-friendly reforms in Moldova. This will ensure both high-level commitment to the reform delivery as well as private sector contribution to setting the most effective implementation arrangements.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT

59. **The policies supported by this operation are not expected to have adverse impacts along poverty, social, gender, or environmental dimensions**. In terms of the broader social impact, reforms aim at addressing key governance constraints. Indeed, according to the recent Life in Transition Survey, only 4 percent of adults in Moldova believe that the political situation in 2016 was better than 4 years ago (only 8 percent believed that the economic situation was better than 4 years ago), compared to 28 percent and 24 percent, respectively, for the group of Transition countries on average. Only 10 percent of adults believed that there was less corruption at the time of the survey than 4 years ago, compared to 31 percent for the Transition region on average (55 percent in Germany).

60. **Under Pillar A, Prior Actions 1 and 2 aim at strengthening fiscal sustainability and are expected to have direct positive welfare effects, while the remaining actions are not expected to have direct distributional effects**. According to the household budget survey data, increases in pensions have been one of the key drivers of improved living standards and shared prosperity in Moldova in recent years.[36] Given the rising share of elderly[37] and the shrinking of the working-age population because of out-

[33] All laws with exception to the amendments to the laws related to Prior Action 2 and Prior Action 6.

[34] http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/EXTCENFINREPREF/0,,contentMDK:23764577~pagePK:64168445~piPK:64168309~theSitePK:4152118,00.html.

[35] www.consecon.gov.md.

[36] During 2010–2015 pension increases accounted for one-third of total disposable household income growth in the bottom 40 group (World Bank. 2017. "Moldova Poverty and Shared Prosperity Update." Mimeo).

[37] By 2060, the old-age dependency ratio is projected to have tripled to 45.7 percent, relative to its 2015 level (World Bank. 2017. *A Human Rights-Based Approach to the Security of Older People in Moldova*. Report No. 112339-MD.)

migration, the importance of pension adequacy will increase over time, particularly for the bottom 40 percent.[38] As such, the reforms supported by Prior Action 1 will have a positive welfare effect by preventing a decline in the replacement rates for new pensioners, as well as improving the replacement rates of existing pensioners through retroactive valorization. While gender-disaggregated data are not currently available, by providing an equal retirement age, the reform helps increase pension benefits for women, as well as improving labor market incentives, reducing therefore potential pension gaps. Old-age pensions for women were 18 percent lower, on average, compared to pensions for men according to official data from the National Bureau of Statistics. According to a recent World Bank study, the gender pension gap is due to a combination of limited participation of women in the labor force, as well as the gender wage gap (26 percent) due to segregation between men and women in different sectors and occupations (World Bank 2017). Moreover, given greater life expectancy among women in Moldova (in Moldova, 62 percent of elderly women are widows, compared to only 25 percent among elderly men, World Bank 2017), improving pension replacement rates is particularly beneficial for women, especially in single elderly households.[39] The welfare effect of changes to tobacco taxation (Prior Action 2) depends on the combination of the changes in tobacco expenditures and lower medical expenses. Simulations of a tax increase equivalent to a 25 percent increase in price, using a partial equilibrium model,[40] suggest that a tobacco price increase would generate a rise in household expenditures on tobacco, but this increase would be proportionately higher for households in the middle and upper tail of the income distribution, assuming that households can change consumption patterns in response to price changes.[41] Meanwhile, over the longer term, reduced consumption of tobacco is associated with a reduction in tobacco-related diseases and thus, with a reduction in medical expenses, which is also estimated to benefit disproportionately lower-income groups in the population. The estimated net effect of a tobacco tax increase is found to be progressive in all three elasticity scenarios, and the upper-bound scenario (reflecting a longer-term impact) would benefit, in absolute terms, the incomes of the lower-income groups in the population (the bottom 40 percent of the population), implying that the reduction in medical expenses among low income households would outweigh the effects of price increases. In the bottom decile, the magnitude of the net effect is 0.18 percentage points of household income (0.02 percentage points for the 4th decile). Moreover, the reform has an important gender effect by tackling the much higher mortality rate among men compared to women (20 percent higher for men), in part due to higher incidence of smoking among men (43.6 percent of all men smoke compared to 5.6 percent women). The remaining actions of Pillar A, Prior Actions 3 and 4, aim at strengthening the transparency of economic institutions and are therefore not expected to have direct distributional effects.

[38] Between 2007 and 2014, the share of pensions in total income among the elderly increased from 47 percent to 60 percent; pension dependency among the elderly poor is especially high, at 69 percent of income (World Bank. 2017. “Moldova Poverty and Shared Prosperity Update." Mimeo).

