

- establishment of a principle, based on which amendments in fiscal legislation can be introduced not more than once a year – once with the adaptation of the annual budget. It will ensure fiscal rules stability and will avoid emergence of any unexpected tax circumstances;
- giving up of state guaranties. Special regulations should be established which will provide responsibilities and duties to public expenditures (e.g. monitoring of such credits, etc.);
- elimination of barter transactions between economic entities in internal and external economic relations;
- ensuring of a public acquisition transparency and, an efficient and reasonable usage of public financial resources. A severe control should be established on public expenditures at all stages of budgetary process and administrative responsibilities for non-destination expenditures of money;
- diminution of expenditures for central and local administrations taking into account that the role of the state in the economy is decreasing. The territorial-administrative reform as well as reorganization of central institutions aimed at their efficiency enhancement, should contribute to budget sources savings;
- reform of social infrastructure (Medicare, education, social protection, etc.);
- reform of military ministries and their structures.

### 3.5 Investment policy

Investment resources are an important factor for successful national economy restructuring, reviving the manufacturing sector and ensuring social prosperity. Insufficient levels of investment are particularly responsible for the lack of GDP growth in the 1995 – 1997 period, despite a sound financial policy by the National Bank of Moldova with regard to stability of national currency and reduction of inflation and interest rates.

In the 1990s, investment in the national economy has shrunk considerably (1990 = 100 %):

	1992	1993	1994	1995	1996	1997
Capital investment, total including in:	67	32	16	14	13	12
– manufacturing sector	48	22	12	11	12	11
– non- manufacturing sector	99.8	49	24	18	13	13

At the same time, composition of investment by source has changed: state investment has been reduced to 12.0 % of the total in 1997, while the share of private sector in total investment went up to 77.0 %. Investment of personal savings is still low (11.0 % of the total). Efforts to attract foreign investors have had relative success (5.5 %), but overall the process of mass privatization did not bring about a desired increase in investment.

The share of capital savings in the GDP structure is rather insignificant: around 16 – 17 % in 1991 – 1996 and 19,4 % in 1997. Budget crises, tax arrears and spending of about 50 % of the budget on social needs sharply reduced the level of budget investment: in 1995 – 132.8 million Lei, 1996 – 155 million Lei, 1997 – around 130 million Lei, or 4.2 % of total budget expenditure. The volume of investment from all sources amounted to no more than 12% of GDP in the 1991 – 1997 period.

Stimulation of investment activities at the current stage of transition will translate into increased capacity of the country in the future. In order to get over the crisis, the share of investment in GDP has to be raised to more than 25 – 27 % until 2005, which is the minimum level for the European countries in transition. Investment should be directed, in particular, to the

restructuring of manufacturing capacities and infrastructure, as opposed to previous years of investment primarily benefiting the services sector.

In order to revive Moldova's investment climate in the near future, the following tasks must be fulfilled: improvement of the legal framework; adjustment of the state financial policy in favor of investment in the real sector of economy; stimulation of internal financial savings (economic entities and population); attraction of direct foreign investments; support for small business development.

**Improving of investment environment** creates basic prerequisites for positive results. For this reason, a number of objectives – reduction of political risks and the predictability of economic policy, legal protection of property rights, free capital flow, development of land and real estate markets, improvement of capital market management – have to be achieved.

The measures recommended for improving the investment environment are as follows:

- (i) stimulating of the long-term financing of the real sector by commercial banks (interest rates subvention, differentiation of contribution to commercial banks reserve funds, etc.);
- (ii) development of special investment structures – investment banks, leasing companies, as well as involvement of non-banking companies in investment activities (like privatization investment funds, insurance companies, pension funds);
- (iii) enforcement of capital repatriation – this should be a significant source of investment finance;
- (iv) simplification of tenders procedure for privatization and regulations of portfolio investment and acquisition of Moldovan equities by foreign investors;
- (v) improvement of investment insurance system.

**The main direction of investment policy – mobilization of extra-budgetary sources of finance** which would cover 90% of all capital investment. There are three such sources: capital savings of the enterprises, personal savings and foreign investment.

**Re-investment of economic entities and population's savings.** Domestic savings must be the main engine of investment activity in the next 5 – 7 years. For this purpose, a "state savings policy" has to be elaborated and implemented. Such a policy will encourage economic entities and population first to save their financial resources and, second, to transform them into investments. Adjustments to fiscal, credit and income policy and investment insurance policy should be made in order to achieve the above defined objectives.

Regarding **enterprises** this policy has to be implemented through:

- a) accelerated **depreciation** mechanism and control over use of funds;
- b) re-investment of **profits**; total or partial tax exemption of reinvested profits;
- c) **issue of corporate securities** – financing of economic activity, including investment activity, through issuing of securities and bonds;
- d) investment of **earnings from privatization**;
- e) **mortgage lending** – financing construction, real estate development, etc. on the basis of land and property as a collateral.

Joint modes of financing investment projects (by the state and private sector) can be considered a viable option (experience of Czech Republic, Slovenia, Russia) for attracting financial resources from the private sector. The tenders organized by the state have to require: a project's pay-off period of maximum of 2 years; state investment share under 20 %; the share of private investor own resources (authorized capital, profits, depreciation) – no less than 20 %; bank

credits – no more than 50 %. To participate in a tender, a potential investor must present an investment project, a business plan, and bank's guarantee of credit.

**Savings of the population** (more than 500 million lei in bank deposits) are an important source of investment finance, especially for building of housing. One of the mechanisms – the issuance of real estate bonds – was determined by Government decision No. 601 of September 29, 1996. The system of mortgage lending has to be complemented by a network of insurance companies.

In the future, provided an improved state budget standing, the state's lending for the construction of housing can be considered. By year 2005, the state investments in housing building sector have to amount to no less than 0,5 % of GDP, the young and low-income families receiving special attention in this matter.

**Direct and portfolio investment** are very important resources for the economy restructuring. There are 1162 (as of Oct. 1, 1997) economic entities registered with foreign capital share in Moldova, including 30% with full foreign capital. Economic entities with foreign capital hold 12 % of manufacturing and services in the country, and provide for about 10% of the exports from this country.

Evolution of foreign investments is unstable, no sharp increase yet.

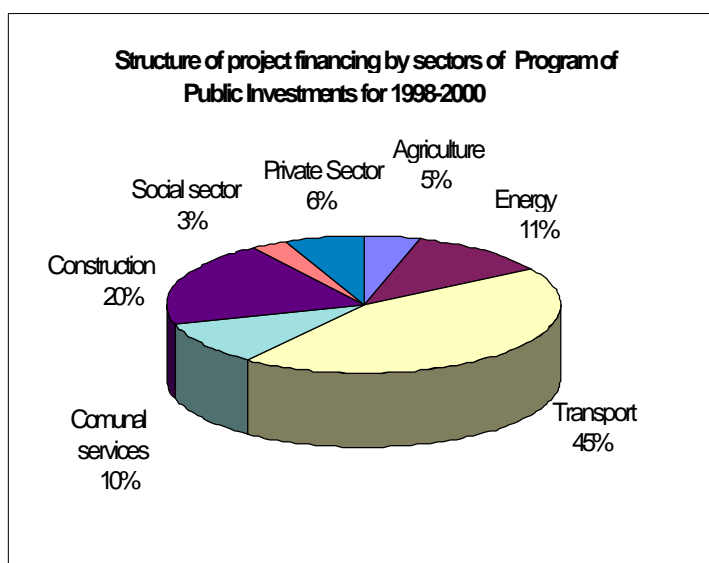
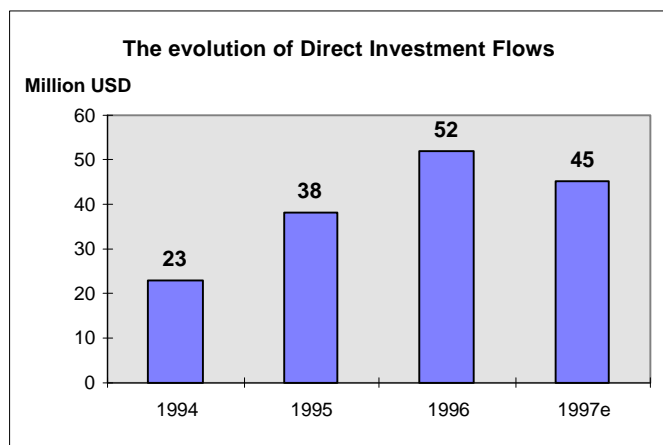
Most investments are directed to agricultural, industrial and services sectors, especially to small and medium businesses. Investments in equipment, cement and gypsum, infrastructure are the strategic orientations for Moldovan economy.

