

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;
- 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.

Educational measures:

- 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.

Implementation of these measures could serve as first steps in fighting the parasitical phenomenon of tax evasion and could permit solving the problem of budget deficit, external debts, transition of the economy to a more civilized, stable, attractive for the international organizations and investors stage.

CHAPTER 4. SOCIAL DEVELOPMENT

Analysis of the current situation

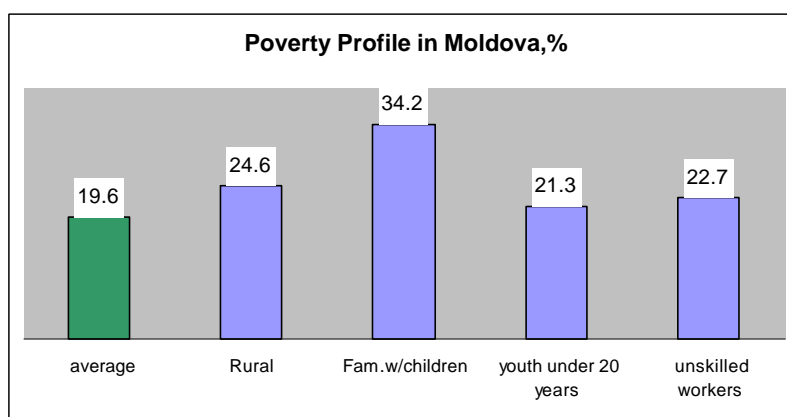
Recent evolution of the social sphere (in 1997 and the 1st quarter of 1998) confirm the trend of a dramatic worsening of this sector. Anti-crisis measures of the Government and the correction of 1998 budget (July 1998) will certainly have a dramatic impact on population's living standards. The galloping growth of pensions and salaries' arrears, accompanied by the erosion of real incomes of the population and enhancement of latent unemployment, amplifies the poverty and lack of people's confidence in the days to come, entailing a considerable increase of the social costs' burden. Although maintenance of macroeconomic stability (the major objective of the Government for the period under review) had a positive impact on the monetary policies, the precarious state of the public funds had a negative effect on the programs of the social protection of the population. Facing severe fiscal constraints, the Government did not succeed to provide for a proper financial coverage of the social costs. As a result, the discrepancy between the financial possibilities of the state and its social commitments has considerably broadened. By mid 1998 the social funds were in a sharp crisis, which endangers the fate of the social sphere in the future. Besides, the universal nature of the social protection schemes and wide spread of social benefits have considerably devalued their real value. Due to this, the social program efficiency is miserable, and the vulnerability risk extremely threatening.

Being treated as a secondary derivation of the economy, the reform of the social sector has been unwillingly delayed. The structure of social benefits and eligibility conditions, in most cases, remain to be those inherited from the old economic system. In addition to that, the legal framework is antiquated, frustrating the activity of the social employees. The performed modifications during the recent 7 years are perfunctory and often are at variance with the market

economy requirements. This is why, the social programs' solvency is low, badly impacting the public expenses. And that entails considerable worsening of principal social parameters, such as: living standards, health state, demographic composition and employment.

Life quality, as exponent of the social sphere performance, has considerably diminished during the period under review. The joint effects of the living standards decline are manifested in *extension of poverty*. In macroeconomic terms this is reflected in the small value of GDP per capita. According to an estimate of the World Bank, the average income of inhabitant of the Republic of Moldova amount to \$115 (adjusted to the Purchase Power Parity). This is one of smallest indicators registered in those 28 states in transition. Only Kirgizia ranks the last in the rating, by \$75 per capita. In microeconomic terms, the poverty is expressed through dramatic worsening of personal (family) budget's viability to cover the vital necessities. Although there is no formal quantification of the poverty line in the republic, nevertheless as preliminary scale, there may be the estimates attained from the household budget survey. According to that, almost 1/5 of the population has average monthly incomes below 64 lei, (which is regarded as poverty line). During 1997 the poverty line rose by about 13%, encompassing new social groups. From the viewpoint of the macroeconomic policies, these illustrate the need to budget means reallocate budget means to fighting poverty, which are estimated at about 7% of GDP.

Poverty profile has peculiarities specific to Moldova and derives from the insolvency of the public funds. The empiric evidences show that the individuals from the rural localities, families with many children, unqualified workers and



solitary elder are the groups mostly endangered by poverty. All these social groups outrun to a great extent the republican average of poverty (19.6%). Particularly, it has been proved that availability of children is mostly correlated with the probability to be affected by poverty. Thus, each 3rd family with children is in poverty, whereas the families without children have a poverty rate of 13.5%. The estimates show also, that the poverty is even deeper and more severe in rural localities, with unqualified workers and young under the age of 20. As a result we can conclude, that poverty will extend even more amongst vulnerable groups mentioned above, forming so called "poverty pockets". This trend will exercise severe impacts upon social assistance policies, requiring on behalf of the government urgent measures, with a view to localize and alleviate this phenomenon.

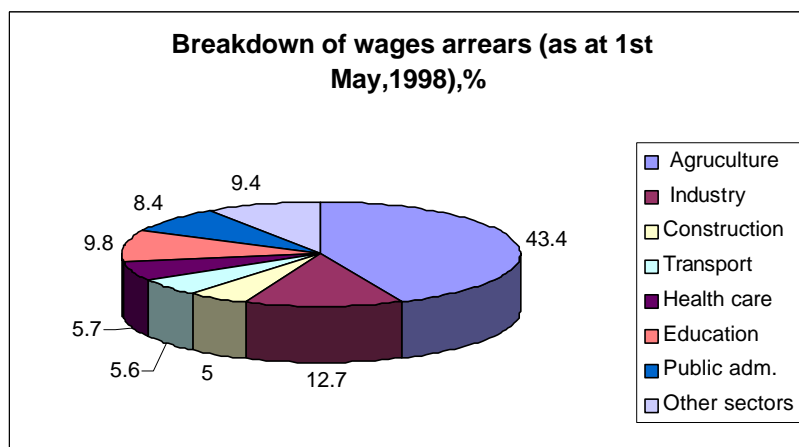
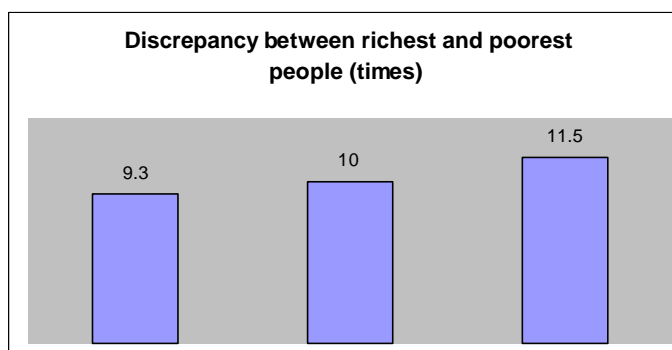
A derivation of the poverty is also the *discrimination of population in terms of incomes*. The *gini* coefficient, which estimates the degree of population income distribution, is 0.44. This index suggests that the incomes and expenditures of the population are distributed very uneven. The span of welfare differentiation is extremely large and constitutes 1 to 11.5. A mere extrapolation of the situation reveals the trend of concentration of wealth by a relatively small number of population. As confirmation there can be the results of the household budget survey, which demonstrates, that half of the overall income of the population is maintained by 1/5 of the population. Mostly poor stratum (20% of the population) gains only 4.3 of incomes. A thorough analysis of the social stratification shows, that the level of incomes varies pretty much, depending on the place of residence. By mid 1998 the discrepancy between the townspeople's incomes and those of villagers accounted for 62%, increasing almost twice in comparison with previous year. To mention is, that the gap between the

incomes is wider with the persons ranking in the lower part of the welfare rating, and is more uneven with the groups who have higher incomes.

Modification of incomes occurred under the influence of the consistent diminution of “cash” component and deepening the social stratification of the population. This fact reflects the crisis of public funds as a whole and of the remuneration system, in particular. Subsequently, the differentiation of labor remuneration deepened, in terms of branches and payments in kind. This is why the incomes of the population constitute at present only 60% of those registered at the moment of introduction of national currency – in 1993.

The composition of population incomes reveals the diminishing trend of salary share within the overall income of the population: from 74.5% on the moment of national currency introduction, in 1993, to 33.1% by the mid May 1998. These changes partially reflect the problem related to salary arrears and accuracy of provided data.

However it is true, that a good deal of salaries are paid in kind and typically are not recorded in books. Besides, the performed estimates cannot “catch” the structure of incomes gained in the informal sector and shadow economy. In this regard one can conclude, that the share of salary is somehow underestimated, yet, this does not change the picture of incomes as a whole. The configuration of incomes shows, that the private sources of income get a more importance in building up personal welfare. Thus, the incomes from real estate and financial transactions, including those in foreign exchange and intermediary activities, account for more than 1/3 of the gross income. This is a positive sign in the evolution of personal incomes; yet, at the same time it points the attention to the requirement of their formal bookkeeping. Although social transfers (indemnities, pensions and compensations) constitute an insignificant share in the families’ budget (14.8%), nevertheless, they are important

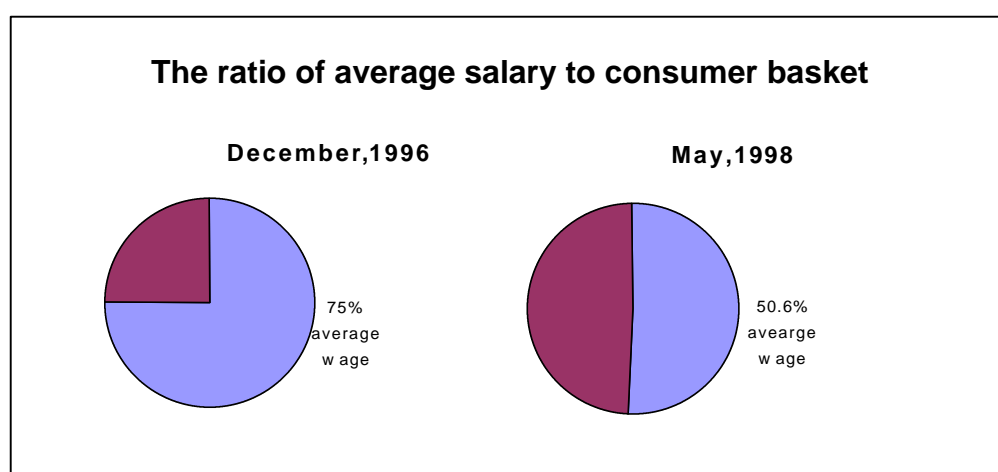


for the urban population. For this category of population, the benefits from social benefits rank 3rd in the overall structure of the personal welfare. Relatively small are the incomes deriving from private and entrepreneurship activities, that account for only 5.5%. This fact proves the underestimation (hiding) of real incomes, as well as the existent barriers hindering this type of activity.