[39] Households with elderly members, or elderly-only households, are poorer than the households without elderly—Moldova is one of only a few countries in the Europe and Central Asia Region where the elderly are poorer than the average population (World Bank 2017).

[40] For a detailed analysis, see Fuchs, Alan, and Francisco Meneses. 2018. “Tobacco Price Elasticity and Tax Progressivity in Moldova.” Policy Research Working Paper 8327, World Bank, Washington, DC.

[41] The model allows for several assumptions of the price elasticity of demand, ranging from a population average value of −0.13 (lower bound), to −0.33 (medium bound) and −0.53 (upper bound). The lower-bound elasticity reflects consumption behavior of population groups that are not likely to make significant changes to their consumption patterns (elderly and rural residents); the upper bound reflects a longer-term scenario, thus capturing the effect that taxes could have on younger people. Elasticities are also allowed to differ by decile, ranging from −0.51 for the bottom decile to −0.26 to the top decile for the medium-bound scenario. Elasticities are estimated from Household Budget Survey data. For more details, see Fuchs and Menenes (2018).

61. **The Prior Actions in Pillar B are expected to have neutral or positive welfare effects.** Individuals in the bottom 40 percent of the income distribution have lower employment rates and higher self-employment rates among those who work.[42] Reforms that aim at strengthening the business climate should benefit them to the extent that the impact of the prior actions on growth is through greater employment opportunities, inclusively on account of greater ease of doing business and compliance with regulations (Prior Actions 5 and 7). The main effect of Prior Action 6, aimed at improving farmers' access to agricultural inputs, is expected to be through greater productivity and resilience in agriculture. Survey data show that almost 80 percent of the poor and 70 percent of the bottom 40 are employed in the agricultural sector,[43]which is characterized by low productivity and high volatility due to its susceptibility to frequent climate shocks. The volatility of the income stream increases the vulnerability of households in agriculture, many of whom are already poor or near poor.[44] As such, improvements in the productivity and resilience in the agricultural sector, supported by Prior Action 6, should have a direct positive poverty impact, although it is not possible to evaluate the magnitude of this impact based on household survey data. The direct effects of Prior Action 8 on households are also difficult to estimate quantitatively, given that the policy measures supported by the prior action are upstream, in the wholesale electricity market. However, the prior action supports stability, predictability, and competition in electricity pricing. To the extent that greater competition translates into a lower end-user tariff increase path, this would benefit low-income households directly, given the higher share of energy expenditures in overall expenditures in these households.

### 5.2 ENVIRONMENTAL ASPECTS

62. **The operation is not expected to have adverse environmental impact.** World Bank experience in Moldova shows that the existing environmental assessment legal and administrative frameworks in the country are overall well developed and in compliance with good international practices. Moreover, and in line with the country's high degree of climate vulnerability, Moldova has a midterm climate change adaptation goal to reduce climate change vulnerability by 50 percent.

63. **The Prior Actions under Pillar A are expected to have neutral environmental impact.** They aim at strengthening transparency and anticorruption mechanisms, reforming the pension system, increasing tobacco taxes (Prior Actions 1, 2,3, and 4) with neutral environmental impacts.

64. **Reforms supported by Pillar B are expected to have overall positive environmental impact.** Prior Action 5 is legislative in nature but the reform provides for transparent process for obtaining authorizations, licenses, and certificates, including environmental ones.[45] Thus, by reducing multiple, duplicative, and burdensome procedures and by providing for a single entity responsible for the issuance of these acts (and separated from the activities linked to inspection and regulation), the reform may encourage an environmental licensing process that can more effectively protect and enhance public

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[42] In the bottom 40 percent, among those who worked, 25 percent were self-employed in 2014, compared to 19 percent in the top 60 group (World Bank Group. 2016. Poverty Reduction and Shared Prosperity in Moldova: Progress and Prospects. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/24734)

[43] Moreover, among people who are not employed, an expanding share, especially among the poor and the bottom 40, is engaged in low-intensity farming (less than 20 hours a week)—among the poor, this share increased from below 20 percent in 2007 to over 50 percent in 2014 (World Bank 2016).

[44] A recent Poverty Assessment notes that a majority of farm households are smallholders, who tend to be poorer and are not well protected against shocks. More than one-third of all farm households reported they faced difficulties in paying for the food needed to ensure decent nutrition among household members over the previous year. Subsistence farm households consume more than 99 percent of their farm production (World Bank 2016).