**As regards leasing – establishment of financial structures** providing international assistance of foreign co-owners of Moldovan enterprises, have a real perspective for enterprise retechnologization.

Portfolio investments (*i.e.* purchasing of Moldovan equities by foreign companies and banks) should be oriented to funding those enterprises by means of purchasing certain quotas of their share capitals, in order to avoid their provisional and speculative nature.

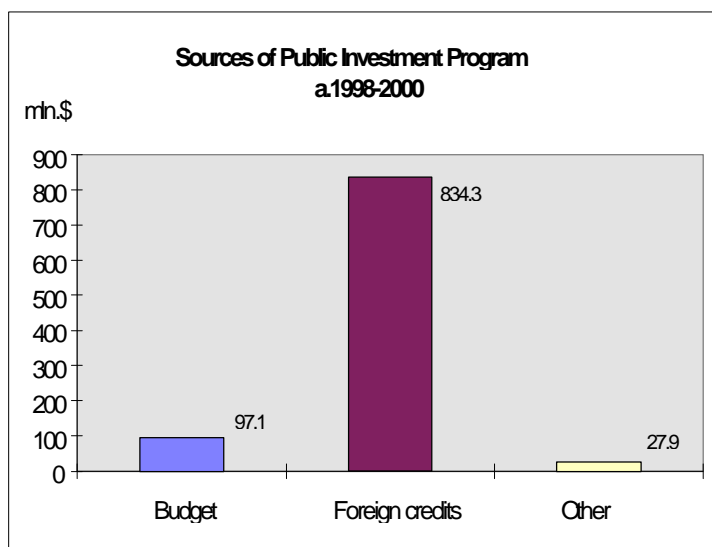
#### **Public Investment Program (PIP).**

The energy sector, restructuring of agricultural enterprises, communications infrastructure, public services, buildings and social sector are the priority areas for PIP. Other sectors, like telecommunications, public transportation, industry, and commerce, will be the priorities for private sector investment. The first PIP was adopted for three years (1995 – 1997), the new one is drafted for the 1998 – 2000 period. The PIP is financed with internal capital resources and external credits and grants.



The Government has selected 36 investment projects for the second PIP. The structure and financing resources are represented in the graph. Investment projects in energy sector, transportation and public utilities hold more than 60 % of the total investment volume.

**Concessions.** According to the Concessions Agreement, the foreign partner has to ensure building and development of property/enterprise with its own financial resources and can remain in possession of it for the period of time extended enough to ensure the pay-off of the invested capital plus profits. The first such concession agreement was signed with the US company "Redeco" (developing and extraction of oil and gas in Southern Moldova).



On October, 1996, the Parliament adopted the preliminary list of concession projects: construction of water pipeline to Cantemir, Comrat, Ceadar – Lunga, Basarabasca; reconstruction of the Străeni – Călărași water pipeline; sand extraction for bottle production in Codreni village, district Ocnișoaia; waste processing plant in Chișinău, etc.

The key objects proposed for concession are in road infrastructure: the Chișinău – Giurgiulești and the Chișinău – Cimișlia highways and the bridge across the Nistru river in Dubăsari.

In general, foreign investment policy must be focused on the following: stability and transparency of the economic legal framework and policy in Moldova; identification of foreign investment goals and objectives; making use of Moldova's specific advantages; concentration of investment in the area of capacity building; and the economic security interests of the country.

The development of Moldova's competitive advantages can be attained through the country's opening to foreign investment and concession arrangements.

Foreign investment in Moldova should be sought, but not unconditionally. The inflow of capital in Moldova as a result of foreign investment is important, but we need to ensure that along with it come other benefits necessary for long-term development – technology, access to foreign markets, knowledge, managerial skills, integration into global economy.

Moldova's cooperation with foreign partners is a two-way street. As Moldovan exports must be further promoted, the internalization of its enterprise activity is extremely necessary, including investment abroad, especially in Moldova's main trade partners – Romania, Germany, Russia and the Ukraine.

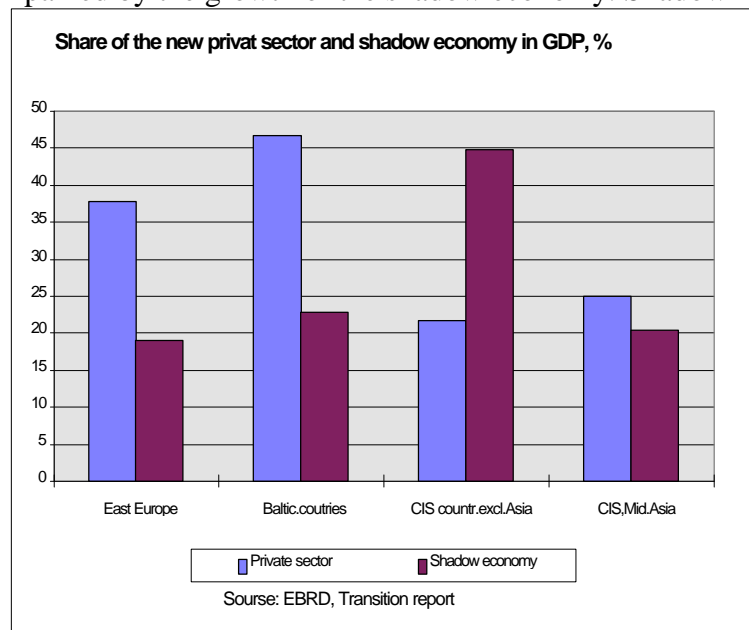
The presence of Moldovan economic entities abroad becomes a necessary condition for export promotion. In the future, the presence of foreign investment in Moldova should be accompanied by products being exported to the countries of investment origin.

### 3.6 Reduction of the shadow economy

#### Present situation and problems

The transition of the Republic of Moldova to the market economy similar to other central and east European nations is being accompanied by the growth of the shadow economy. Shadow economy consists of all forms of economic activities which are not reflected in the official statistics, such types of activities which generate added value, but are not controlled, illegal or legal, but not legally registered for such reasons as tax evasion or unfavorable conditions for operating within the formal (official) economy.

The shadow economy, as a complex phenomenon, includes negative, counter-productive aspects, which need to be eradicated, as well as positive, productive aspects, which need to be incorporated into the official economy.