The disturbances taking place in the structure of personal incomes are conditioned basically by the incidence of the following two factors: non-payment of salaries in due course and big share of payments in kind. The problem of salary arrears reflects the overall financial instability in the economy and is directly correlated with the extremely poor solvency of the economic agents. Delayed salaries by 3-4 months and their partial payment created a difficult problem of “chronic” debts, which have poor chances to be settled in the near future. This is why, during 1997 and 1998 the salary arrears have considerably increased, exceeding the current payments. As of May 1st, 1998, the overall amount of arrears constituted 413.251 million lei. Only within one month (April '98) the salary arrears increased by 22 million. The critical situation in this regard, particularly

worsened in agriculture, industry, education and medicare, where the salaries were paid some 4-5 months ago. The perspective of paying-off salaries is ambiguous and depends in a great extent on the performance of the economic agents and financial management as a whole. Yet, this fact constitutes a guideline for a long run outlook. For short run there might be applied some untraditional measures. We mean first of all the possibility of the enterprises in collection of additional funds by privatizing, selling or leasing out some fixed assets. Besides, the state might issue 1-2 years treasury bonds in order to purchase the salary arrears to the employees of the budget sphere and public sector.

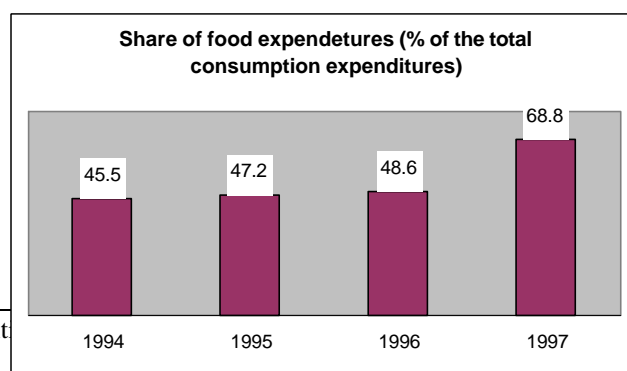
A derivation of big salary arrears - the share of *incomes in kind* - continues to grow. Thus the result of the household budget survey shows, that about 1/3 of the gross income is paid in kind. In rural localities this indicator accounts for 45.5%. The big share of incomes in kind is characterized to the states with low velocity of cash. Payment of a share of salaries, pensions and other transfers in kind can provoke severe distortions in cash circulation of a state and amplify tax evasion. This is why, urgent measures are required that would cease practicing payments in kind. For this purpose there might be used efficiently the fiscal leverage – lending for working capital.



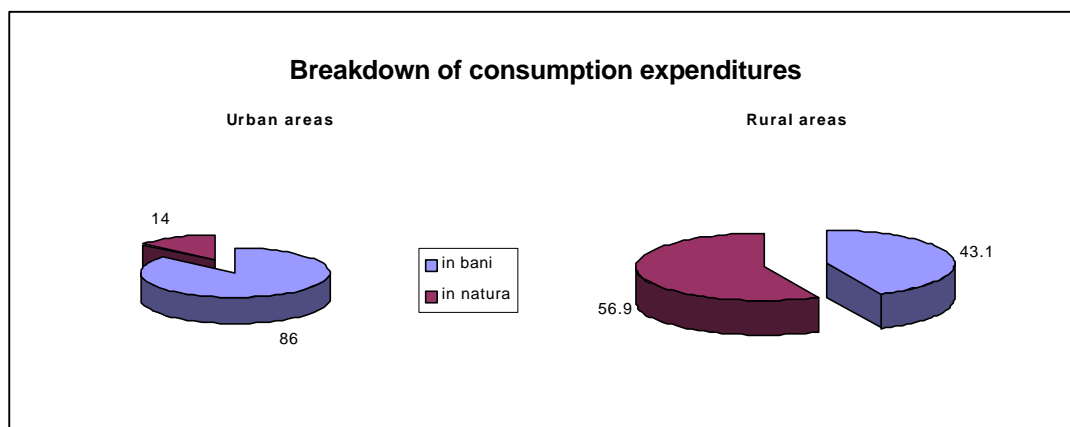
Another quite controversial aspect of the living quality is the parity of average salary within consumer price index. Although during the 1st quarter of 1998 there was noticed a slight increase of the average salary's share within the consumer price index, caused by the deflation (+3.4%), the discrepancy is still very large. In comparison with Dec. 1997, the *ratio of average salary to consumer price index* declined by 25%, currently constituting about 50%. Of course is disputable the validity of data and methodology of consumer price calculation, yet, even if these preliminary estimates denote the imperfections persisting in payment of labor. In this regard it is necessary to adjust the techniques and methodology aimed at real appreciation of those figures.

Practical implications of the ratio of the consumer price index to the average salary might be used in elaboration of social programs designed for poverty alleviation and granting social protection for vulnerable strata. Making this procedure operational requires the adoption of a respective legal framework, which would stipulate the minimal quantum of social benefits and their eligibility conditions.

The *consumption of the population* represents probably most painful point in the amelioration of the living standards of the population. The analysis of the statistical data and household budget survey discloses the poor content of consumption, characteristic to transition period. The big share of the food items in



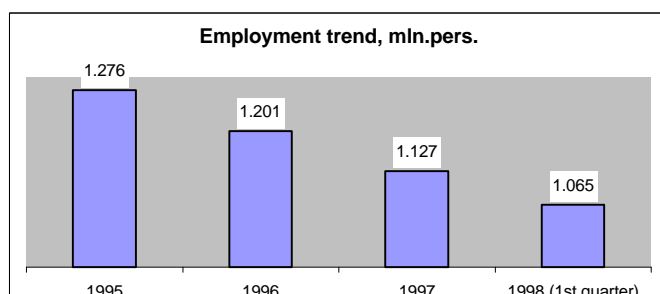
the overall consumption volume demonstrates the low level of population and high social costs that they incur. To mention is that recently there's been noticed a trend of exceeding growth of expenditures on foodstuffs. If in 1994 the population of the republic used to expend on average some 45.5% from the personal budget for purchasing food items, in 1997 this figure went up to 68.8%. The shares of food items vary considerably depending on the locality and material state of the person. Thus, the persons living in rural localities expend on foodstuffs 74% of their budgets, whereas those from urban localities – 63%. In addition to that, the expenditures for food grow exceptionally once with the rising of poverty level: the more material state is worse – the bigger are the food costs. For ex. the population of the first quintile (the poorest) pay 87.1% of the budget on foodstuffs, whereas the population of the 5th quintile (the richest) pay for that only 63.4% of the budget.



It is significant the breakdown of the food costs in terms of the form they are incurred. About 27% of them are expenses in kind that characterizes the deplorable situation of the labor payment; as well the pretty imposing role of the land plots in the overall consumption of the population. The share of expenses for food items made in kind is even more noticed in the rural localities. Only 20.4% are paid in cash, the other 79.7% representing expenses in kind.

Low incomes and delayed payment of salaries makes the population limit only to consumption of strictly necessary goods and services, such as communal services, public transport, heating, electric power. They rank 2nd in the structure of the consumption of the population and account for some 17%. The share of expenses for medicare, education and cultural activities has a constantly decreasing trend, which demonstrates the high price and difficult access of population to those services.

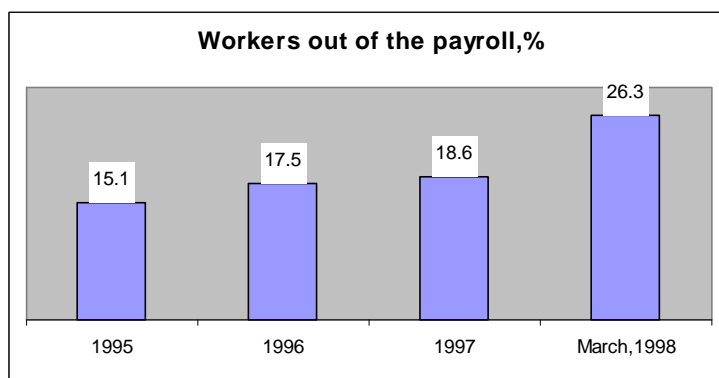
The *labor market* has a crucial impact on the living standards of the population. By offering varied possibilities of getting jobs and a high degree of job stability, this way the labor market constitutes to consolidation of population welfare. And conversely, the evolution of the recent situation demonstrates, that the labor market continues to face severe distortions, which destabilizes the reformatory processes as a whole. This fact is reflected first of all in the low capacity of the economy to absorb the available manpower. The investment activity of the economic units to create new jobs is still relatively poor. This is why we witness a considerable shrinkage of manpower demand. Only in the first quarter of 1998 the number of employees of the economic units decreased by 6%, constituting as of today 1.065 million individuals.



Staff was dismissed practically in all the spheres of the national economy. Dismissals occurred mostly in the agrarian and industrial sectors, registering an approximate fall of about 10%. In the

agrarian sector it occurred due to the problems regarding the brake up of large farms into smaller ones and a multitude of private undertakings that are not registered yet. In the industrial sector dismissal of man power occurred basically due to decline of industrial output and financial blockage of the industrial businesses and their restructuring, which obviously, require less man power. It is surprising, that the medicare, education and social assistance spheres registered a growth of manpower, although the salaries are mostly modest within the national economy, whereas capital investments have been for a long time in a profound decline. This unusual phenomenon, at first sight, may be explained by a relative stability of jobs in these branches, as compared with other sectors of the national economy (industry, transport, agriculture, etc.), as well as by the possibility to gain additionally from the individual (informal) activities.

The other aspect of manpower dismissal is *unemployment*. Although the officially reported employment rate continues to be extremely low – 2.3% (39.1 thousand individuals in the 1st quarter of 1998), in reality the situation is totally different. The data of the household budget survey denotes that only 41.5% of the questioned stated that are



officially registered as employees with any of enterprises. This is a very alarming signal, which can have hard consequences on the labor market. There is a growing trend of the unpaid leaves. The statistical data proves, that the share of people on such leaves accounts for only about 8% of the overall manpower. The shares of unpaid leaves vary from one sector to another. The largest share is in industry – 54%, and in agriculture – 13%. The medicare, education and social assistance suffered less of this problem – only 4% of employees have been forced on unpaid leaves. A more veritable picture on the labor market we get by making a comparable analysis of the employees, according to the staff and employees included in the pay-rolls. The difference between them shows us the really available manpower at the enterprises. Thus, the figures reveal, that the number of employees non-included in the lists (*i.e.*, who really do not work), but who are formally registered in the pay rolls of the enterprises, as of March 1998, account for about 26.3%. This figure is 1.5-fold more than in 1995 and has a constant growing trend. This phenomenon is more noticeable in agriculture and industry.

Being disappointed in finding a job within the national economy, more and more persons leave for work abroad. Thus, *labor migration* rises. To mention is that this phenomenon is semi-organized, often without assuring even the minimal social protection. From this point of view, the risk probability is very high. According to a study performed by the National Bank of Moldova it has been revealed, that the number of persons working temporarily abroad is about 20 thousand individuals. Most of them are worker professions, such as constructors, waiters and housekeepers. Higher education specialists are not desired abroad. The estimates of some independent experts report this figure amounts to 45-50 thousand individuals. We believe the second figure is closer to reality, because in both reports the average annual income attained by the migrants stands at 80 million lei. The geography of manpower migration comprises many states (Israel, Germany, Greece, and USA), yet; the bulk of the flow is oriented to Russia and other parts of the CIS (67%). Although labor migration offers additional opportunities to work and earn money, its adverse effects can have long run negative impact on the local labor market. Given that particularly the young (20-29 years), experience labor migration the losses (even temporary) of this segment can amplify the problems related to adjustment of qualified man power. Besides, the issue of undeclared (or under-estimated) incomes intensifies.