[45] The reform also introduces an integrated environmental permit.

health while facilitating economic growth in an environmentally responsible way. Prior Action 6 is expected to generate climate co-benefits, because farmers could improve access to inputs, widely used in Southern Europe, and more resistant to droughts and variability of weather conditions. Reforms related to the banking sector (Prior Action 7) are not expected to have environmental impacts.

**5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS**

65. **The latest available Public Expenditure and Financial Accountability (PEFA) assessment for Moldova, which was undertaken in 2015, concluded that public financial management (PFM) arrangements and systems have continued to perform well with marked improvements since the previous assessment in 2011.** Moldova continues to have in place fundamental systems for macro-fiscal management, a strong framework to enable strategic allocation of resources, and effective tools for improving operational efficiency. These were evidenced by overall strong scores in ratings of credibility, comprehensiveness, and transparency of the budget. Areas for improvement were identified as (a) deficiencies in collection of tax revenues, with recommendations for improvements in operational procedures through enhanced regulations and modernized business processes; (b) deficiencies in the predictability of availability of funds for expenditure commitments; (c) weaknesses in the effectiveness of internal audit, appreciating that work was in progress toward adopting the Public Internal Financial Control (PIFC) approach in line with the requirements of EU partnership agreements; and (d) deficiencies in donor practices mainly relating to predictability of budget support disbursements and multiple donor-specific fiduciary requirements. There are ongoing reforms supported by the operations financed by the World Bank and EU in several of these areas, including reforms in tax administration and internal audit. The 2016 annual report on PIFC outlining progress achieved in its implementation and development objectives for the next period has recently been published by the Government. Notable improvement has also been observed in timely approval of the state annual budget by the legislature.

66. **A new public procurement law became effective on May 1, 2016.** It provides a satisfactory regulatory framework and incorporates fundamental EU principles. However, certain provisions are not fully compatible with EU requirements and will require further amendments. Procurement in the areas of defense and utilities remains unregulated, while the legal framework governing concessions and public-private partnerships requires revisions and alignment with relevant EU legislation. The new law brought major changes in the process of resolving public procurement complaints, including the creation of the National Complaint Settlement Agency in September 2017. Ongoing reform efforts by the Ministry of Finance, including the establishment of an e-procurement system, are supported by the EU and other donors.[46]

67. **The latest IMF Safeguards Assessment[47] of the National Bank of Moldova (NBM) was undertaken in February 2017.** It observed a strengthening of the safeguards framework at the NBM through legal reforms which established a new governance structure with independent oversight over

[46] The Ministry of Finance further elaborated a strategy and action plan for the development of public procurement systems. The strategy and action plan were approved by the Government in December 2016 and aimed at implementing the provisions of the EU-Moldova Association Agreement and World Trade Organization Government Procurement Agreement. Moreover, a Memorandum of Understanding signed among the Ministry of Finance, the Public Procurement Agency, the Electronic Governance Center, several business associations, IT companies, and nongovernmental organizations foresees the establishment of a partnership to develop an e-procurement system to increase transparency in the public procurement process.

[47] The purpose of a safeguards assessment is to provide reasonable assurance to the IMF that a central bank's control, accounting, reporting, and auditing systems are adequate to ensure the integrity of operations.

management. It further noted that transparency and accountability practices adhere to international standards, and the NBM continues to maintain sound operational controls. The NBM has enhanced its internal oversight on reserves management and is updating emergency lending regulations. NBM authorities continue to implement recommendations of the IMF assessment.

68. **The most recent audit opinion on the financial statements of the NBM for the year ended December 31, 2016,[48] and those of the preceding year were unmodified**. Because the audits of the NBM do not indicate any weaknesses and the overall public financial management system together with the Government's commitment and plans to reform are adequate to support this operation, the audit of the dedicated account is not considered necessary for the EGDPO.

69. **IDA's standard disbursement procedures for DPOs will apply to this operation.** Following the approval of the credit and notification by the World Bank of credit effectiveness, the Government will submit a withdrawal application. The proceeds of the credit will be deposited by IDA in a dedicated account at the NBM designated by the borrower and acceptable to the World Bank. The borrower should ensure that upon depositing of the credit proceeds into the said account, an equivalent amount shall be credited in the Treasury current account at the NBM. Within seven days of remittance of funds by the World Bank, the Government will provide a confirmation to the World Bank that the funds have been received by the Treasury account in the NBM and that these funds are available for financing budget expenditures. The Government will maintain accounts and records showing that credit disbursements were made in accordance with provisions of the Financing Agreement. If, the proceeds of the credit are used for ineligible purposes (for example, to finance goods or services on the World Bank's standard negative list), the World Bank will require the Government to promptly, upon notice from the World Bank, refund an amount equal to the ineligible expenditure to the World Bank. Amounts refunded to the World Bank upon such request shall be cancelled. This condition will be reflected in the terms of the Financing Agreement.