Among the *negative aspects* of the shadow economy are the following:

- state budget losses due to tax evasion;
- shadow economy is one of the reasons of the decline of economic discipline and hence of the people's decreased respect towards state institutions;
- being out of the state control, the shadow economy can be one of the potential sources of economic shocks, economic and political instability;
- shadow economy leads towards distortions in market information and changes the effects of the state policy;
- shadow economy is closely related to the organized crime;
- labor legislation requirements are not working within the shadow economy (working hours, paid holidays, sick-leaves, etc.);

Among *positive aspects* of the shadow economy are the following:

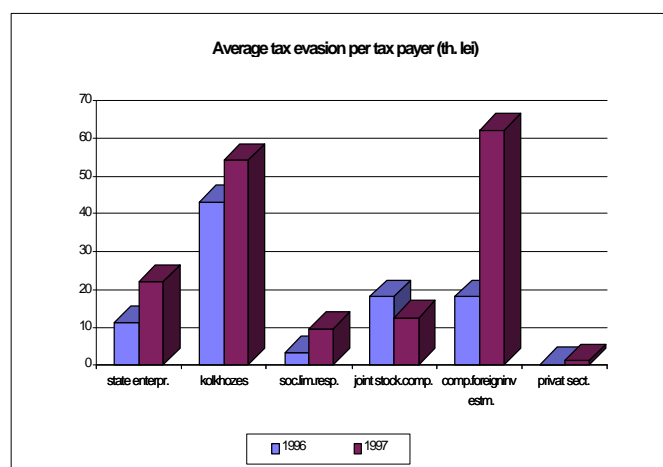
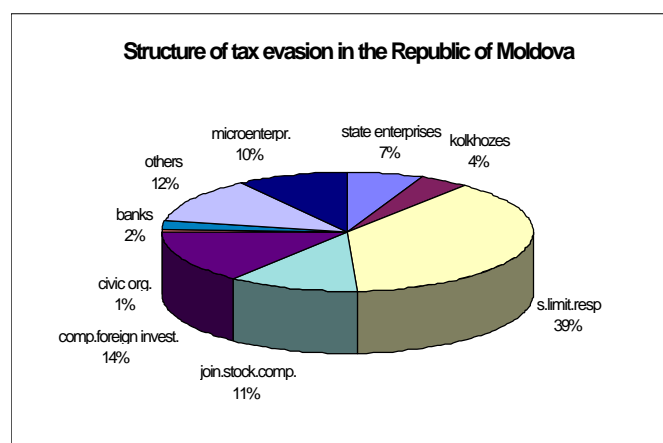
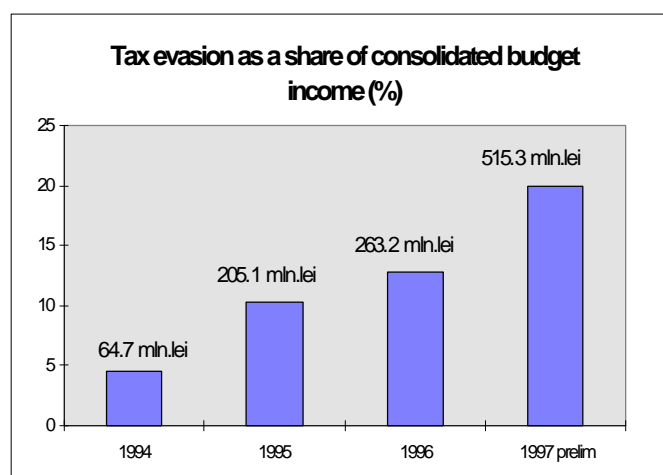
- shadow economy brings additional revenues for its operators and members of their families, being sometimes their only source of income;
- it creates jobs thus decreasing the unemployment rate;
- shadow economy increases the competitiveness of goods because of lower prices caused, very often, by tax evasion;
- shadow economy can be more elastic, more adjustable to the new conditions, bypassing the bureaucratic obstacles faced by the formal economy;
- it can serve as a factor of market stability and balance, often offering exactly those goods and services which are in demand in the formal economy;
- in a way, shadow economy can be a factor of financial stability due to the transactions performed in national currency, covering the monetary excess with goods and services.

**The main forms of shadow economic activities in Moldova are:** hiding of production and revenues, tax evasion, illegal import-export operations, illegal privatization, production and marketing of fake or uncertified goods and services, corruption and others.

According to the sociological poll within the project “Strategy for Development” (CISR, November, 1997), the shadow economy poses a serious threat in terms of lower state budget revenues, economic security and prestige of the state. In respondents’ opinion the share of the shadow economy can be decreased by legal actions (40.8% of respondents), by administrative actions (32.65%), and through economic methods (25%).

One kind of shadow economic activities’ is **tax evasion**. In 1995-1997 the formal number of economic agents practically doubled, while the amount of collected incomes adjusted to the inflation practically diminished. The evaluation of tax evasion extent in the Republic of Moldova was based on the information of the Head State Fiscal Inspectorate, taking into account the number of inspected taxpayers and the revealed amount of tax evasion. Calculations show that the ratio of estimated tax evasions among officially registered economic agents to the consolidated budget revenues increased from 4.5% in 1994 to 20% in 1997. The structure of tax evasions is shown in the diagram. The share of violations among the inspected taxpayers has increased from 33.5% to 58% during the same period of time. The reasons for the decline of fiscal discipline and for the extension of tax evasions include the heavy tax burden, the lack of governmental protection, the inflation, and low capacity of the fiscal control institutions. Thus, the share of inspected taxpayers has decreased from 32.3% in 1994 to 10% in 1997, which implies that the probability of being caught in tax evasion is decreasing making tax evasion more attractive for an increasingly large number of taxpayers. It should be mentioned that the average amount of tax evasions and other violations differ considerably depending on the type of taxpayers.

Collection of funds by the Head State Fiscal Inspectorate takes a long time. Thus, in 1996 only 19.09% of all penalties and sanctions were repaid, while in the first semester of 1997 – only 11%. Inflation and a lack of some indexation mechanisms devaluates these sums, which again encourage tax evasion. Fighting tax evasion is likely to solve the problem of budget deficit, ease the tax burden and encourage production in Moldova.



**Import-export operations** are a favorite area for illegal activities. In the Republic of Moldova they take the form of:

- smuggling, (in 1997 there were prevented 52 attempts to smuggle material values worth 6.4 million lei, which achievements have been, monetarily, 20-fold greater than 1996 year.
- “pseudo-barter”, when goods are exported and marketed, while the proceeds are deposited in foreign bank accounts;
- “pseudo-exports” (for the example the production of the Tobacco Factory, which had to be exported, but was sold on the territory of the Republic of Moldova, thus resulting in losses in value added tax and excises in value of 4.9m lei;
- import-export transactions at inappropriately low prices with further sharing of the proceeds between the “partners” (by the Head Department of Fiscal Inspectorate has previously reported cases when the price was diminished 20 times);
- obviously unequal exchange operations;
- unlicensed exports;
- violations of exports quotas;
- “pseudo-transits”, when goods never reach the document destination and instead are sold within the transit country with no taxes paid, etc.

A good illustration of the extent of illegal import-export transactions is that of tobacco export. In this respect, according to Moldovan information sources, tobacco exports from Moldova to Russia in 1996 constituted about 8000 tons (“Anuar Statistic de Comerț exterior 1996, Chișinău, 1997). According, however, to similar Russian sources (“Ôèíà íñîâúâ èçââ ñòèÿ”, N82(433), 1997) tobacco imports from Moldova to Russia constituted already 17700 tons, i.e. almost twice as much.

**Production and marketing of fake or uncertified goods** is another activity of the shadow economy. In the Republic of Moldova it has more serious implications on a big number of consumers due to illegal production of fake or not conforming to the established technology standards foods (candies, baking and dairy products, alcoholic beverages, etc.), marketing of products without their proper certification and labeling indicating the date of production, shelf life, quality specifications and chemical content. Almost 75% of the enterprises inspected by the Department for Standards, Metrology and Supervision were operating in breach of the current requirements.