The cumulative effect of the social costs is reflected in the dramatic diminution of the *demographic parameters of the population*. Although recently a slight stabilization has been noticed in live expectancy, the demographic processes that occurred at the initial phase of transition, made the life expectancy in Moldova be one of the shortest in the CIS (70 years for women and 63 for men). The analysis of the demographic parameters show, that the trends that are manifested in this field impact negatively upon the composition of the population and structure of genetic fund in general. First of all the fall of the natural growth of the population (0.8 promiles in 1997), directly leads to absolute reduction of the population of the republic. During 1997 the intensification of this phenomenon accounted for 2%. This fall has been speeded up particularly under the impact of two factors: decline of birth rate and rise of mortality. In comparison with 1990 the birth rate fell by 1.5 times, whereas the overall mortality rate grew 1.2-fold. To mention is, that in 23 raions of the republic the mortality rate outpaces that of birth rate, and that is why the natural growth of the population is negative. Thus, the depopulation phenomenon extends, especially in rural localities. Simultaneously, there's observed an erosion of the family status. During 1997 the number of marriages diminished by 20%. The rate of infantile death keeps high (20 promiles), as well as that of the overall death rate. The latter increased during the last year by 12%, being mostly registered with the men of working age (18%), due to sicknesses of respiratory, digestive organs and cardiac-vascular system. Consequently the modifications that take place in the demographic composition of the population have an evident trend of aging. The decline of population segment under 15 and simultaneous growth of the one above 60 displays the aging trend of the population of the republic. Thus the rate of demographic dependence constitutes at present 61.4% in comparison with 51.2% in 1990. The modification that takes place in the demographic structure will impact negatively the social policies. In financial terms, this indicates a redistribution of the financial means within the social sphere in compliance with some priorities. In terms of social programs, this fact signals about the erosion of the public health and pressures, which will grow on behalf of the inactive population (elder, invalid, and numerous families). In this regard, implementation of sectoral social programs seems to be the opportune solution in the created situation.

Financial position of the social sphere

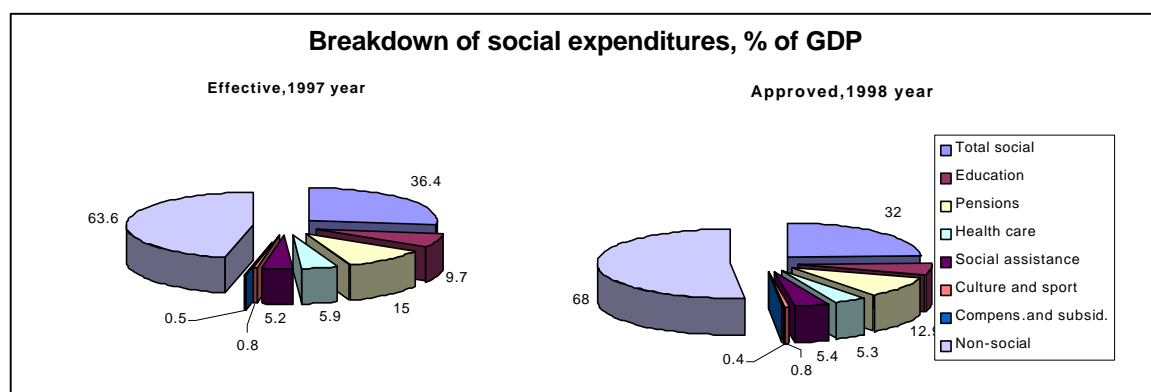
The evolution of recent events marks a considerable worsening of the social funds' trend. The flow of incomes does not comply with the effected expenses. The failures in collection of social payments and galloping growth of arrears amplify the public domestic debt. The discrepancy between the incomes and expenditures provoke hard distortions in the structure of the public expenses. Having no sufficient funds, a good deal of services transform simply in hardly realizable quasi-commitments. By mid 1998 the social liabilities' deficit (difference between the promises and current incomes) reached the figure of 43% of the GDP. Thus diminution of the social funds might seriously jeopardize the reforms progress.

Moreover, the universal nature of the social services and loose eligibility conditions impose the economic agents and budget to incur high financial costs. As attested by statistical data, the social expenses account for a considerable part of the GDP- circa 36%. In quantitative terms, this figure is comparable even with that of some western countries. However, in quantitative terms, their usage is net inferior even for transition countries. The efficiency of the public expenses is extremely low and contradicts the market economy requirements.

The structure of the social costs shows, that the biggest share account for pensions, (15%), then education (9.7%) and medicare (almost 6%). The other branches of the social sphere (culture, social assistance and sports) commonly account for slightly less than 6% of the GDP. The content of the social costs shows, that they are adjustable and are oriented mostly to *ad-hoc*

funding of social programs. The funds are typically allocated to those objects and programs that are in emergency state. Thus, there's an attempt to withhold further aggravation of the adverse phenomena and to localize them within that area. Yet, the effect of this model is for a short time and cannot resolve the problem essentially.

In line with the *ad-hoc* model, funding of the *current social expenses* is practiced, which in fact do not differ considerably. The explanation is, that in this case the cash is earmarked for funding the stringent current needs aimed at a superficial "repair" (improvement) of the situation. In both cases the volume of allocated funds is net inferior to the real needs. For ex. the education and medicare have been financed in volume of 45% of the required, education and science even less – only 1/3. Besides this functional structure of the social expenses shows, that at least 1/3 of them are expenses on the assets side (machinery, training stuff, professional training), the remainder being liabilities related expenses (salaries, taxes, capital repairs of buildings). Talking about the social expenses in macroeconomic terms, it should be mentioned that they are still public expenses (funded basically from the state budget and managed entirely by the state). The non-budget and non-state sources are still very insignificant. According to preliminary estimates, their share does not exceed 5% of the total volume of the social costs. Slightly more are the private resources aimed at funding the first medical aid and higher education. Of course, all these data are regarded partially as underestimates (given that many informal private activities in the social sphere are not book-kept), yet, in principle the situation is like this.

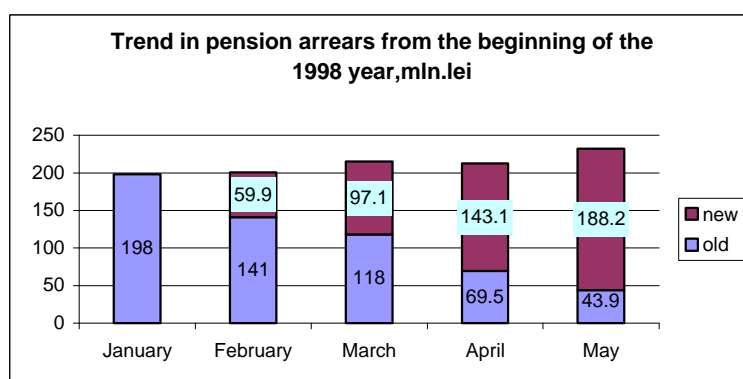


Maintaining the social funds only of public nature engenders serious discrepancies in the implementation of the social programs, essentially reducing their efficiency. This phenomenon's behavior can be easily illustrated by the example of the social fund. The monthly based data regarding the incomes and expenses show that the financial situation of the social fund is critical.

The poor solvency of the public pensioning system is significantly caused by the galloping growth of the pension arrears. Although during 1997 a reduction was reached of historical pension arrears by 90% (basically through payments in kind and netting), the problem continues to be a destabilizing factor of the public finance. The aggregate arrears

reached the figure of 232.1 million lei, considerably increasing during the 1st quarter of 1998.

Braking down the structure of arrears shows, that the payment of the old arrears is made in small amounts. For example for May 1998 the old arrears were paid in amount of 25.6 million lei, whereas the new arrears grew by 40 million lei. This is why, the overall amount of the pension



debts grows considerably as a result of outpacing accrual of the new arrears as compared with the settlement of historical debts.

Insufficiency of cash imposed the social assistance bodies to practice the method of payment in kind. The span of this type of settlement varied from 49.5% (1st quarter of 1997) to 22.8% (4th quarter of 1997). In 1997, on average, each 3rd pension was paid in kind. Though in smaller size (22.8%), settlement of pensions in kind still continues. Partially this is linked to the considerable reduction of the volume of goods and products conveyed to the social fund by the economic agents as social contributions. Yet, the main reason consists in the refusal of the elder to accept the pension in kind (even partially) instead of that in cash. The prices of pension settlement in kind are too unfair.

The analysis of the funding sources of the social fund budget shows, that the perspective of the amelioration of the situation is very ambiguous. The statistical data confirm that the decline of social contributions' collection is deepening. If during 1997 the disbursements of the social contributions accounted for 51.8%, then in the 1st quarter of the current year their collection decreased to 35%. Non-payment in due course of the social contributions by the economic agents derives from the financial blockage they face. According to preliminary data, the accounts payable of the enterprises during the 1st quarter of 1998 grew by 43%. The fact is significant, that circa 2/3 of them constitute the debts to the social fund and labor remuneration. In these conditions it would be erroneous to believe, that the disbursements to social fund will be made entirely. As confirmation to those mentioned above, could be the statistical data, which prove, that only during June 1998 the debts of the economic agents to the social fund grew by about 65 million lei, amounting to an overall amount of 482.2 million lei.

The enormous discrepancy between the inflows (incomes) and outflows (expenses) confirm the assumption that the social sphere funds are on the edge of the crisis. The enormous fiscal burden borne by the economic agents and the antiquated manner of social disbursements can cause serious impediments to the financial system as a whole. Bearing in mind, that the critical situation of the budget system and the big commitments of the government to serve the public (and external) debt, we can conclude, that the amelioration of the social funds (at least during the recent 10 months) is mostly improbable. In this regard, the social fund budget for 1998 seems to be unreal. The reasons for a pessimistic scenario may be the aggravation of the decline of sources to compete the social fund and unjustified increase of various social privileges (facilities). The preliminary estimates show, that even if we keep the collection of contributions in cash equal to that the level of April 1998 (35 million lei – one of the highest indicators during the recent 2 years), the total amount of the disbursements for the remained period until the current year might hardly reach the figure of 400 million lei. At the same time, the payments to the social fund in kind decreased considerably: from 43% on average in 1997 to 18% in May 1998). From this viewpoint, we can forecast that incomes deriving from disbursements in kind will not exceed the amount of 80 million lei. Thus, the overall incomes into the social fund for 1998 will amount to only 500 million lei, which accounts for much less than the officially reported amount in the budget (1369.7 million lei). On the background of the small and pessimistic incomes, the expense part seems to be a banal joke. Forecasting a series of increases (of minimal pensions, special deserved pensions, for military, etc.), are just quasi-commitments without any financial background. Taking into account the enormous debts the government has to pensioners (232 million lei), we may conclude, that the burden of the social fund exceeds its real possibilities. All these together indicate that the social fund deficit can reach the amount of 630 million lei (7.8% of GDP).