70. **This assessment concludes that fiduciary risk for the DPO is moderate.** This rating appreciates the consistent achievement of high PEFA ratings and also considers ongoing PFM reform efforts toward modernizing tax administration, strengthening internal control and strengthening public procurement practices. Also, it appreciates the overall robustness of financial management arrangements at the NBM.

### 5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

71. The Ministry of Finance will steer the administration of this operation, as the main body responsible for financial aid coordination and management. The Ministry of Finance has recently assumed this role and will be responsible for the supervision for the monitoring of progress in the policy areas supported by the operation.

72. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate

[48] Audit opinions by an independent auditor were rendered on the 2016 annual financial statements of the NBM. The opinion included the balance sheet as on December 31, 2016, the statement of comprehensive results, statements of capital and reserves, and statement of cash flows for the year that ended, notes to the financial statements, including a summary of significant accounting policies. The opinion revealed that "the accompanying financial statements present fairly, in all material respect, the financial position of the Bank as of 31 December 2016, and its financial performance and its cash flow for the year then ended in accordance with International Financial Reporting Standards."

local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

## 6. SUMMARY OF RISKS AND MITIGATION

73. **The operation faces overall moderate risks** (Table 6)**.** The highest risks relate to macroeconomic, technical, and sector strategies risks, which are rated as substantial.

74. **Substantial macroeconomic risks stem mainly from the vulnerability of the agriculture and financial sector and the uncertainties linked to the forthcoming parliamentary elections**. The vulnerability of the agriculture sector to extreme weather conditions largely affects the volatility of GDP growth rates. The vulnerability of the financial system, in particular its opaque ownership, is also a threat to macro-financial stability, with fiscal implications. Moreover, the increased demand observed for the unregulated and poorly monitored nonbanking financial intermediation sector raises concerns. In addition, political risks compound macroeconomic risks. The Parliamentary elections in 2018 may erode fiscal discipline and undermine sustainability. Moreover, external assistance from the EU Macro-Financial Assistance is conditional upon an assessment on the impact of the recently adopted electoral law on democratic mechanisms. The risks are partially mitigated by Moldova's prudent and flexible macroeconomic policies, by the reforms supported by this operation and by the three-year IMF program that serves as a macro-fiscal anchor.

75. **Substantial sector strategy risks relate to the uncertain policy environment, especially post-November 2018 general elections and the possible opposition of vested interests to reforms**. Authorities' appetite for reforms is likely to diminish in preparation of and during the election campaign. To mitigate these risks, the EGDPO has been designed as a stand-alone operation with focus on advancing difficult reforms mainly during calendar year 2017 and early 2018.

76. **Substantial technical design risks relate to weak institutional capacity.** The risks are partially mitigated by TA undertaken by the World Bank Group and other development partners to strengthen the capacity of selected agencies, including the planned engagements to support reform of the Moldovan energy sector by the European Union and the World Bank (such as in the planned Transparent Power Market Project and the long-term support to the energy sector regulator); the ongoing World Bank corporate governance Technical Assistance for board members of SOEs and the forthcoming EU-World Bank technical Assistance on Economic Governance of SOEs; the support of the EU and IMF particularly in relation to reforms for strengthening the financial sector; and the IFC and World Bank's support to the Food Safety Agency, the Ministry of Agriculture, and Custom Services on developing secondary legislation on agriculture inputs and to the Ministry of Economy and State Chancellery on operationalizing and implementing the Single Window (through the IFC Investment Climate Reform Project and the World Bank Competitiveness Enhancement Project).

**Table 6: Summary of Risks**

| Risk Categories | Rating (H, S, M, or L) |
|---|---|
| 1. Political and governance | M |
| 2. Macroeconomic | S |
| 3. Sector strategies and policies | S |
| 4. Technical design of project or program | S |
| 5. Institutional capacity for implementation and sustainability | M |
| 6. Fiduciary | M |
| 7. Environment and social | L |
| 8. Stakeholders | M |
| 9. Other | L |
| Overall | Moderate |

*Note:* H = High; L = Low; M = Moderate; S = Substantial.