Delays in legal privatization in the Republic of Moldova caused, on one hand, by the need for the creation of a legal basis for this process, and, on the other hand, by the lack of interest from the part of some people (especially those who enjoyed considerable profits from improper use of state-owned material resources) have led to the **irregular privatization** with all its consequences. Irregular privatization has largely shown itself both outside and within the legal privatization framework, violating, however, the provisions of the current legislation. One form of illegal privatization is “donation” of state-owned property (wine and building materials producing enterprises, buildings, lands etc.) through the decision of the Government of the Republic of Moldova to some private enterprises (businesses, collective farms, public organizations, etc.). The transfer in 1991-1992 of FSU centrally controlled enterprises under the authority of the Republic of Moldova offered big opportunities for illegal privatization of state-owned property. A more sophisticated method is based on the association of state-owned and public enterprises with private enterprises and individuals. In this case two objectives were achieved at the same time: business people with initiative would take over the management of these associated enterprises thus making it possible to use and dispose of the state-owned and public property; state-owned and public property was severely underestimated taking into consideration that, despite big inflation, no adjustments in the price of fixed assets were made during the period between 1983 – 1992, while, on the other hand, private property share, usually in form of money, was overestimated. The nationalization of both former Soviet Union’s and Moldova’s

Communist Parties in 1991 was also used as an opportunity to transfer vehicles, equipment, furniture, financial resources etc., the private sector. In many cases, apartments as well as buildings and commercial spaces were transferred irregularly by the national and local authorities to individuals and legal persons and thereafter privatized.

In defiance of the fact that many cases of the law violation were discovered by the proper control institutions, there have practically been no cases of proper punishment for people found guilty and of payment of appropriate damages.

**Corruption** is a serious constraint to the development of market economy, private business activities and free market competition. Data from a number of pools show that economic agents routinely pay, directly or indirectly, for public officials' services for getting permits or licenses for manufacturing, exporting or retailing. Thus, according to the sociologic poll "Barriers to foreign Trade in Moldova", October, 1996, world Bank resident Mission) an annual average of such payments constitutes \$3,350.00 per enterprise.

*Reasons for the development of the shadow economy in the Republic of Moldova* include:

- weakness of the newly formed state and its institutions, which have practically built from scratch a new legislation system – non-transparent and often contradictory, sometimes with no clear mechanisms of its implementation;
- wide spread lack of respect and indifference towards state institutions and public property, considered by many citizens as nobody's property;
- tax burden growth;
- high level of bureaucratic intrusion;
- inadequate awareness of the population and economic about changes in economic legislation and lack of proper interpretation of legal and other regulating documents;
- existence on the territory of Moldova of practically three state entities with different economic legislation and mechanisms, especially in the case of Transnistrian region of frontier control on the East part of the country, border transparency and penetrability – practically there is an administrative border but not a state frontier;
- growth of unemployment rate and poverty of the population, income distribution inequalities;
- higher profitability rates in the shadow sector due to non-payment of taxes;
- lack of balance between the supply and demand in the official economy;
- monopolistic systems in some sectors of the economy;
- lack of will and drive, lack of risk understanding and of a clear strategy for the elimination of the parallel economy on the part of authorities;

The share of the shadow economy has been (and still remains) dependent on the level of severity, cruelty, and insistence in fighting the "unsocial" behavior, and varies from country to country.

#### Share of the unofficial economy in GDP, %

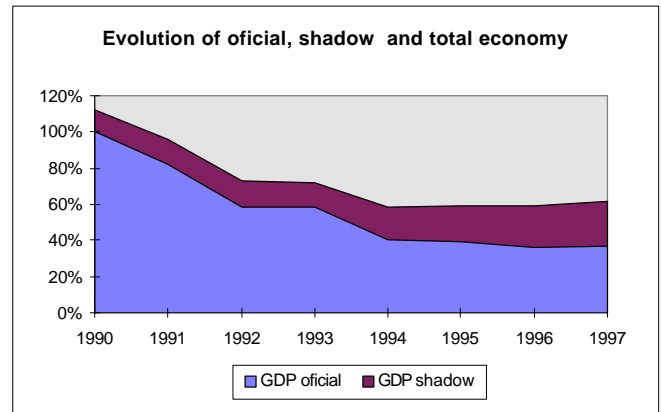
	1989	1990	1991	1992	1993	1994	1995
Moldova	12	18.1	27.1	37.3	34	39.7	35.7
Bulgaria	22.8	25.1	23.9	25	29.9	29.1	36.2
Hungary	27	28	32.9	30.6	28.5	27.7	29
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6
Romania	22.3	13.7	15.7	18	16.4	17.4	19.1
Russia	12	14.7	23.5	32.8	36.7	40.3	41.6
Ukraine	12	16.3	25.6	33.6	38	45.7	48.9

Source: EBRD, Transition Report 1997



*The evaluation of the extent of the shadow economy in the Republic of Moldova* was done based on six methods: *transaction method, currency-ratio method, turning assets analysis method, power consumption method, structural method and Italian (labor market analysis) method*. Analysis showed that the share of shadow economy compared to that of the formal economy fluctuates in between 55-65%. Although the official GDP was diminishing during recent years, the *total GDP of Republic of Moldova, including its shadow component started to grow since 1995*.

This rapid growth of the shadow economy sector is caused by two tendencies: the increase in the number of transactions within the shadow economy and the recession in the formal economy (1997 GDP constitutes 36% compared to that of 1990). Some studies of this phenomenon imply the anti – cyclic way of the shadow economic development, i.e. growth of the shadow economy along with the decline of the official economy.



The existence of a large shadow sector within the national economy creates a number of **problems** both to the state as to the population:

- Spread of tax evasions causing instability in the society;
- A growing share of operators of the shadow economy takes a considerable part of state expenditures (compensations for power resources, free education system and medical assistance, social services etc.). These expenses are an additional burden on the economic agents of the formal economy;
  - Decrease of the state budget revenues along with the decline of formal economy, faster than the decrease in state expenditures, which aggravates the budget deficit problem;
  - Decrease of population's trust in state institutions and the reform process, resulting in dwindling economic and fiscal discipline, which, in turn, encourages illegal economic activities;
  - Prices for goods and services provided by the shadow economy which do not include proper taxes imposed within the formal economy lead to an unhealthy competition environment the formal sector of the economy, forcing it to choose between going bankrupt or moving towards the shadow economy sector;
    - Spread of corruption and economic crime;
    - Increasingly deepening income disparities in society;
    - Distortions in reporting of such macroeconomic indices as GDP, unemployment rate, population incomes and expenditures, quality of life, etc. Such distorted information generates suspicions among prospective foreign investors;
    - Quantitative and qualitative deformations of all macroeconomic patterns producing the impression of Moldova as a country apparently not subject to general rules of economic development. Distortion of the results of state policy regarding formal economy.

### Objectives and goals

Given that the shadow economy has both positive, productive aspects (generation of wealth) as well as negative, counter-productive aspects which contribute to the destabilization, dismemberment and poverty increase of the state and society, the role of the state in the regulation of the shadow economy sector is very important and depends on those respective aspects. The state's objective would be fighting the negative aspects of the shadow economy and assimilating the positive ones in the official economy. In order to achieve these objectives three types of measures are necessary: legal, economic and administrative.

**Legal** measures must include development of a stable and transparent legal system, which would effectively distinguish between legal and illegal economic activities, provide a clear penalty mechanism for illegal activities and a means for ensuring security of legal economic activities.

**Economic** measures imply encouraging economic activities within the formal economy and discouraging those of the shadow economy sector, in terms of their efficiency.

**Administrative** measures must include removing of all bureaucratic barriers to private business development .

### Policy and implementation methods

Assigning each different section of the shadow economy a color shade based on its importance to the society, it must be said that, for the **“black” economy**, i.e. such sorts of activities as drugs distribution, racket, corruption, unauthorized arms selling, dilapidation, extortion, there is one universal *legal way* – the more severe, the more efficient.