Thus the estimates pointed above confirm the imminence of social funds adjustment to new realities. In this regard, urgent measures are required aimed at reforming both the inflows

(incomes) and outflows (expenses) of the social fund. It is particularly necessary, that the social fund budget reflects more realistically the collection of incomes and reduces unjustified expenses. Besides, the financial management of the social fund should be strengthened, by specifying clearly the distinction between the pensions and allowances. It is important to determine the functions and obligations of the state budget and of the social fund in covering the social costs. We consider, that the budget should limit only to granting benefits pertaining to social assistance (family allowances, for children, to the poor, etc.), whereas the social fund – to payment of pensions and unemployment programs.

Problems related to development of social sphere basic branches

Education occupies a specific place in human potential development. Providing various educational services and by developing the human intellectual faculties, educational institutions contribute this way to affirmation of civic positive position and formation of highly qualified manpower. From this viewpoint, the education is considered as precondition for deepening the economic reforms.

As many other branches of the social sphere, the education faces big difficulties that adversely effects the efficiency and quality of rendered services. These are financial, structural and managerial problems. For ex, although the GDP share earmarked for education exceeds 9% (indicator comparable with those of many western states), in reality expenses for education are extremely small. Calculations per pupil constitute only 684 lei, which is similar only to the developing countries. In 1997 from the state budget there were allocated 184 million lei, which constitutes less than half of the funds required by the training institutions. This is why, 10% of the total number of schools are in emergency state, and each 3rd – needs capital repair. A major problem continues to be the insufficiency of rooms for studies and the excessive number of pupils in a class. Thus, during the last year about 10% of the schoolchildren were going to school in the 2nd shift, in the urban localities this indicator is even higher – 17%. The normal capacity of classes is overburdened, often consisting of 35-40 children. In these conditions the quality of teaching is essentially suffering.

The private sector is still very timid and incoherent. Of those 3243 training institutions of the republic, only 25 are private. The share of students attending colleges and higher education institutions constitutes 15% of the overall. This figure is even smaller among the secondary general schools –only 0.26%. In these circumstances, obviously, the non-budget funds' contribution to financing the educational costs is symbolic – about 7% of the total amount necessary for this purpose.

In addition to the financial difficulties, the education has to overcome many problems related to the content and structure of education. They include the methods and antiquated techniques of teaching with most of the training institutions, curricula that do not fit to the actual requirements, incoherence in pupils' results assessment, insufficiency of manuals and modern teaching materials, poor motivation of teachers to perform efficient activities and others. As a result, so far no training institution of Moldova has been adjusted to the European standards. In addition to that, to mention is the situation of anarchy and lack of coordination that prevails in relation to entrance exams at the higher institutions. For ex. last year circa 40% of the school-leavers were registered at the economic specialties (banks, finance and bourses). This disproportion will create hard distortions on the market in the near future.

All together, the problems mentioned above can provoke serious disturbances in the activity of the educational system in Moldova. This is why, measures are required to avoid further diminution of the situation, that would facilitate the deepening of the reforms in this strategic

sector of the social sphere. In this context we consider opportune to focus the activities on the following two *priorities*: rationalization of budget expenditures and diversification of the non-state funding sources; adjustment of the programs and training techniques to the current requirement; consolidation of stimulants in teachers' activity. In operational aspect (in terms of programs) the realization of the above objectives can be reached in the following packets of *activities*:

- Revision of all curricula and their adjustment to date requirements;
- Priority funding and stimulation of commercial (private) activity of publishing manuals and training materials;
- Rationalization of budgeting and diversification of non-budget (non-state) sources of funding for public education;
- Acceleration of evaluation activity and accrediting of higher training institutions through European standards;
- Modification of current experience of teachers' remuneration and stimulation, making it flexible and in compliance to work performance;
- Elaboration of macro-national scenarios regarding the estimation of demand in preparing high quality specialists.

The precarious state of the *medical assistance* amplifies the negative demographic process and ruins the public health. The situation of the national medicare system is characterized by poor performance, insufficient funding and poor management. During 1997-1998 the dynamics of medicare indicators diminished considerably, dramatically nearing to a critical limit. The increase of infectious and socially contagious illnesses (tuberculosis, HIV, cancer, etc.) constitutes an alarming signal for the human genetic fund of the republic, which can affect seriously the demographic situation as a whole. The state of the adolescents' health state continues to worsen: circa 1/3 of recruited to the national army have severely affected health. At the same time the number increased of psychological deviations increased with the children, broadening the extent of the population invalidization. On the background of the general morbidity increases the pathology incidence of confined women and at delivery. Thus, as of the end of 1997 the maternal morbidity rate reached the figure of 48.3 promiles. Assessing the trend of the public health during the recent 2 years, to mention is that it was characterized to a large extent by the unstable sanitary-epidemiological situation and pathology chronicity.

Facing tough fiscal constraints, the Government is compelled to allocate less and less funds for health care. Thus, during 1997 the allocations from the overall budget shrunk by 3%, amounting to only 145 lei per capita. In macroeconomic terms, they constitute less than 45% of the required resources required in the field. At the same time, the structure of expenses remains to be irrational, which considerably reduces the efficiency of funds. Of the overall amount allocated to medicare, only 1/5 constitutes active expenses (procurement of medicines, medical equipment, personal training), the remainder (4/5) account for the communal services, labor payment and capital repairs of buildings. Distribution of funds between the two domains of medicare is inadequate too - only 18% are allocated for primary medical assistance (outpatient services and pre-illness diagnostics), whereas the funding of hospitals consumed 82% of the overall funds. Of course, this disproportion in distribution of financial resources is far from contributing in making the active-preventive measures more efficient.

Is pretty low the development of private sector in the field of medicare. The statistical data shows that the paid medical services rendered to the population in 1997 made up only 1/10 of the overall expense. Per capita they make up only 3.18 lei, which is slightly more in the urban localities (Chişinău – 5.65 lei and Bălţi – 6.85 lei). Obviously, in these conditions the budget cannot support entirely the medical assistance, which becomes more and more costly. It is

necessary to both rationalize the public funds earmarked for medicare, as well as the branch as a whole.

Taking into account, that the macroeconomic environment in which the medicare performs its activity in Moldova, as well as the trends manifested recently in this domain, we can conclude, that the perspective of the amelioration of the situation, based entirely on the support of the state, is pretty ambiguous. The viability of the branch depends to a great extent on the pace and degree of reforms. From this point of view, we consider opportune to speed up the reforming actions, focusing on the following priorities:

- Modification of public costs' structure, by increasing the share of allocations for primary health care (preventive diagnosis, prophylactics and out-patient services);
- Enforcement of law regarding the obligatory medical assistance of citizens;
- Development of a minimal packet of medical services guaranteed by the state and funded from public budget;
- Stimulation (encouragement) of private sector development and competitive behavior in rendering medical-curative services;
- Decentralization of medicare net, by granting real autonomy to medical units;
- Elaboration of national sectoral programs aimed at fighting the socially contagious sicknesses (cancer, HIV, diabetes, environment hygiene, etc.).

Social protection of the population besides the macroeconomic difficulties, faced by the whole economy, has to overcome atavisms inherited from the old system of the social benefits. Preserving the public nature of the social funds means to expose the social sphere to certain hazardous, long run disturbances. This is why, the structure of social costs needs to be rationalized and eligibility criteria revised. The social protection needs to gradually shift from the principle of universal distribution of benefits to that of individual accumulation. It is important, that the burden of social expenses be evenly borne by all individuals, economic units and state. In this regard, a closer correlation will be provided between the beneficiaries and taxpayers.

Social protection reform will run in conditions of tight *fiscal and political constraints*. They will be noticed pretty much in the immediately forthcoming period (1998-1999), as a result of the external debt of the republic and amplification of budget deficit. The vulnerable point in the activity of the social protection system constitutes its financial viability, which is almost collapsed. The designed transformations need to be implemented in line with the measures aimed at improving the consolidated state budget. The immediate aim is to offset the incomes with expenses, based on the enhancement of budget accumulations and reduction of unjustified financing. For this purpose it is important to provide for financing of current social payments for pensions and salaries, by suspending the plans (intentions) to rise wages or other indemnities.

Although the strategic objective in the pensioning filed envisages a gradual shift from the current universal system to three-dimensional one, *priority* should have measures of rationalization of current pensioning fund budgeting. In terms of *urgent policies*, the actions should be channeled to the following directions:

- Freezing up any increase of pensions until the pension arrears are not entirely paid off;
- Ceasing for a longer term the payment of particular-deserve-pensions and those granted in privileged conditions;
- Reduction of pensions and compensations to working pensioners;
- Elimination of compensations for gas and electric power, by shifting the social assistance to vulnerable social groups;

- Banning netting with the social fund;
- Ceasing the experience of paying the pensions in kind;
- Restructuring the debts of the social fund to pensions and indemnities;
- Strengthening the financial management regarding the accumulation and distribution of social contributions.

In order to make the targeted measures operational, it is necessary to establish an adequate legal framework. It is necessary to update certain legal acts and develop some new, such as the laws: regarding state pensions, operationalization of private pension funds, social fund, state social insurance, private social insurance, etc.

As regards *social assistance*, it will play an important role in amortizing the social costs. Proceeding from the budgetary constraints that the social fund is going to face during the forthcoming months, it is necessary, that the funds be channeled mostly to *protection of most needy strata* and those easily vulnerable to risks. For this purpose, the results of the household budget survey may be used, for identifying the vulnerable groups and determining the social assistance quantum. As proved by the poverty profile in Moldova, mostly affected category comprises families with children (76% of the total number of poor account for the families who have at least a child under 15). This is why, the children should be placed in the focus of the social assistance efforts. We consider opportune to substitute the multitude of family allocations (for children) with one single – poverty allowance. This will exclude incoherence and will be more explicit for beneficiaries. It will be granted only to vulnerable individuals, based on the means testing.

Given that the social funds will be extremely limited in continuation, the social transfers need to be distributed to a high extent in terms of concrete addresses. For this purpose it is necessary to make tougher the current eligibility conditions, by reducing essentially the list of recipients. The size of indemnities (social allowances) should be as flexible as possible and vary depending on the category of beneficiaries and degree of their need. At the same time, the social costs should be maintained at a prudence level, in order to avoid a potential deepening of budget deficit.

Assessment of current situation and development of eventual scenarios shows, that besides the measures aimed at speeding up the social reforms, urgent actions are needed to recover the social finances. Social budget's adjustment to reality might make public expenses more efficient and facilitate promotion of their reform as a whole.

CHAPTER 5. REGIONAL DEVELOPMENT: A CASE OF TRANSNISTRIA

The Program of Activity of the new Moldova's Government, approved by the Parliament in May 1998, among priorities includes "*restoration of the territorial integrity, formation of a sole viable economic complex, in conditions of market economy*". Following after well-known events of 1992, the economy of Transnistria has been developing in is particular conditions, differing from those of other regions of the country, a fact which should be taken into consideration both while running the territorial-administrative reform in Moldova, and while implementing the European

norms of local self-administration in compliance with the *European Charter of Local Self-Government*, ratified by the Parliament of Moldova in July 1997.