## ANNEX 1: POLICY AND RESULTS MATRIX

| Prior Actions | Results |
|---|---|
| **Pillar A--- Reducing fiscal risks** | |
| Prior action #1 Enacted amendments to its public pension legislation by introducing a new benefit formula and indexation, increasing the retirement age, and streamlining the special pension regimes. | Average old age pensions replacement rate:<br>Baseline: 24 (2018 - status quo)<br>Target: 26 (2018 - reform) |
| Prior action #2 Enacted legislation to increase specific excise taxes on cigarettes. | Excise tax collections from tobacco:<br>Baseline: MDL 1.7 billion (2016)<br>Target: baseline + 12 percent in real terms (2018) |
| Prior action #3 Enhanced transparency and oversight of SOEs by enacting legislation that: (a) mandates the auditing of the annual financial statements of state/municipal enterprises which are part of the medium, large, or public interest category; (b) classifies Large SOEs as public interest entities and obligates them to prepare financial statements under IFRS; and (c) establishes improved institutional and funding arrangements for an audit oversight system. | Percentage of medium and large Municipal Enterprises and medium and large State Owned Enterprises that have submitted audit reports to the competent national authority:<br>Baseline: 38% (2017)<br>Target: 50% (June 2019) |
| Prior action #4 Strengthened its asset declaration regime by (a) enacting amendments to the NIA Law, the Law on Declaration of Assets and Interests, the Criminal Code, and the Contravention Code; (b) adopting a regulation on the methodology for verification of asset declarations and conflicts of interests; and (c) launching the NIA's electronic asset declaration and verification system online. | Number of asset and interest declarations filed electronically:<br>Baseline: 0 (2016)<br>Target: 60,000 (2018)<br><br>Number of asset declaration undergoing automatic cross-checks with public registries<br>Baseline: 0 (2016);<br>Target: 60,000(2018) |

| Pillar B---Leveling the playing field for private sector development. | |
|---|---|
| Prior action #5 Enacted amendments to its legislation on the regulation of entrepreneurial activity to streamline requirements for application and the procedure for receiving authorizations, including mandating the use of a one-stop-shop, and to reduce the list of required licenses, authorizations, and certificates. | Number of authorizations (permits and licenses):<br>Baseline: 300 (2016)<br>Target: 153 (2018) |
| Prior action #6 Enacted amendments to its legislation to improve farmers' access to agricultural inputs (seeds, seedlings, fertilizers, and pesticides) by simplifying the domestic mandatory requirements for testing and registration for European Union-registered inputs. | Number of plant varieties, types of fertilizers and pesticides imported:<br>Baseline (2016): seeds 566; seedlings 90; fertilizers 146; pesticides 754.<br>Target: baseline +10 percent (June 2019) |
| Prior action #7 The National Bank of Moldova initiated evaluation of compliance by three banks in accordance with the bank governance provisions of the new Law on Banks' Activity and the new Regulation on Internal Governance and Risk Management in Banks through its on-site and off-site monitoring systems. | Number of banks materially complying with the governance provisions in the Law on Banks' Activity and the Regulation on Internal Governance and Risk Management.:<br>Baseline: 0 out of 11 (2016)<br>Target: 5 out 11 (June 2019) |
| Prior action #8 Taken steps to improve the transparency and competition in the wholesale electricity market by i) the approval of the Guidelines for Annual Procurement of Electricity for the purchase of electricity on the wholesale market (excluding regulated purchase of domestic power generation, power reserves, and emergency supply); and by ii) the involvement of the Group of Observers in the monitoring of the tender-related process. | Share of electricity purchased under published Guidelines (for April-March 12 months cycle):<br>Baseline: 0 (2016)<br>Target: 50 percent (2018) |

## ANNEX 2: LETTER OF DEVELOPMENT POLICY

MINISTERUL FINANŢELOR
AL REPUBLICII MOLDOVA

MINISTRY OF FINANCE OF
THE REPUBLIC OF MOLDOVA

MD-2005, mun.Chisinau, 7 Constantin Tanase str.,
www.mf.gov.md, tel.(022) 26-25-23, fax 022-26-25-17

No. 10/1-7/144 May 18, 2018

**Letter with regard to Development Policy**

**To the attention of Mr. Jim Yong KIM**
**President**
**World Bank**
**1818 H Street NW**
**20433 Washington D.C.**

**Moldova Economic Governance Development Policy Operation**

Dear Mr. Kim,

On behalf of the Government of Moldova, I have the pleasure to submit to you the Policy Document for the Economic Governance Development Policy Operation. This Operation will help Moldova's efforts to increase the sustainability and transparency of the public sector and implement key reforms for levelling the playing field for private sector development.

Moldova's economy maintained the growth momentum. Following the 2015 recession, the economy of the Republic of Moldova recovered towards its trend. In 2017, investment in fixed assets increased, the public revenues and expenditures grew double digit, and foreign trade intensified. There are positive developments in the real sector such as in industry, agriculture, transport services. The real increase of the average monthly salary and the increase in remittances from abroad have led to higher consumption. Moreover, our fiscal policy remains characterized by low fiscal deficit while we focus on prioritizing public investments and social spending.