**“Gray” forms** of the shadow economy such as prostitution, games of chance it’s more efficient using both *legal and economic measures*. Thus, methods of legalization, state regulation and restriction of these activities are worth considering. Appropriate taxation level and strict control over such industries will be beneficial, amongst others, in term of state budget revenues.

In order to solve the problem of **illegal import-export operations**, it is necessary, first of all, to develop an unified border patrol and custom system in association with Transnistrian customs service. If this problem is not solved over a reasonable period of time, temporary relocation of border patrol and customs to the Transnistrian border is necessary. Also Ukrainian – Moldovan frontiers demarcation problem must be solved at the interstate level.

The successful eradication of **tax evasion** could be done by all means: economic, legal and administrative.

*Economic measures* include:

- lower taxing;
- increased fines and frequent inspections by fiscal institutions to such an extent that to make tax evasion unprofitable;
- wider and more active use of bankruptcy legislation;
- freezing enterprises’ debts, deblocking of bank accounts and finding ways of cutting debts by taking into account the non-objective ways of their formation;

*Legal measures* would include development of a legal system to promote these changes as well as:

- simplification of enterprise “shat-down” procedures for those that cannot prove their being in operation over an established period of time;
- implementation of the management law and means of its enforcing, providing management administrative and penal responsibility for not paying taxes and other payments due to the state;

*Administrative measures* would include:

- creation of a body endowed with functions and powers sufficient enough to fight tax evasion, including the right for investigation and application of administrative sanctions, to

promote a single policy with regard to the investigation, discovering and penalizing people breaching the financial discipline;

- strict delimitation of functions of control institutions;
- building the prestige, quality and incentives of fiscal control institutions;
- development of an awareness raising program explaining the implications of tax evasion on people's welfare, educating a negative attitude towards this phenomenon. This program is likely to be more efficient if conducted by non-governmental organizations and financed by the state;
- psychological education of economic agents with regard to the increase of severity on the part of fiscal control institutions via all available information channels (mass-media), explaining the positive effects of such measures, including eventual lightening of the tax burden;
- ensuring transparency and free access of large parts of the population to the decisions made by state authorities, which might be an efficient measure of fighting corruption.

The "*white*" component of the shadow economy is informal economy, which includes afferent land processing, voluntary work and micro-business activities. Micro-business activities are exactly that component of the shadow economy that can be regulated by the state. Although for tax evasion reasons most small businesses do not regularly submit their income statements, this sort of activities is a productive component and should be supported by the state and encouraged especially in rural areas. Often the legal framework does not encourage small business activities forcing them to shift towards operating within the shadow economy. The volume of wealth generated in this sector is relatively low, and the amount of potentially levied taxes, therefore, would be negligible. Therefore, the economic measures likely to withdraw small businesses from the shadow economy sector into the formal one include preparatory steps for possible introduction of tax-holidays for small and micro-businesses.

*Legal measures* include ensuring personal security of the informal sector manufacturers, combating racketeering and other forms of extortion.

Among the *organizational measures* of incorporating informal small businesses into the formal economy are the following:

- removal of bureaucratic obstacles to private business activities within the limits of formal economy (manufacturing, marketing, import-export transactions), maximal simplification of enterprise registration procedures, statistics data reports and taxation system;
- development of an integrated information system, accessible to large parts of the population, including all aspects of economic activities and integrating all legal steps, starting with possible forms of small business activities, registration procedures for newly established enterprises, systems of registration fees, terms and conditions of activity, bookkeeping, taxation procedures, legal rights and responsibilities in case of violation of legislation.

Reducing the share of the shadow economy, legalization some parts of it by legal and economic methods opens up an important opportunity for budget revenue growth, greater social protection of those employed in the shadow sector, and a healthier moral and ethical environment in the country.

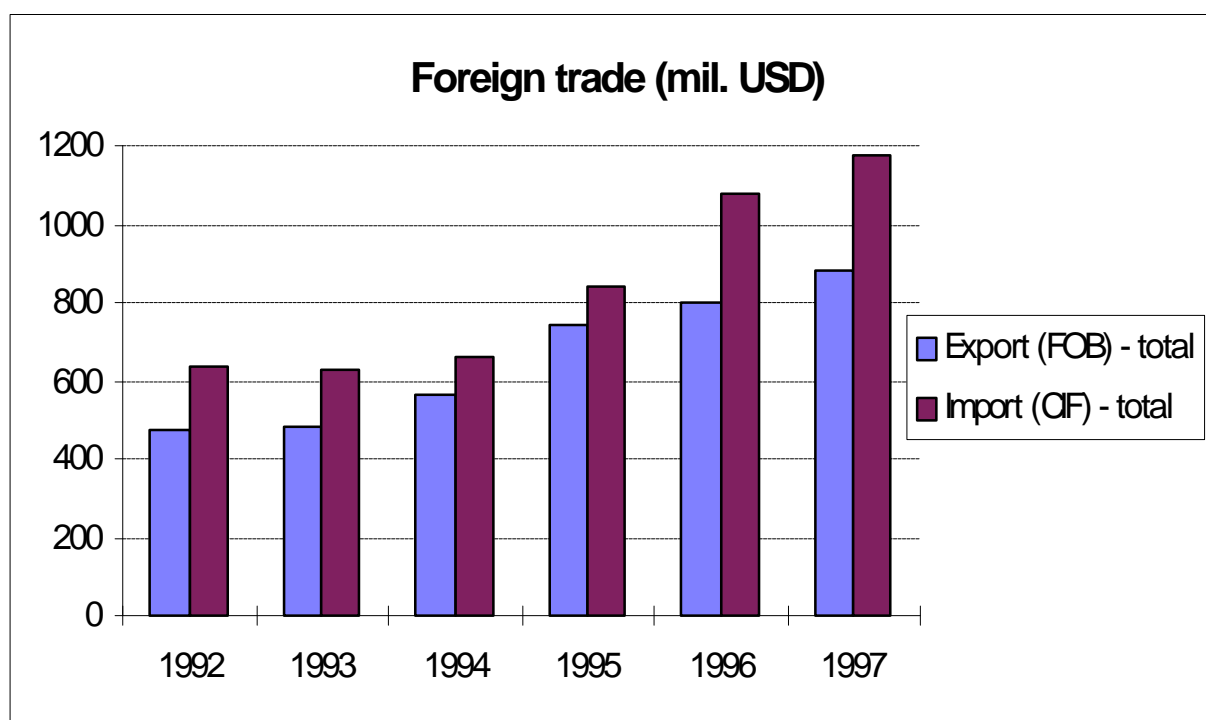
### 3.7 Foreign economic relations, export promotion

The Strategy considers the development of the foreign economic relations as a main component in implementing the concept “Moldova – small open economy”. The strategic objective of this relations is promoting Moldova as a trustful trade partner, a regional quality producer. The loans and credits, along with the technical assistance grants are being used by Moldova for restructuring and development in its transition and for the integration with the European Union.

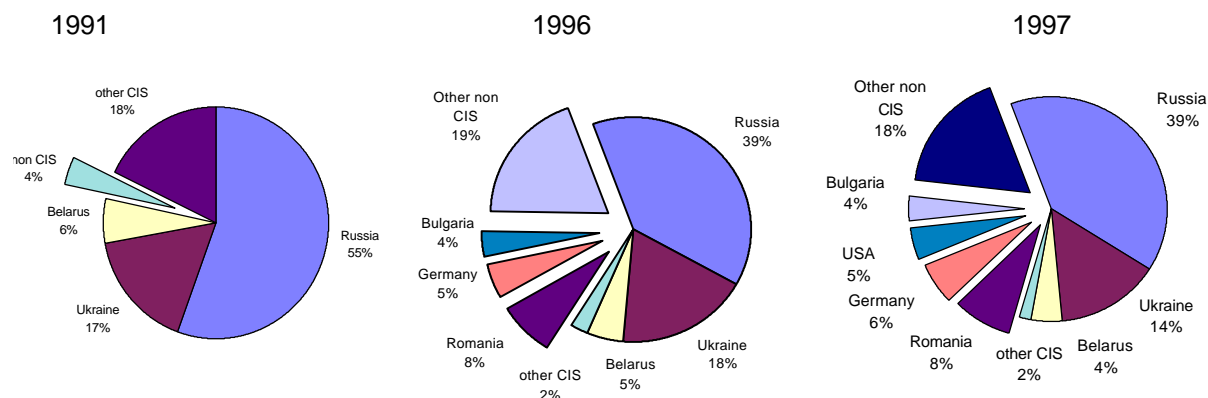
#### Foreign trade

By the GDP/exports ratio (circa 47%) Moldova is an economy with high dependence on foreign trade. *The overall increase of exports constitutes the priority economic objective of the country.* In 1997 the exports soared 87% comparing with 1992 and the imports by 83%.