One of the tasks of the new Parliament is to generate a national legislation in line with the Charter, including the laws “On Territorial-Administrative Organization”, “On Local Self-Government” and “On Elections of Local Administration Offices”, the drafts of the above having been submitted to the commissions of the Parliament for almost an year.

Europe operates today in the context of a new juridical, political and social-economic reality: *regionalism* is manifesting itself in increasing the rights and responsibilities of regions in some countries (Germany, Spain, Austria, etc.), and developing cooperation among regions, across national borders.

In the case of Transnistria, as for regions in other countries, the key problems are: (i) *how to distribute responsibilities between the central and regional governments in the best possible way for the country and the region; and (ii) how to ensure that the process of decentralization does not undermine the national state.*

Solution of the problem related to Transnistria will not be easy, ways continue to be sought, including through providing with analysis and information. Below, there is a digest of the Report “Republic of Moldova: Economic Review of the Transnistrian Region” (World Bank, Chi” in”u, June 1998).

* * *

Since 1992, the Transnistria region, an economically important part of the Republic of Moldova located on the east bank of the Nistru river, has suffered self-imposed isolation from the rest of the country and, for the most part, from the world at large. This isolation arose as a consequence of unsettled conflict in which ethnic and language factors exacerbated the marked differences in approach to economic reform.

In Soviet times, Transnistria was considered the most economically developed region of the Moldovan Soviet Republic. According to rough calculations, it accounted for more than a quarter of the republic's gross domestic product (GDP). It produced more than a third of total industrial output, including about 90 percent of electricity, all steel and rolled metal, and most heavy industrial equipment, construction materials, and light industrial products. Transnistria's contribution to agricultural output was less important (about 10-15 percent), but agriculture was more productive compared with that of the rest of the republic. Due to its geographic location, the region has always been a natural hub for Moldova's trade with the east in respect to both land transportation and energy pipeline connections.

The Transnistrian conflict has considerably complicated Moldova's transition to a market economy. Disintegration of the internal market has weakened the economic potential of the country. Already extremely high dependence on energy imports has deepened. Competitiveness of exports has suffered as use of the most convenient transport routes to major export markets has been blocked for the majority of economic agents. De facto separation and lack of structural reforms in the Transnistria region have provided a large window for opportunity for various forms of shadow economic activities. Moldovan authorities have repeatedly expressed concern about governance problems arising from the Transnistria situation, including numerous cases of unrecorded foreign trade, tax evasion, and smuggling resulting from the lack of effective control over the eastern border with Ukraine. Compounding the tangible economic damage has been the negative effect of the conflict on the image of Moldova in the eyes of the international community; this has hurt its chances of competing for new markets, making new trading partners, and attracting foreign investors.

Transnistria's move towards isolation was manifested in a number of radical steps taken in 1992-93 to establish separate economic institutions. The Transnistrian Republican Bank (or the Transnistrian central bank, TRB) issued a separate currency that is not recognized outside the region. Fiscal policy is also managed independently from the rest of the country. The region has established its own customs service and maintains a distinct trade regime. Trade with the west bank territory of Moldova is treated as foreign trade. Although division of the energy sector, which is crucial for the whole country due to its dependence on imported energy resources proved to be impossible, coordination between the two parts of the country is limited. The fundamental legal framework for market economy adopted by Moldova in recent years has not been accepted by the Transnistrian authorities and does not function in the region. No statistical data have been provided officially from the Transnistria region to Moldovan authorities since 1992.

It would be wrong to say that the central planning system has remained unmodified in the Transnistria region. Although no official program of market reforms has been implemented in Transnistria, the regional authorities did not cancel liberalization measures already undertaken in Moldova before separation. Furthermore, they have attempted to introduce some new, select elements of a market economy while maintaining many aspects of the old Soviet style economic system. In addition, in several areas *de facto* liberalization took place during the initial period of economic chaos and lack of supervision by regional authorities. The majority of prices are now free of controls and the foreign exchange market is developing. Commercial banks operate actively and new private firms have begun to emerge. The actual trade regime is much more liberal than the one proclaimed officially as a consequence of weak customs controls and the unsolved problem of regulating trade relations between the east and west bank territories.

Selective liberalization measures were not supported by macroeconomic stabilization and structural reform, which resulted in a severe economic crisis. For several years, monetary policy in the Transnistria region was characterized by chaotic developments and the absence of any real control mechanisms. Budgetary and credit policy remained largely a tool of politicians, who used it without regard to economic consequences. Few, if any, structural reforms have been implemented in Transnistria. Executive and legislative authorities have failed to achieve consensus on the main principles of reform, including the role of private property and the functions of the state in the economy. As a result, the public sector dominates production and distribution, and the private sector is relegated to a minor role. This stands in sharp contrast with the rest of Moldova.

Starting in late 1995, the Transnistrian authorities appeared to make more concerted efforts to respond to the deteriorating economic situation. Measures were taken to keep the monetary and financial crisis from deepening further. The role of the TRB was strengthened, and a concerted effort was made to establish its control over the monetary and credit situation in the region. A tougher stance was taken in issuing new currency. The TRB refinance rate began to be adjusted to inflation and it replaced the symbolic interest rates fixed by the Transnistrian Supreme Soviet (or regional Parliament, TSS). The TRB began to intervene more actively in the foreign exchange market. Parallel measures were undertaken to reduce the fiscal deficit and to find nonmonetary sources for its financing. However, budgetary policies remained contradictory, as soft budget constraints persisted and the Soviet-type pattern of public expenditures essentially remained the same. Supervision over commercial banks was strengthened through the introduction of prudential standards and the gradual increase in required minimum statutory capital. Some steps were taken to reanimate the process of privatization. The basic legal framework for expansion of nonstate

forms of ownership in the region was approved by the TSS. However, the legislators' inability to reach consensus on the implementation mechanisms resulted in the failure of most of the laws to work in practice. The authorities made visible efforts to attract foreign investors to the region. Various forms of cooperation between the Transnistrian enterprises and foreign partners were encouraged, with some modest results.

Internal measures aimed at redressing the crisis were accompanied by a number of partial steps in the direction of economic reintegration with the rest of Moldova. In 1995-97, several important economic agreements were signed between the Government of Moldova and the Transnistrian authorities, which were aimed at eliminating some of the most distortionary inconsistencies in economic regulation between the two territories. These agreements, which include, *inter-alia*, measures to simplify foreign exchange and trade relations, could form a substantial basis for future economic reintegration in case of their full implementation. An agreement on the relations between the monetary and credit systems was signed in mid-1995. In particular it envisaged official introduction of the parallel circulation of the Moldovan leu as legal tender for noncash transactions in the territory of Transnistria. The National Bank of Moldova subsequently opened a branch office in Tiraspol, which functions as a settlement center for transactions between the commercial banks of the two territories. However, Transnistrian commercial banks prefer to maintain direct correspondent relations with the banks in Chi^oin^ău, and the level of transactions channeled through the settlement center remains insignificant. A customs agreement was signed at the beginning of 1996, which envisaged the Transnistrian authorities taking some important measures to adapt their foreign trade regime and eliminate most differences with the national trade regime. Although import tariff rates for nonfood products, tobacco, and beverages have been increased to the national levels, the greatest part of the customs agreement remains to be implemented. These agreements were followed by the signing in May 1997 of a memorandum on the principles for settlement of the conflict. The memorandum envisages a final status that would accord Transnistria a substantial amount of economic autonomy within a unified national framework. However, the timetable for reaching a final settlement remains uncertain.

Although the recent efforts of the Transnistrian authorities to stop the deepening of the crisis and to upgrade economic ties with the west bank have brought partial results, the measures undertaken have not been sufficient to stabilize the economy. The deliberate policy of isolation, combined with the lack of comprehensive macroeconomic stabilization efforts and a reluctance to carry out structural reform, has resulted in major economic difficulties in the Transnistria region. Measured by most comparators, these difficulties are considerably greater than those faced by the rest of the country. After a period of accelerated deterioration in economic conditions, which reached a peak in 1995, some relative improvement occurred in 1996-97. Nevertheless, the region's economy is mired in a deep recession, and living standards have dropped sharply.

The monetary and financial situation remains very unstable. The region continues to suffer from high inflation, although price growth significantly decelerated in 1997. The average monthly inflation rate was below four percent in 1997, compared to more than 50 percent in 1995. In step with the inflation rate, depreciation of the Transnistrian ruble (TR) slowed down, but has not yet stopped, even with active TRB interventions. Indeed, the local ruble fell sharply in March 1998. Local economic agents generally substitute foreign currencies for the local currency. After a near collapse of the regional budget in 1995, some rehabilitation of the budgetary system has taken place, but the overall financial situation remains extremely fragile. Payment arrears have become

chronic. The largest and most acute financial problem is the huge amount of accumulated external arrears to Russia for energy resources, which makes up about half the energy debt of the whole country. These arrears have become, in fact, a massive subsidy to the economy of the region and a major liability for the future.

Both industrial and agricultural outputs continue to decline. In 1997, industrial output was about 70 percent below the 1990 level. According to rough estimates, the relative share of the region in the Moldova's total industrial output has fallen by about 7 percentage points due to higher rates of decline compared to the west bank territory. However, at the micro level, the situation is differentiated. Amid the continuing decline in physical output of most industrial products, there are some exceptions. More favorable trends in the production of a number of products (e.g., steel, rolled metal, slate, cement) are associated with more effective management policies at a few leading enterprises. In general, these firms had better starting conditions in terms of internal organization, management and labor skills, and competitiveness. They managed to adjust more quickly when the command economy was dismantled *de facto*. Agricultural output has also been declining at a faster pace than in the rest of the country. The fall in agricultural output has been accompanied by a decline in yields relative to the rest of Moldova. This has resulted in a loss of a comparative advantage for many important agricultural products (cereals, sunflower, vegetables) which Transnistria used to enjoy in the Soviet times.

Recession in the main productive sectors has generated high levels of hidden unemployment in the form of forced underemployment in the public sector. Even though a large part of those underemployed succeed in finding alternative jobs, the underlying unemployment rate is estimated to be at least 7 percent of the labor force.

Poor economic policies followed by a long-lasting economic crisis in the region has led to a sharp fall in living standards. In 1995-96, average wages were about 20 percent below the average for the rest of the country. In comparison, at the time of the breakup of the Soviet Union, Transnistria had better starting conditions in terms of wage levels than the west bank territory. In 1997, however, the difference in wage level practically disappeared. This is probably a temporary phenomenon, since it is primarily a consequence of administrative increases in wages decreed by the regional authorities. Indeed, the Transnistrian ruble depreciated sharply in mid-March 1998, from TR 650,000 to TR 1,200,000 per US dollar, implying a potentially important erosion in real wages. Total household revenues on average do not exceed US\$35 per capita. The urban majority of the Transnistrian population appears to be significantly poorer than the rural minority and the urban population of the west bank territory. The two major factors that probably prevented household revenues from an even deeper fall are (a) populist social policies of the Transnistrian authorities conducted at the expense of financing the economy through the accumulation of external arrears, and (b) the availability of alternative revenue sources, including a large share of revenue earned from household agricultural production.