Supported by consumption, Gross Domestic Product increased by another 4.5 percent in 2017, supported by a strong domestic demand and a positive external environment. Domestic demand increased sharply, largely driven by private consumption and investment growth, that became positive for the first time since the 2014 crisis. Stronger domestic demand was offset by negative net trade, with imports outweighing the export's dynamics.

Poverty reduction is a key priority of the Government of the Republic of Moldova. Progress in poverty reduction is achieved through the consistent, efficient and coordinated implementation of economic and social policies capable of generating sufficient employment and ensuring a high degree of social inclusion for all members of society. Particular attention is paid to the development of employment programs and social support for the population, as well as measures to develop small and medium-sized businesses and modernize agriculture.

In December 2017 the National Bank of Moldova (NBM) published a detailed summary of the banking fraud investigation received along with the second report of the Kroll and Steptoe & Johnson companies

In March 2018, after receiving the final investigation report of Kroll and Steptoe &Johnson, the National Bank of Moldova transmitted all investigation documents of the international consortium to the Anti-Corruption Prosecutor's Office, which will serve as basis for asset recovery.

Moldovan competent authorities are determined to take all necessary steps to recover the embezzled funds. Thus, in alignment with the commitments undertaken towards other external donors as well, a Recovery Strategy in this regard will be developed and implemented.

To help anchor the reforms, in November 2016, Moldova signed an Agreement with IMF on a reform program supported by a three-year Extended Credit Facility and Extended Fund Facility arrangement. On December 20, 2017, the Executive Board of the IMF concluded the Article IV consultation and the second review under the Extended Credit Facility (ECF) and Extended Fund Facility (EFF) Arrangements for the Republic of Moldova. By now Moldova has received from IMF 57.4 million SDR.

The reforms supported by the Moldova Economic Governance Development Policy Operation are in line with the National Development Strategy "Moldova 2020" and based on the World Bank Country Partnership Framework for the period July 2018-July 2021.

Currently a new strategy Moldova "2030" is under discussion. NDS "Moldova 2030" will be a long-term vision document, which will contain 10 priorities according to the following areas: economic sector; regional and rural infrastructure and development; labor market; education; health; social protection; equal opportunities, personal development and family life; justice and public administration; public order and environmental protection.

Supported by this program and dedicated World Bank technical assistance, the Government of the Republic of Moldova has undertaken a number of policy actions aiming at improving the governance issues:

## I. Reducing fiscal risks

*Action 1:*

To increase the efficiency and the fairness of the pension system, we enacted amendments to the legislative framework on public pensions through the introduction of the new calculation and indexing formula, introduction of a valorization mechanism, increase in retirement age and the abolition of special pension schemes as approved by the Law no.290 of 16.12.2016 (published in the Official Gazette of the Republic of Moldova, no. 478-490/964 of 30.12.2016) amending and supplementing certain legislative acts. At the same time, for the implementation of the respective law, the Government Decision no. 165 of 21.03.2017 and no. 287 of 04.05.2017 were approved.

*Action 2:*

The Law no. 288 of 15.12.2017, regarding the modification and completion of some legislative acts (concerning fiscal and customs policy for the year 2018) (published in the Official Gazette no. 464-470 art. 808 of 29.12.2017) regulated the increase of the excise quota for tobacco products and petroleum products in order to reach the minimum set by the EU Directives. Starting with 2018, the specific quota for filter cigarettes increased from 360 lei to 410 lei, and the minimum excise from 480 lei to 540 lei. Also, a significant increase in excise duty was made for non-filter cigarettes, with a specific quota increasing from 120 lei to 260 lei for oval ones and up to 300 lei for those with a mouthpiece. At the same time, for non-filter cigarettes, for the first time, the ad-valorem component was 3%.

*Action 3:*

In order to enhance the transparency and oversight of SOEs the law on the state enterprise and the municipal enterprise was enacted on December 22, 2017, along with the law the audit of financial statements enacted on January 12, 2018 and the law accounting and financial reporting enacted on January 05, 2018. The results of these legislative changes will transpose in equaling the regulatory framework for the activity of the municipal enterprises with the state-owned enterprises. As a consequence, mandatory audit for certain categories of municipal enterprises are now required. Previously, the legislation did not provide for any mandatory rules for auditing financial statements in municipal enterprises. Additionally, new reporting rules are implemented for the activity of both state and municipal enterprises. According to the new legislation, all financial and audit information should be made publicly available.