In 1997, according to Customs Department data, exports reached \$879,6 million (an 9.7% increase comparing to 1996 level), while the imports increased to \$1172.4 million (8,6% up from the previous year), a fact that contributed to widening trade and balance of payments deficits. Thus, in 1997 the trade deficit of Moldova grew to \$292.8 million.



*The diversification of trade partners* is a long term strategic objective of Moldova. The CIS countries continue to be the main trade partners of Moldova; at the same time the exports to the European Union and the rest of the world had an important increase reaching over a quarter of the total exchanges. In 1997 the export to EU grew 15.5% and to CIS – 12.2%, while the exports to CEECs dropped by 27.7%. Moldovan exports is made up predominantly by foodstuffs, wines, tobacco, textiles, footwear, chemicals and machinery. The first ten export partners of Moldova (Russia – 58%, Romania – 6.7%, SUA – 6.6%, Ukraine – 5.9%, Belarus – 4.1%, Germany – 3.7%, Italy – 2.7%, Lithuania – 1.2%, Bulgaria – 1.1%, Austria – 1.15%) accounted for 91% of Moldovan exports in 1997.

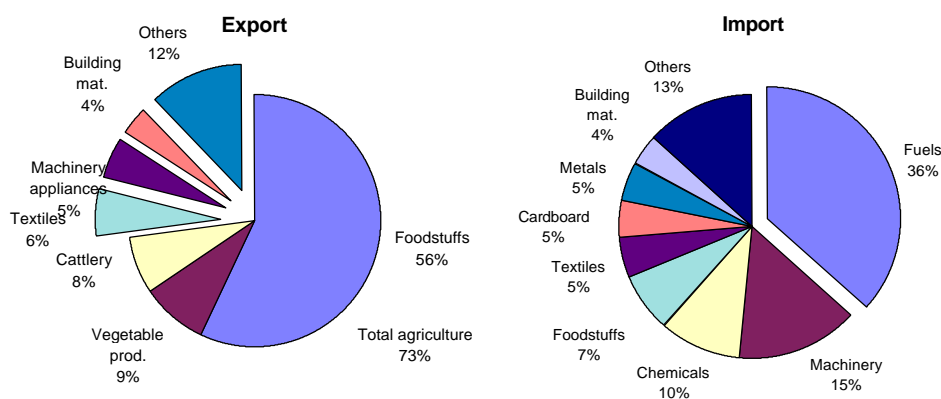


Changing patterns of Moldovan trade

The state of economies of Moldovan trade partners is an important factor that has an overall impact on rise or fall of Moldovan exports, especially when the main trade partners of Moldova – the CIS countries – experience a continuous economic recession. However, since Moldova is a minor partner for them, this fact reduces the correlation and makes possible for Moldova to increase its exports at a higher pace than the natural market growth.

Out of total Moldovan exports in 1997 – 30.3% went outside CIS. This were: walnuts, sunflower, concentrated apple juice, leather, apparel.

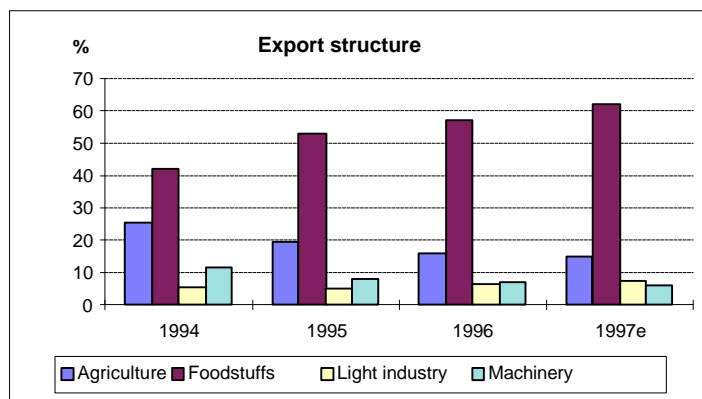
The imports stood at \$1172.4 mil, including 47.8% from outside CIS. 39.8% of imports have accounted for oil, gas, coal and steel. The main 10 suppliers were: Russia – 26.0%, Ukraine – 20.5%, Romania – 9.3%, Germany – 8.1%, Bulgaria – 5.4%, Belarus – 4.4%, Italy – 3.6%, USA – 3.0%, Hungary – 1.9% and Poland – 1.3%, that combined held 83.5% of the market in 1997.



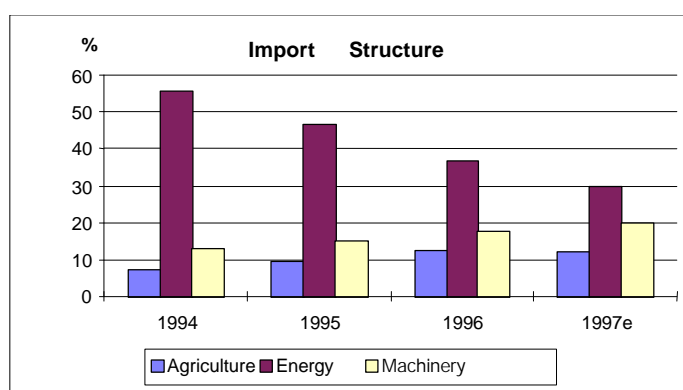
Foreign Trade Structure in 1996

Several trends can be identified in the pattern of Moldovan exports. First: Moldovan food products make the bulk of Moldovan exports, and have increased their share in the total exports from 40.5% in 1992 to 71.7% in 1996. In the same period the share of mineral and chemical products, machinery, electrical appliances and vehicles decreased from 42% to 13.3%.

Second: the lack of quality packaging, along with insufficient number of qualified personal in marketing has boosted the phenomena of raw material export to third countries for re-export. E.g., Moldovan apple juice and ketch-up are dissolved and repackaged in Germany, and an part of Moldovan wines are bottled and labeled in Bulgaria etc.



The share of agriculture in total exports has decreased from 20.0% to 17.1%, while the share of foodstuffs has soared from 28.3% to 54.6%. The light industry has increased its share only in 1997, when it accounted for 6.6%. As it was expected, the mechanic was losing strength, resulting in decrease of its share from 9.5% in 1992 to 5.7% in 1997.



Concerning imports, it is necessary to mention the increase of machinery in the total imports – from 9.3% to 15.8%. Also, the decrease of energy resources from 52.9% to 35.3% is observed. In order to have a real improvement of the economy it is necessary to reach a level of 30-35% of machinery in imports, while the share of energy resources has to be reduced to 20-25%. The share of agriculture and foodstuffs has increased from 2.9% to 7.1%.

Almost all the barriers were lifted to facilitate exports (including licensing, quotas and indicative pricing, existing until recently). At the same time, the restrictions imposed by the “Budget law for 1998” for import of some commodities through import customs levies and excises do not satisfy the international standards, especially the WTO provisions.