It is clear that the policies followed by the Transnistrian authorities of isolation and piecemeal reforms combined with heavy reliance on external subsidies are associated with high risks and are inadequate to create internal conditions for stabilization and economic growth in the region. It is true that, despite all the difficulties, the region's economy has avoided collapse so far. The following three factors are probably the major determinants behind this phenomenon: (a) *de facto* liberalization in a number of areas, which in many cases took place spontaneously; (b) massive external subsidy to the whole economy; and (c) partial reforms undertaken by the authorities under the danger of full economic collapse. The first two of these factors are not under

the control of the regional authorities and could exert destabilizing influences in the future. Only the last factor can really contribute to the conditions for stabilization and growth in the longer term. Partial efforts to reform some elements of the economic system should be developed into a comprehensive market reform program. To achieve this, much greater effort is needed on the part of the Transnistrian authorities, particularly in the areas of macroeconomic stabilization, privatization, external trade liberalization, and general reform of the legal framework, in order to create conditions for stability, growth, and economic reintegration. Most elements of this reform program exist within the national framework already adopted by the west bank of Moldova. In practice, this framework could be readily expanded to include Transnistria while making the adjustments required to take into account the specific characteristics of the region.

Economic benefits of reintegration for both parts of the country are clear. Only through economic reintegration can Moldova realize its full internal economic potential and maximize external competitiveness. For the Transnistria region, reintegration would precipitate accelerated economic reform and provide stable economic linkages with the rest of the country and the outside world, without which its tiny economy would be unlikely to survive and prosper in the long term. However, economic reintegration cannot be expected to happen by itself. The prospects depend on achieving a final political settlement of the conflict which is a great challenge facing the Moldovan Government and Transnistrian authorities. There are obviously many social, ethnic and linguistic factors to be taken into account. A strong will, as well as great effort are needed from both sides to reverse the process of separation which has developed over the last five years.

CHAPTER 6. ANNEXES

6.1 Selective indicators of countries in transition

For the Republic of Moldova the experience of other countries in transition is quite important. The following comparative analysis provide a picture of Moldova within other countries in transition from Central and Eastern Europe. Table 6.1.3 ranks these countries according to a selection of indicators for reform, while Table 6.1.1 and 6.1.2 give a more specific picture of the GDP growth performance and inflation over the recent years.

Table 6.1.1 Selected group of Countries in Transition: Real growth of GDP: 1990-97

	1990	1991	1992	1993	1994	1995	1996	1997
	percentage change							
Albania	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0
Bulgaria	-9.1	-11.7	-7.3	-2.4	1.8	2.1	-10.9	-7.4
Croatia	-6.9	-19.8	-11.1	-0.9	0.6	1.7	4.3	6.3
Czech Republi	-1.2	-11.5	-3.3	0.6	2.7	5.9	4.1	1.2
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.0
Moldova	-	-	-	-1.2	-30.9	-1.9	-8.0	1.3
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9
Romania	-5.6	-12.9	-8.7	1.5	3.9	7.1	3.9	-6.6
Slovak Republ	-2.5	-14.6	-6.5	-3.7	4.9	6.8	7.0	5.7
Slovenia	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	3.7
Ukraine	-4.0	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.2

Source: *International Financial Statistics*, IMF and *Transition report*, EBRD

Table 6.1.2 Inflation in Eastern Europe

	1991	1992	1993	1994	1995	1996	1997
	(change in the year-end retail/consumer price level, in per cent)						
Albania	104	237	31	16	6	12.7	32.1
Bulgaria	339	79	64	122	33	123	1,089
Croatia	250	938	1,149	-3	4	3.5	3.6
Czech Republi	52	13	18	10	8	8.8	8.4
Hungary	32	22	21	21	28	23.5	18.3
Moldova	-	424.3	393.6	76.1	21.7	15.1	11.2
Poland	60	44	38	29	22	19.9	15
Romania	223	199	296	62	28	38.8	154.8
Slovak Republ	58	9	25	12	7	5.8	6.2
Slovenia	247	93	23	18	9	9.7	9.1
Ukraine	161	2,730	10,155	401	182	80.2	15.9

Source: Based on EBRD, *Transition report 1997*

Table 6.1.3 Progress in transition by countries

Countries	Population (millions, mid-1995)	Private sector share of GDP in %, mid-1997 (rough EBRD estimate)	Enterprises			Markets and trade			Financial institutions	
			Large-scale privatisation	Small-scale privatisation	Governance & restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2-
Bulgaria	8.4	50	3	3	2+	3	4	2	3-	2
Croatia	4.8	55	3	4+	3-	3	4	2	3-	2+
Czech Republic	10.3	75	4	4+	3	3	4+	3	3	3
Hungary	10.3	75	4	4+	3	3+	4+	3	4	3+
Moldova	4.4	45	3	3	2	3	4	2	2	2
Poland	38.5	65	3+	4+	3	3	4+	3	3	3+
Romania	22.7	60	3-	3	2	3	4	2	3-	2
Slovenia	2	50	3+	4+	3-	3	4+	2	3	3
Ukraine	51.9	50	3-	3+	2	3	3	2	2	2

Source: Based on EBRD, *Transition report 1997*

The classification system for transition indicators has the 1-4 scale indicating the scale from the worst category 1 (little progress) to the standards and performance of advanced industrial economies (4).

The “private sector” of GDP represents rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term “private companies” refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the “private sector” or by the “non-state sector”. This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the “non-state sector” – broad concept, which incorporates collective farms as well as companies in which only a minority stake has been privatized.

In recent years, most of the East European countries have registered a growing trade deficit and a continued deterioration of their current accounts.

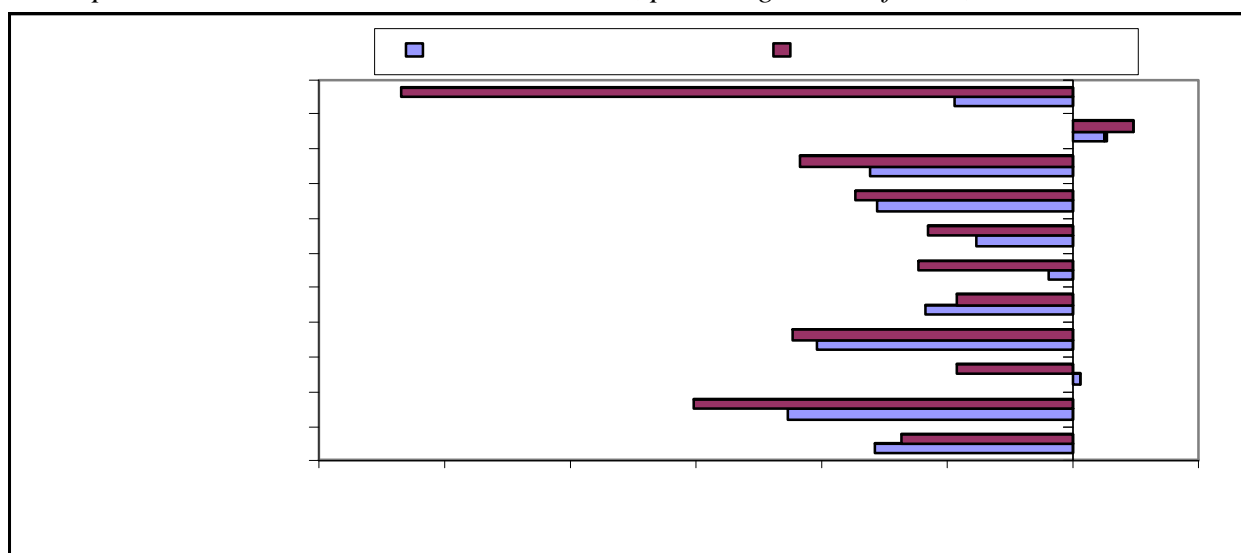
Table 6.1.4 Current account and trade balances in Eastern Europe

	Current account balance	Marchandise trade balance	Current account balance	Marchandise trade balance	Change in current account balance	Change in marchandise trade
	1996	1996	1996	1996	1995-96	1995-96
	(in million US dollars)		(in per cent of GDP)		(Change in GDP share in per cent)	
Albania	-123	-692	-4.7	-26.7	2.7	-7.1
Bulgaria	117	209	1.3	2.4	1.8	1.5
Czech Republic	-4,476	-5,972	-8.1	-10.9	-5.3	-3.4
Macedonia	-288	-317	-7.8	-8.6	-1.7	-2.4
Hungary	-1,700	-2,600	-3.8	-5.8	1.9	-0.4
Moldova*	-188 (-295)	-252 (-344)	-11.3 (-15.8)	-15.1 (-18.4)	-2.8 (-4.5)	-11.9 (-3.3)
Poland	-1,352	-8,154	-1.0	-6.1	-5.7	-4.6
Romania	-2,336	-2,130	-5.9	-4.6	-1.0	-0.1
Slovak Republic	-1,941	-2,106	-10.2	-11.1	-8.0	-9.8
Slovenia	47	-853	0.3	-4.6	-1.7	-3.1
Ukraine	-1,184	-4,296	-7.9	-6.8	1.5	-3.5

Source: Based on EBRD, *Transition report 1997*

* Data for 1996 are revised by MET. Data in brackets are for 1997.

Graph 6.1.1 Current account and trade balance, percentage share of GDP; 1996



Source: Based on EBRD, *Transition report 1997*

In general, foreign direct investment has continued to flow into the region at a rapid pace. It has to be mentioned that several large infrastructure privatization's in Hungary (power sector) and the Czech Republic (telecom) taking place in December 1995 distort the annual comparison. In 1996 Poland replaced Hungary as the leader recipient of FDI. Concerning Moldova, the flow of FDI are registering one of the lowest value in CIS countries and Eastern Europe.

Table 6.1.5 Foreign direct investment for selected countries; 1994-96

Countries	1994	1995	1996	FDI inflow per capita 1996	FDI inflows as % share of GDP 1996
	(in million of US dollars)			(US dollars)	
Albania	53	70	90	28	3
Bulgaria	105	82	100	12	1
Croatia	98	81	349	73	2
Czech Republic	1,024	2,720	1,264	123	2
Hungary	1,097	4,410	1,986	195	4
Moldova	18	64	24 (60)*	13 (17)*	2
Poland	542	1,134	2,741	71	2
Romania	347	404	210	9	1
Slovak Republic	178	134	177	33	1
Slovenia	131	170	180	90	1
Ukraine	100	300	500	10	1

Source: Based on EBRD, *Transition report 1997*

* Data for 1996 are revised by MET. Data in brackets are for 1997.

Foreign trade

Table 6.1.5 presents an overview of trade specialization in transition economies by major products categories. Notably, the largest differences are between resources-rich economies with a very high share of raw materials and fuel exports and the rest. A high share of machinery and transport equipment in total exports is registered in exports of more developed East European countries, such as: The Czech Republic, Hungary and Slovenia. The lowest shares of machinery and transport equipment are in export of CIS countries. The main items of Moldovan exports remain agricultural products, chemicals and intermediaries.