*Action 4:*

In order to strengthen the asset declaration regime, the amendments to the Law on the National Authority of Integrity, Law on the declaration of property and personal interests, Criminal Code and Contravention Code were enacted. The main scope of this actions is to: eliminate the deficiencies and inconsistencies allowed in the process of promoting and adopting the integrity package in 2016 and increase the efficiency and impact of the property and wealth declaration system; enhance the integrity and transparency in the public sector; prevent and fight acts related to corruption. In the process of strenghening the asset declaration regime, Moldovan authorities ammended the provisions of the Criminal and Contraventional Code to ensure that sanctions related to conflict of interest and asset declarations violotations are enforced and dissuasive. Moreover, auhorities adopted a regulation on methodolgy for verification of asset declarations and conflict of interest that are mandatory to be submitted online thouth the electronic portal „e-Integrity". The official launch of the e-Integrity Information System was realized on December 28, 2017. Up to March 31 2018, through the information system "e-Integrity" for submitting and verifying on-line the declarations of assets and personal interests, available on the ANI website were submitted approximately 58080 statements, digitally signed and available to the public wide, except for personal data.

## II. Leveling the playing field for private sector development

*Action 5:*

In order to reduce the list of required licenses, authorizations and certificates for the private sector development, the Law no.185 of 21.09.2017 was enacted and 270 permissive acts were abolished, which allowed the administrative burden to be reduced by about 70%. The total existing permissive documents is 149. Moreover, the Government is working on the creation of the Electronic One-Stop-Shop for Permissive documents issuance which will support on-line application, processing and issuance of licenses, authorizations and certificates.

*Action 6:*

In order to simplify the domestic mandatory requirements for testing and registration for EU-registered agricultural inputs, the amendments to legislation were enacted. The amendments contain provisions favoring the real liberalization of the agricultural markets for seeds and seedlings through elimination of compulsory testing procedures for these products registered in the EU catalogues. In order to facilitate the placing on the market of authorized plant protection products in EU countries and for the fertilizers marked "CE fertilizer", the Law no.119/2004 was modified by the Law no. 245 which was adopted on 23.11.2017 and published in the Official Gazette no.1-6/6 of 05.01.2018. Upon the approval of the primary laws setting up the foundation of important reforms in the agricultural input markets, the Government of Moldova is committed to put in place the needed implementation arrangements so that the private sector can truly benefit from the enacted reforms.

*Action 7:*

In order to strengthen banks corporate governance, internal controls and risk management practices, in June 2017, the National Bank of Moldova approved the Regulation on Internal Governance and Risk Management in Banks as a first step in ensuring effective corporate governance. Later on, in October 2017, the new Law on banking activity was approved by the Parliament and entered into force on January 1, 2018, transposing Basel III principles and further strengthening corporate governance provisions. During the onsite inspections carried out by the NBM (since June 2017) in four banks, the fifth being underway, it was

established that banks mostly comply with the provisions of the above-mentioned Regulation, with minor deviations noted. Moreover, all banks report on regular basis, once in two months, about the progress achieved in the execution of the individual strategies for the implementation of the Basel III principles, including alignment to the requirements set out in the Law on banking activity and the Regulation on Internal Governance and Risk Management.
Thus, following the improvement of the legal framework on corporate governance, banks are attesting a conscious and mature attitude towards its implementation, by undertaking the following:
-engaging consulting firms for specialized assistance in Basel III framework implementation and setting up of working groups in this regard;
-amending their internal regulatory frameworks;
-setting up specialized committees of the banks' Boards of Directors (audit, risk, nomination and remuneration committees);
-self-evaluating the collective suitability of their management bodies (Boards of directors and executive management) in terms of knowledge, skills and relevant experience, etc.

*Action 8:*

On the basis of the Guidelines for the Annual Procurement of Electricity, approved by Ministry's Order No. 5 of 05.01.2016, the electricity market operators signed on March 31, 2017 contracts with JSC „Energocom". In order to improve transparency and competition in the wholesale electricity market tender related materials are publicly available on the official web pages of almost all electricity market operators JSC „Furnizare Energie Eletrică Nord", JSC „RED Nord-Vest", JSC „RED Nord", SoE „Moldelectrica". Since June 07, 2017 the sources of supply were diversified, JSC „Energocom" signing a new contract with JSC „MGRES". The supply ratio, between DTEK Trading Company (Ukrainian Power System) and JSC „MGRES", is 30:70. Consequently, at the moment, according to the signed contract, the share of electricity was acquired competitively is more than 75%.
With reference to the electricity acquisition for the next period – from April, 2018 to March, 2019, according to the new Guidelines, for the Annual Procurement of Electricity (approved by Ministry's Order No. 31 of 30.01.2018) all electricity market operators have carried out the tendering procedure during the period January-March 2018. Therefore, on March 14, 2018 all market operators have concluded and signed, electricity acquisition contracts with the JSC „Energocom", as the best offeror. Thus, JSC „Energocom" has disclosed that the electricity needs of the Republic of Moldova will be covered from two sources, as follows – 70% from the JSC „MGRES" and 30% from the DTEK Trading Company.