Moldova makes efforts to extend the geography of its foreign relations by cooperating with a wide range of trade organization and unions. Moldova’s trade with the CIS countries and Romania was eased by free trade agreements. In order to further diversify its exchanges with the countries of the world, Moldova has applied for *WTO membership*, clearly reflecting the strategy of integration into the international community and global economy.

**World Market tendencies.** Currently the global economy is characterized by a consolidation of trade blocks. At this stage such blocks have a rather inward orientation, protecting the interests of their member-states. Because of the fact that the trade among different blocks is a necessity, they will determine the competition policy and economic development during next quarter of a century. The largest trade block in the world is the European Union (a population of 337 mil). The countries in Central and Eastern Europe have historical ties with Northern and Western Europe and most of them have applied for EU membership, adapting their policies and legislation to the requirements of the White Paper.

**Quality issue: consumer protection.** The EU protects its citizens through a large range of standards and regulations concerning environment protection, labor, health, consumer protection. Moldovan exports to this trade block faces the problem of competitiveness of Moldova goods. The listed standards represent new trade barriers for Moldovan exporters (HACCP, AZO, CE, Pharma, Packaging, etc.).

**Access of Western goods on CIS markets.** Currently 66% of Moldovan exports go to CIS markets. There as well the requirements of international standards become a rule due to Western goods that invaded the markets, some of them being produced locally. Therefor the quality issue for Moldovan commodities becomes relevant not only for its trade with the EU countries but also for preserving its traditional CIS markets.

### Export promotion strategy

The threat from the low competitiveness of Moldovan products requires an immediate and adequate reaction from the state and economic agents. The standardization is growing in international markets and this should be regarded as a trend of primordial importance in Governmental policy of export promotion. This policy should rely on three pillars:

- **Quality**
- **Competitiveness and productivity**
- **Image of the country**

Export promotion should become the number one priority of social and economic development of the country. This task belongs first of all to the Ministry of Industry and Trade. The liberalization and export promotion will create jobs, stimulate investment, increase the level of knowledge and technology and will raise productivity and efficiency, that will lead to the emergency of Moldovan World Quality Products. The export promotion has to be considered a key to equilibrate the balance of payment, new products design, modernization of equipment, development of service sector.

**Quality standards** have to be regarded not as a barrier but as a challenge to improve efficiency, lower the energy consumption and the production costs, that, combined, will improve the competitiveness. The quality requirements have to be applied not only to products designed for export but also to the ones sold on internal market. The quality presupposes a control at different stages of technologic process by representatives of various ministries. The Total Quality Control and the State Department of Quality are two important tools in fighting shadow economy.

**Image and reputation building** can be done through developing of quality products and their export to regional and European markets.

- Exporting to traditional CIS markets has as a goal the extension of Moldova's market share, employing the reputation of a quality producer.
- Promotion of export to EU markets has as a goal, first of all, decreasing Moldovan dependence on one market. Secondly, it is targeted at attracting know-how, technology and management skills through commercial association, joint-ventures and sub-contracting.
- Exporting to the world market. The adjustment to European quality standards will guarantee a also an access to world markets. All the promotion materials have to stress the efforts of improving quality and, because of increased efficiency, the capacity to offer better prices.

All this will be performed by increasing the potential of national management team and improving the production and marketing at European quality standards. **Moldova must become a regional supplier of world quality goods and services.**

The simplest way to success would be the concentration on a limited number of **key sectors** of the economy capable of becoming export leaders. Moldova has shown good potential in advanced processing of agricultural products (grapes, tobacco), leather, production of small agricultural machinery, electronics, medical equipment, pharmaceuticals, building materials, light industry (footwear, fur, apparel, carpets, artificial leather), packaging.

Meeting the market demand by development of *new products*, based on market studies will help to find new profitable niches for Moldovan producers on the world market. This could be highly value added ecological products. The service sector is expected to grow in the transportation and tourism sectors, etc.

**Coordination of Governmental activity** in export promotion can be done by setting-up an Inter-ministerial Council of Export Promotion. The Council has to be supervised by the Ministry of Economy and Reforms, the only representative of the country at the donors community. The same ministry should be responsible for implementation of the Strategy of Export Promotion. This responsibilities render unavoidable the institution of a new Vice-minister for Trade and Liberalization charged also with export promotion, the implementation of the Export Quality Program, new export-oriented products development, relations with external donors concerning trade, development of bilateral and multilateral trade, coordination of commercial attachés working in Moldovan Embassies.

**Moldovan diplomatic missions as export promoters.** Being the only state institutions in permanent contact with export markets Moldovan embassies have to become the eyes, mouths and years of Moldova on this markets. The commercial attaches and special export promotion envoys have to lobby Moldovan interests in the international donors community and trade organizations (WTO, EU, NAFTA), to monitor the investment programs of multinational companies, in order to spot opportunities for Moldovan companies for sub-contracting, to develop cooperation with national trade agencies, to facilitate the contacts between Moldovan and foreign businessmen, organize participation in international trade fairs, to provide technical assistance concerning the legal framework of the export destination country.

**Facilitating exports** through suspension of internal export barriers is especially important due to the competition from other countries with similar strategies. The first task is the abolishing all fiscal barriers, procedural (licensing) and organizational (one office export licensing), that would allow a fast reacting of producers to business opportunities.

**Moldovan Organization for Export Promotion (MEPO)**, established on February 1998, will be the necessary link in streamlining the efforts of Moldovan governmental and independent producers to facilitating and boosting exports. MEPO will provide assistance to Moldovan producers in retaining and expanding competitive advantages on international markets that will ultimately pull up the standard of living of Moldovan citizens.

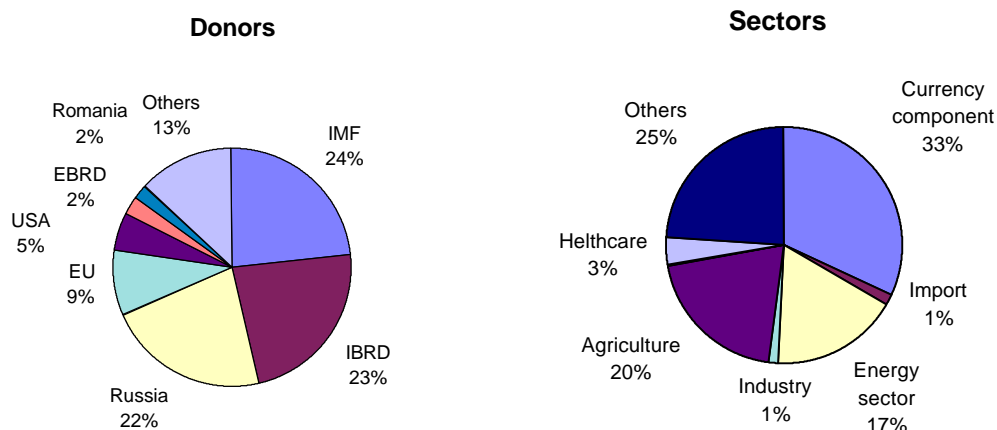
### Foreign loans

The total value of public loans contracted by Moldova at 1 January 1998 amounted to \$1192m, out of which 59.5% are managed by the Ministry of Finance, 19.3% (IMF loans) – by the National Bank, and 21.2% – are debts of companies MoldovaGaz and Moldenergo. The indebtedness is built up of the following components: Government's debt under external loans – \$709m (including \$140m debt to Gazprom of Russia), debt of the National Bank under IMF credits – \$230m, debt of MoldovaGaz to Gazprom – \$168m (Transnistria exclusive); Moldenergo's debt to Ukraine – \$85m.