The structure of imports is relatively uniform across the countries. Most of the countries remain net importers of food and agricultural products. The basic items imported in the region are chemicals, machinery and transport equipment.

Table 6.1.6 Structure of export, percentage share in total exports; 1995

Countries	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Moldova	39.7	11.8	1.1	33.6	2.6	11.1

Source: Based on EBRD, *Transition report 1997*

Graph 6.1.2 Structure of export, 1995

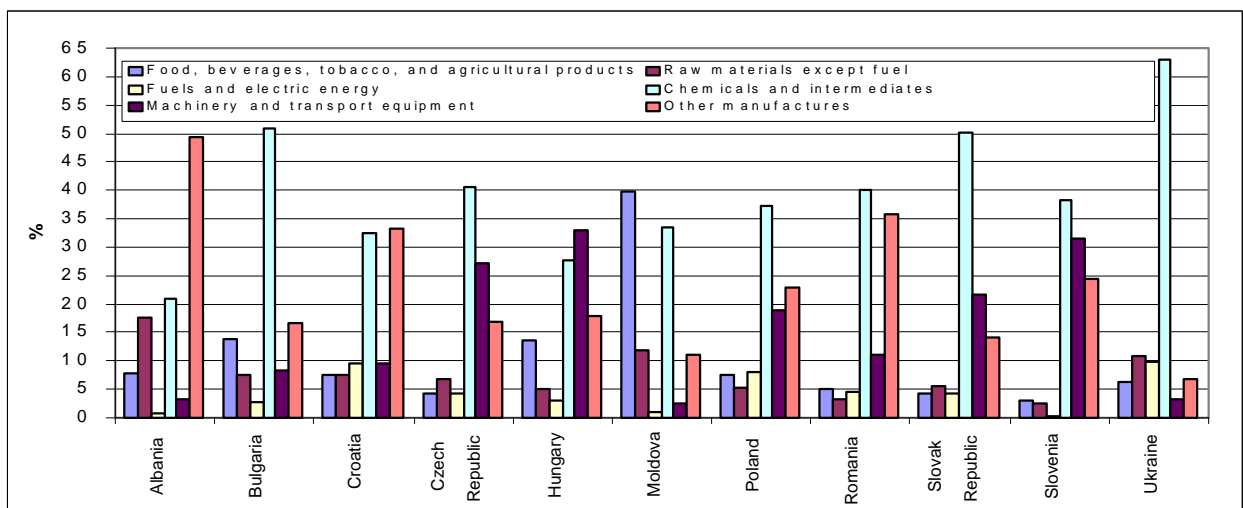
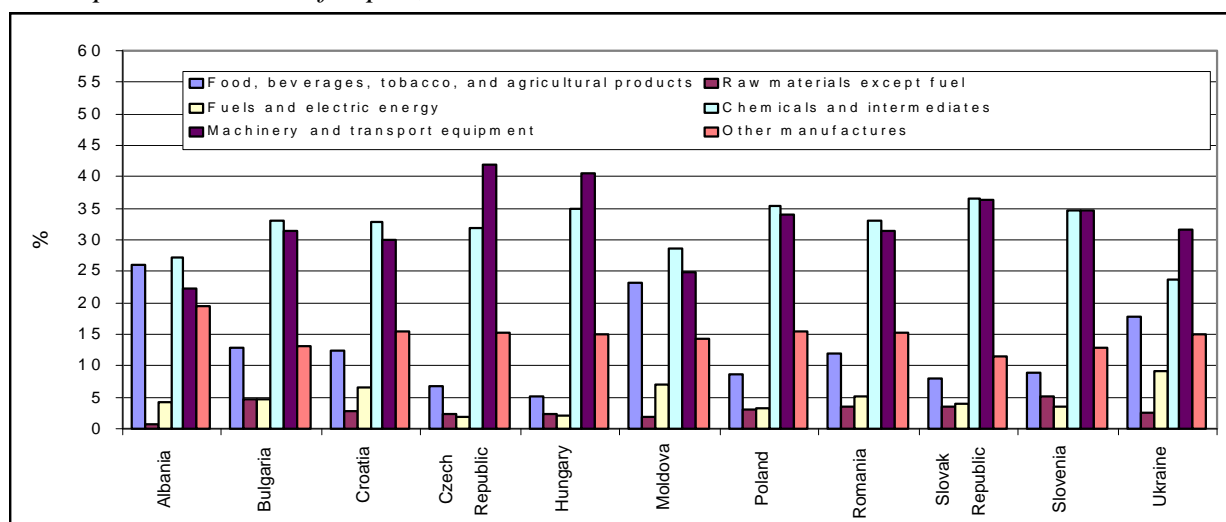
Source: Based on EBRD, *Transition report 1997*

Table 6.1.7 Structure of imports, percentage share in total imports; 1995

Countries	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Moldova	23.1	1.8	7.1	28.7	24.9	14.3

Source: Based on EBRD, *Transition report 1997*

Graph 6.3 Structure of import, 1995

Source: Based on EBRD, *Transition report 1997*

6.2 Neighboring countries: Romania and Ukraine

Romania: the social-economic evolution in 1997-1998⁵

Romania – one of the transition countries ranks the twenty-ninth place among the European countries according to the economic freedom index⁶.

Index of economic freedom, 1997

	Trade	Taxation	Govern.	Monetary	Foreign	Banking	Wages /	Property	Regula-	Black
	sistem		intervent.	policy	investm.		prices	rights	tions	market
Estonia	1	3.5	2	4	1	2	2	2	2	2
Czech Republic	2	4	2	2	2	1	2	2	2	3
Latvia	2	2.5	3	5	2	2	2	3	3	4
Hungary	4	4	3	4	2	2	2	2	3	3
Poland	2	3.5	3	5	2	3	3	2	3	3
Lithuania	1	3	3	5	2	3	3	3	3	4
Slovak Republic	3	4.5	3	2	3	3	3	3	3	3
Slovenia	4	4	3	5	2	2	3	2	3	3
Romania	2	5	3	5	2	3	2	4	4	3
Moldova	3	3.5	3	5	3	3	3	3	3	4
Armenia	2	3.5	3	5	4	3	3	3	4	4
Russia	4	3.5	3	5	3	2	3	3	4	4
Bulgaria	4	4.5	3	5	3	3	3	3	4	4
Georgia	3	2.5	2	5	3	4	4	4	4	5
Ukraine	4	4	3	5	3	4	3	4	4	4
Belarus	4	4.5	3	5	4	3	4	4	4	5
Azerbaijan	5	4	5	5	4	4	5	4	4	4

Romania's transition process to the market economy has its particularities and is occurring in a relatively slight economic decline. Thus, according to the information of the National Statistics Committee, in 1997 the GDP reached lei 249,750.2 billion (US\$ 33.5 billion, coming to 87.1 per cent of the 1990th level (for the comparison, in Republic of

⁵ Sources: Ministry of Industry and Commerce, Romania's social-economic evolution in 1997;

Chamber of Commerce and Industry of Romania; Social-economic objectives of the Radu Vasile Government's Program till 2000.

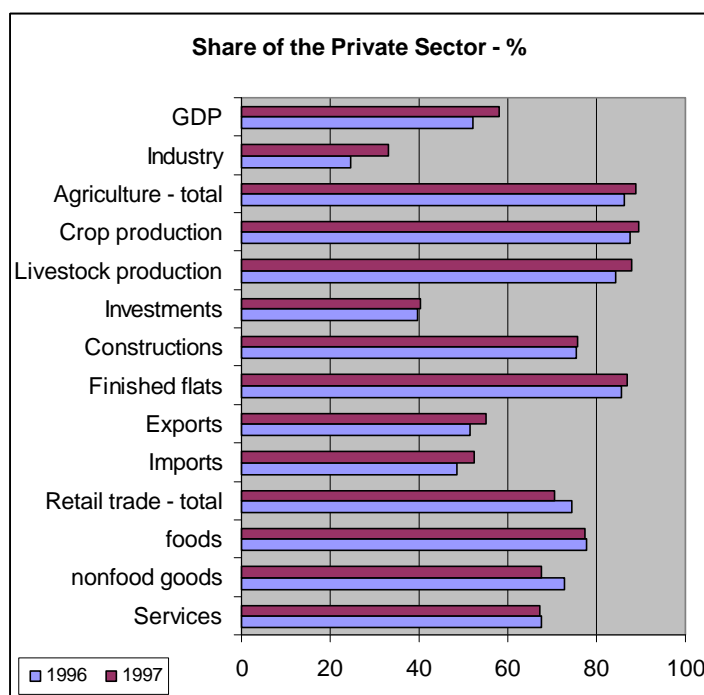
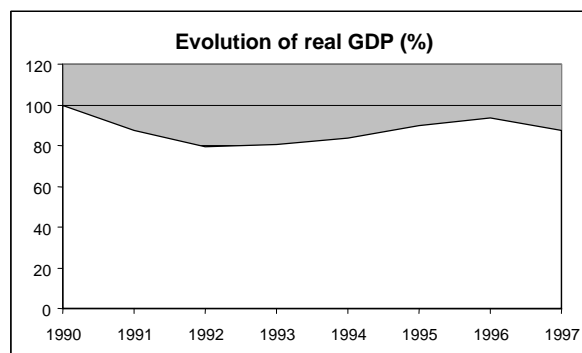
⁶ 1998 Index of Economic Freedom. Heritage Foundation Annual Report (USA)

Moldova this indicator amounts 36 per cent) and marking a 6.6 percent drop in comparison with 1996. *Industry and services*, contributing almost 70 per cent to the GDP, diminished in comparison with 1996, by 5 and 11.2 per cent respectively (by about 10 per cent -in the first quarter 1998 in comparison with the same period of 1997) . The situation of *agriculture* was characterized by two tendencies: a growth in plant cultivation by 10 per cent and livestock production diminishing by 7.1 per cent. Capital *construction* dropped in 1997 by 22 per cent in real terms.

This decline caused a reduction in the domestic demand by 8.5 per cent in comparison with last year and the a of the final consumption by 6.4 per cent. Activity of the *retail* enterprises during 1997 was developing under the direct influence of consumers' behavior and savings of the population, determined, on one hand, by the evolution of the buying capacity of incomes, and on the other hand, by the dynamics of interest rates for bank deposits. The total turnover of the sector diminished by 28 per cent in comparison with 1996. About 70 per cent of the total retail trade belongs to the private sector. As a consequence of these phenomena a

stocking process enlarged in the economy. By the end of the 1997 the *stocks of final products* amounted 58.5 per cent from the total output in December. Trade Services diminished in real terms by 19 per cent, the share of the private sector in services amounting to 67.1 per cent.