Finally, I take this opportunity to assure you that the Government is fully determined and dedicated to its commitment to continue actions and reforms that are required to improve key areas and in particular the performance of economic governance. Taking into consideration that the proposed operation is a key component of the Moldova Country Partnership Framework for FY18-21, the Government expresses its commitment and willingness to sustain progress achieved by the prior actions supported by this Operation and described in the Policy and Result Matrix. I have full confidence that the Republic of Moldova can count on continuous support from you personally and from the World Bank.

Sincerely yours,

**Octavian ARMASU**
**Minister**

## ANNEX 3: FUND RELATIONS ANNEX

IMF Staff Completes Review Visit to Moldova

March 27, 2018

End-of-Mission press releases include statements of IMF staff teams that convey preliminary findings after a visit to a country. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF's Executive Board for discussion and decision.

- IMF staff and Moldovan authorities reached an agreement on the third review under an economic reform program supported by a three-year Extended Credit Facility and Extended Fund Facility arrangement.

- The authorities have made progress in strengthening economic policies and addressing vulnerabilities in the financial sector in order to preserve stability and strengthen the foundation for the medium term.

- Strengthening governance and financial condition of banks, and enhancing regulatory and supervisory frameworks are vital to maintaining stability, growth and job creation.

An International Monetary Fund (IMF) staff team led by Ben Kelmanson visited Chisinau from March 15-27, 2018, and held discussions with the Moldovan authorities on the third review under an IMF-supported economic program. At the conclusion of the visit, Mr. Kelmanson made the following statement today in Chisinau:

"IMF staff and the Moldovan authorities have reached staff-level agreement on the third review under an economic reform program supported by a three-year Extended Credit Facility and Extended Fund Facility (ECF/EFF) arrangement. The agreement is subject to approval by IMF management and the Executive Board. Consideration by the Executive Board could happen as early as May, following the authorities' implementation of a number of prior actions. Completion of the review will make available SDR 24.0 million (about US$34.9 million).

"The Moldovan authorities continue to make progress in strengthening economic policies and addressing vulnerabilities in the banking sector. These efforts have helped preserve financial stability and strengthen the foundation for medium-term. Economic growth was strong in 2017, supported by robust domestic demand and a favorable external environment. These are expected to continue in 2018, and growth is projected to remain solid, at 3.8 percent. Sustained and determined efforts to rehabilitate the financial system – including by strengthening the governance and financial condition of banks, and enhancing regulatory and supervisory frameworks – are vital to maintaining financial stability, sustaining growth and job creation.

"Monetary policy continues to be focused on price stability in the context of a flexible exchange rate regime. Inflation peaked in late 2017 and is expected to slow further in 2018. The current policy stance is appropriate and, in the near term, the NBM should keep monetary policy on hold, without excessively responding to transitory changes to food and regulated prices.

"Implementation of the 2017 budget and the authorities' fiscal policy commitments for 2018 are in line with program objectives and support growth-friendly measures. Efforts should continue to focus on improving public investment and social spending, tax and customs reforms, and improving the efficiency of spending.

"The authorities emphasized their commitment to recover stolen assets. They explained that, on the basis of the recently concluded Kroll investigation, they are working on a strategy and action plan to recover such assets.

"The authorities continue to take measures to improve further medium-term prospects, including through strengthening economic governance, addressing the shadow economy and reducing regulatory and administrative burdens. Promoting greater transparency, predictability, and good governance in the energy sector remain a priority."

**IMF Communications Department**

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## ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

| *Prior Action No.* | *Significant Poverty, Social or Distributional Effects* | *Significant Positive or Negative Environment Effects* |
|---|---|---|
| *1.* | *Positive* | *None* |
| *2.* | *Positive* | *None* |
| *3.* | *None* | *None* |
| *4.* | *None* | *None* |
| *5.* | *Potentially positive* | *Potentially positive* |
| *6.* | *Potentially positive* | *Potentially positive* |
| *7.* | *None* | *None* |
| *8.* | *Potentially positive* | *None* |