During 1997 Moldova's new borrowing amounted to \$110m, while the repayment of principal was at about \$46m; apart from this the interest payments were at about \$50m – all figures here do not include IMF. In 1998 the country has to repay \$152m under credits received during 1994-1997, namely \$47.3m of interest and \$104.7m of principal. Of that sum, \$38.5m will be overdue payment for 1997. Already in the first quarter of 1998 Moldova must repay \$47.4m of its external debts. Ministry of Finance' experts are saying that during 1999-2000 the republic will have to spend 25% of budget expenditures only for repaying the interest under the external debt.



The bulk of credits were contracted from multilateral and bilateral creditors as shown in the diagram below:



Foreign public loans, 1997

The loans contracted in the first three years were used primarily for critical imports. Starting from 1996, several public credits for financing projects in agriculture, industry, energy sectors etc. were also contracted. Distribution of credits by sectors is shown above.

Debt/export ratio has increased from 60% in 1994 to 102% in 1996. Foreign debt/GDP ratio remained on an increasing trend from 40.6% in 1995 to 51% in 1996 and 63.5% in 1997. Volume of Moldova's external debt in 1997 was twice greater than the budget revenue side.

The real problem, that comes to evidence, is the preserving of macroeconomic stability and maintaining donors credibility for Moldova in the immediate future. Therefore any reasonable long term strategy has to attack as soon as possible the problem of foreign debt and trade balance, before it gets out of control.

Based on stated above the following measures are proposed:

(i) priority use of external credits in sectors, whose financial support could have a beneficial impact on revitalizing national economy and reaching practical and visible results.

(ii) use of foreign credits for unproductive sectors only on base of justification of value added expected (raise of labor efficiency and attractiveness of investment in Moldova through consolidation of education and training of local managers etc.)

(iii) careful management of the foreign debt and all the inflows of foreign capital. In this direction, immediate direct and indirect regulatory actions have to be taken to avoid a total crises of foreign obligations of the country;

(iv) negotiation, starting 1998, of received loans on concessional basis (granted for at least 25-30 years, having at least a 10 year grace period);

(v) reducing the practice of attraction of foreign loans under Government's guarantee (moving towards attraction of foreign direct investments).

### Technical assistance

The technical cooperation with donor institutions and countries took off in 1992, but gained momentum and started to have a substantial impact on the reform process only in 1995.

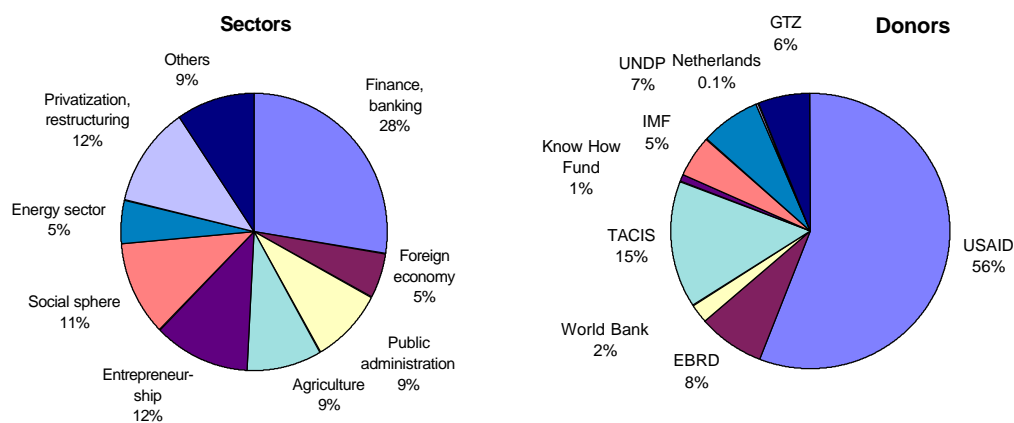
From this period the technical cooperation entered a phase of permanent development and had a net increase of total assistance of 70% in 1996, constituting \$42 mil with 93 projects

comparing with \$25 mil with 81 projects in 1995. As to 1997, donors' commitment for technical cooperation with Moldova amounted to \$120 mil.

In the framework of technical cooperation, Moldova collaborates with 15 institutions and donor-countries, the main one being TACIS and USAID., UNDP, GTZ, WB, EBRD, the Netherlands etc. Starting with January 1, 1997, the Republic of Moldova was transferred into the I part of the DAC list (Development Assistance Committee) of the OECD, becoming eligible for the OAD ( Official Assistance for Development), as well as for diversification of this source of assistance, that can be offered by donors on concession conditions. As a result of this transfer, technical cooperation relations were established with Japan and Italy.

The coordination of technical assistance with the donor countries in 1996 was based on priorities, listed in the Program for technical assistance for 1996-1997, approved on July 27, 1996 by the Government Foreign Trade, Investment, Technical and Humanitarian Assistance Committee (FTITHAC) as a follow-up of the 1995-1996 similar program. The definition of project themes for the 17 priority sectors was performed by the Ministry of Economy and Reforms (MER), deriving from the Governmental Program for 1994-1997.

In 1996 a total of 89 projects were financed through technical assistance with a total budget of \$42.1m. Though this index covered only 49% of priorities stated in the Governmental program for technical assistance, a positive aspect is that no one single sector has been overseen.



Technical assistance distribution, 1996

During 1997, in the framework of technical assistance projects, MER has cooperated with 13 donors. The main input was provided by USAID (USA) and TACIS (EU) with a combined share of 71,2%.

In spite of permanent efforts and negotiations with donor-countries, the *issue of projects' budget structure* still unresolved. Currently, the main share of expanders goes to foreign consultants, that lead to an insufficient cover of other expenditures, such as equipment and local experts. During last year, an optimization of budget distribution was achieved, with a larger involvement of national consultants and increased share for equipment (e.g. TACIS, USIAD, Dutch, PNUD projects) and this trend has to be upheld in the future.

The implementation of a *monitoring system* failed at first attempt. After being presented at the FTITHAC its implementation was considered too difficult. Currently, together with GTZ, the system is being adjusted for implementation.

In this context, the *public information* on technical assistance programs, their results and prospective is considered insufficient. In spite of launching several publications and media programs, the existent projects are not fully known and promoted through media.

**Objectives.** Based on Moldovan experience in attracting and using technical assistance it is recommended to:

(i) Based on results of technical cooperation during 1992-1996, to up-date the priorities of technical assistance for the period of 1998-2000 (including the adoption of a prospective plan for 2000-2005) to be presented to the donors community in the form of an integrated plan.

(ii) Based on above named plan to elaborate and implement plans of individual collaboration with donors, ensuring the best use of donors crediting capabilities and improving the expenditures structure for proposed projects. Complementation of technical assistance programs with investment projects in the same field.

(iii) To ensure the measures set in the Action plan for collaboration with OECD countries, approved on February 18, 1997, targeted at attracting external economic assistance.

(iv) To elaborate and implement the mechanism of monitoring and project evaluation of technical assistance and the efficiency of cooperation between the foreign and national counterparts.

(v) To perform permanent and systematic public information activity through mass media on the projects and results of technical cooperation with foreign donors.

## Conclusions

Economic globalization process has determined the specialization of national economies in sectors where they can achieve competitive advantages on the world market. Moldova has to focus on those industries and segments where its enterprises have a relatively higher efficiency, and to import those products and services where its own enterprises are less efficient than the foreign competitors, this way increasing the average productivity of the economy. Not any work, but only highly productive work generate a high National income.

Competitive advantages will not result in gains of productivity unless a free access to the targeted markets is ensured. The objective of foreign trade policy is to free the access to this markets and suspend the unequal treatment, not to protect the National producers.

During this period, Moldova has to define, as a first attempt, its niches in the global economy and to corroborate efforts to improve the quality of its products and to free the access to targeted markets. Foreign technical assistance and trade policy need to concentrate in the sectors, where Moldova could compete successfully on international markets.