Foreign trade. In 1997, exports of goods amounted US\$ 8,428.9 million (4.3 per cent more than in 1996), which corresponds to a monthly average level of US\$ 702.4 million, over US\$ 673.7 million in 1996. The share of private sector in total exports amounted in 1997 to 54.8 per cent and grew up by 11.2 per cent over the 1996 (in the first quarter 1998 it diminished



	EXPORT -FOB (\$ mil.)		IMPORT - CIF (\$ mil.)	
	1996	1997	1996	1997
Agro-food products	706.9	594.8	869.9	694.4
Mineral products	692.1	637.9	2688.7	2408.4
Chemical	881.7	745.4	1433.9	1383.8
Textiles, confections, leather, shoes	2291.6	2551.3	1730.1	1998.2
Wood and papir industry	838.6	848.3	383.8	360.2
Construction materials, glass	150.3	151.4	144.5	142.9
Metal goods	1268.7	1556.4	715.3	669.9
Mashin building, electronics	1136.3	1209.6	3160.1	3234.1
Total	8084.5	8428.9	11435.3	11275.4

by 1.2 per cent). In the geographical structure of exports 56.8 per cent belong to the European Union. Imports constituted US\$ 11,275.4 million in 1997, or 1.4 per cent more than in 1996 (in the first quarter of 1998 it diminished by 8.3 per cent). The share of private sector in total imports comes to US\$ 5,520.7 million, or 48.3 per cent of the total import in 1996. In total imports, 52.1 per cent fall on the European Union. The Republic of Moldova is placed on the

twenty – first place according to the total volume of commercial exchange of Romania, the fifteenth place on exports side and the thirtieth place on the imports side. The total volume of exchange diminished in 1997 by 5.9 per cent, from which +27.8 per cent - exports and – 21.8 – imports.

Privatization of state property is underway. The degree of privatization (according to the criteria of the social capital) reached 100 per cent in 1997 in textiles, 90 per cent – food packaging, 89 per cent processing of plastic materials, 86 per cent – construction materials, 80 per cent – cement. The dynamic of privatization in industry and agriculture, traditionally considered to be problematic sectors for privatization, exceeded the dynamic of privatization in tourism and trade, branches normally more attractive for private investors. This change marks a movement of the private capital toward the productive sectors, which has a more durable profitability in time.

Investment in 1997 grew up to lei 38,364.9 billion, dropping in real terms by 19 per cent in comparison with 1996 (I quarter 1998 it diminished by 2.1 per cent). Private sector investments constituted lei 15,410.5 billion. More than a half of the total volume of investments was concentrated in a couple of activities: 11.9 per cent – transactions with the real estate, 11.2 per cent - agriculture, petrol and gas extraction – 9.6 per cent, food and beverage industries – 8.5 per cent, power, electric and thermal energy, gas and hot water production, transportation and distribution – 96.4 per cent, mail and telecommunications – 6.3 per cent. The fall of investments was caused, on one hand, by the deterioration of financial situation of the economic agents and, on the other hand, a restrictive monetary policy. Only 7.5 per cent of investments were financed through credits, own sources and those non-banking attracted (population's funds, extra-budget or allocated by the state property fund, foreign capital), continuing to be preponderant.

A situation more favorable than in the Republic of Moldova was created in the domain of the *state budget execution*, the revenues amounting to

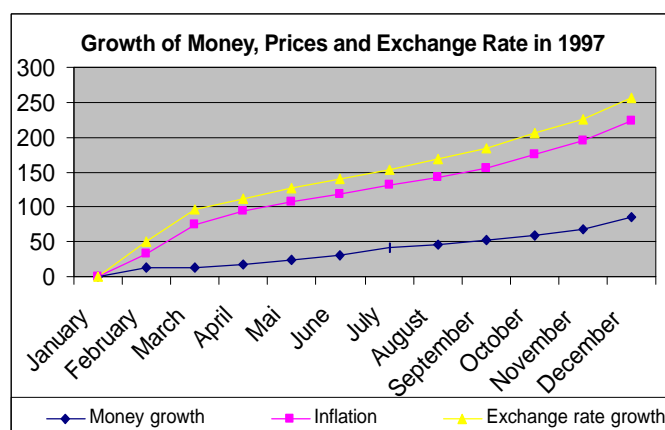
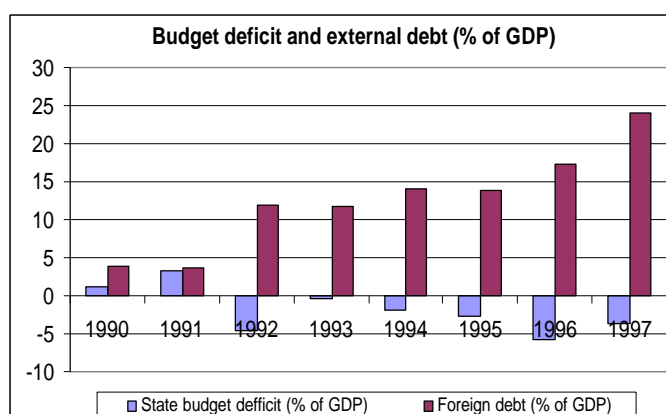
43,863.6, but expenditures - lei 52,933.7 billion, the deficit coming to 3.6 per cent of GDP.

External debt in 1997 reached 24 per cent of GDP (for comparison, in the Republic of Moldova – 64 per cent).

Monetary policy. The loosening of the control over the banking reserves, seasonal factors and measures made in the sphere of incomes, according to the official opinion, were the most important determinants of the monetary indicators' growth in the second half of 1997.

During the whole year broad money (M2) grew by more than 60 per cent, cash – by 75 per cent. This had its impact on the nominal *exchange rate* (from 4 thousand lei per US\$1 at the beginning of the year

till 8 - at the end and 8.2 at the end of first quarter 1998) and inflation (*inflation rate* in 1997 reached 151.4 per cent, and a monthly average – 8 per cent, compare to over 3.8 per cent in 1996). *Food consumer prices* grew up 1.46 times, prices for nonfood goods – 1.42 times, and services – 2 times. The average interest rate used by the National Bank of Romania at the end of the year stood at 52.6 per cent for credits and 15 per cent for deposits.



The number of the employed diminished in 1997 by 507 Thos. persons, the unemployment rate rising from 6.6 per cent in 1996 to 8.8 per cent in 1997 (9.3 per cent in I quarter 1998). In December 1997, the average nominal wage reached lei 1,265,671 (US\$ 170), marking a growth in nominal terms by 116.9 per cent in compared to 1996 which constituted 39.2 per cent in the total household's revenues. The buying capacity diminished to 86.3 per cent of the level of December 1996 and 64.4 per cent of 1990.

The forecast for 1998 is the drop in inflation rate to 37 per cent. Revenues of the public budget will amount 29.5 per cent of GDP, expenditures – 33.5 per cent of GDP, and the state budget deficit - 3.6 per cent of GDP. This level of expenditure from the public national budget is expected due to the realization of radical changes in the allocation of budget resources, among which are increased capital expenditures, the utilization of sources obtained from privatization for development programs, including the concrete projects, such as export promotion, the development of small and medium business, regional development.

Among the *social-economic objectives of the Government* are

- defining the state's role in the allocation of resources in case of the market failure, creation of an integrated system of markets;
- acceleration of the structural adjustment of the economy;
- reaching and consolidation of a macroeconomic stability, creation of conditions for the durable economic development;
- compensation of delays in the domain of social-economic changes necessary for the entrance in the European Union;
- regional and local development, growth of social unity;
- amelioration of adverse social consequences of economic reforms;
- re-launching of the social, interethnic, and interprofessional dialog at local and central levels, as well as supporting of the civil structure of the society, and participation of citizens and communities in the management and control of public affairs;
- improving of the image of Romania, growth in the attractiveness of the economy for foreign capital and re-launching of the efficient dialog with financial institutions, through the growth of public administration capacity in elaborating and implementing policies in all domains.

Ukraine at crossroads⁷

Five years behind the Central Europe

Ukraine is in a difficult economic situation. The expected economic growth in 1997 did not occur. Starting from 1991 the economy experienced a dramatic decline, the tempo of economic growth in 1997 having been by 55% less than in 1991.

The country is *at crossroads*: either it chooses a way to a proper sound development and becomes competitive, or, continues to operate within an ambiguous legal framework and receive assistance from abroad, which is not going to last very long.

Ukraine, according to western analysts, lacks *5 years behind* the Central European countries and 2 years behind Russia, as regards economic reform.

Should the structural and legal reforms be applied, the Ukraine could register a 1.5% economic growth in 1998 and even 2% in 1999. A good management and capital are required.

Vacillating privatization

⁷ M. Bratu. Ucraina la răscruce de drumuri. Tribuna Economică, 1998, nr. 26

Until 1997, *the privatization was vacillating*. The process of mass privatization launched in 1992 and relaunched in 1995 was based on coupons (vouchers). Half of state enterprises, including the small and middle ones, have been privatized.

However, these enterprises are *lacking capital and adequate management*. The big companies are still in state ownership, and need the same recipe of capital injection and management.

The Ukraine *has no legal framework that could attract foreign investors*. They are countered by the decisions of the authorities from Kiev. This happened with the American telecommunications concern Motorola that was hampered to extend in the Ukraine.

The result of the vacillating privatization in the Ukraine shows that this country attained *less than 1/3 of the planned incomes from the privatization process*, that were supposed to come into the state budget. Of the planned incomes in amount of US\$ 500 million, about US\$ 150 million were obtained.

The direct sales of enterprises this year will amount to about US\$ 1 billion, *i.e.* circa half of the total direct foreign investments in the Ukraine.

Foreign investors hesitate

The biggest foreign investor in the Ukraine is the South Korean Daewoo, which signed a joint-venture contract worth US\$ 1.3 billion, with Avtozaz - the largest car manufacture in the Ukraine. Also, the English-Dutch giant Shell invested more than US\$ 1 billion in the pipeline supply through the Ukrainian territory of oil and natural gas from Russia.

Ukraine might become attractive for foreign investors. With a market of over 50 million inhabitants and possibilities to invest in energy sector, chemistry, air transport and telecommunications, Ukraine might attain almost US\$ 10 billion from direct foreign investments, according to western analysts.

The major drawbacks that the Ukrainian economy faces are its lacking behind in the reforming process, ambiguous legal framework and tough taxation system.

The taxes and duties should be diminished, and government expenditures should be drastically curtailed. Some steps in this regard have been made through the law on profit tax and VAT introduction. Yet, this is the beginning and only the beginning.

The banking financial sector is fragile. The capital market is necessary and needs to be supported. For this purpose, and for economic growth as a whole, much money is needed. This money can originate from foreign investment of capital. This is the chance of Ukraine.

Ukraine needs to become out of a large potential market and of a potential remarkable economy an existing one.

The undercapitalized economic potential

Reality shows that the market potential of Ukraine is so large, that in commercial terms it is possible to do a good job in this part of Europe. The export towards Western Europe account for almost 16% of the overall Ukrainian exports.

The car manufacturer Avtozaz plans to export about 250.000 pieces per annum, particularly in Russia.

The Ukraine upkeeps close economic ties with Russia, venturing to lose some western markets.

Anyway, it can afford neither to lose the *western markets*, being in urgent need of capital nor lose economic links with Russia, being dependent of the natural resources from this country.

The Ukraine needs to gain trust of the western investors and creditors, both of those from London Club and Paris Club.