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GEARING PUBLIC FINANCE TO GROWTH, EMPLOYMENT AND POVERTY REDUCTION IN MOLDOVA

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Terry McKinley
Senior Researcher and Acting Director,
International Poverty Centre,
United Nations Development Programme

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United Nations Development Programme
International Poverty Centre

International Poverty Centre
SBS – Ed. BNDES,10º andar
70076 900 Brasilia DF
Brazil

povertycentre@undp-povertycentre.org
www.undp.org/povertycentre
Telephone +55 61 2105 5000
Fax +55 61 2105 5001

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COUNTRY STUDY PUBLISHED BY THE INTERNATIONAL POVERTY CENTRE

GEARING PUBLIC FINANCE TO GROWTH, EMPLOYMENT AND POVERTY REDUCTION IN MOLDOVA

Terry McKinley*

This Country Study was part of a comprehensive UNDP-supported national report on Economic Policies for Growth, Employment and Poverty Reduction in Moldova. This study focuses on analysing Moldova's public finances, including mobilizing more domestic revenue, reducing its external and domestic debt and re-allocating its public expenditures. It counsels against lowering rates on direct taxes, which it predicts will be not only inequitable but also ineffectual; instead, it offers alternative recommendations on how to raise more revenue and make the tax system more progressive. While commending the government of Moldova for being able to unilaterally reduce its external debt burden, it sharply criticizes international donors for not having provided the country with concessional lending during the difficult transition years of the 1990s. Had the country's income per person been correctly calculated, it would have qualified for such lending and not been saddled with such an onerous debt burden. Lastly, the study recommends that the government devote more resources to economic services, and public investment in general, in order to stimulate a more rapid rate of growth and employment generation and focus more economic resources on poor households.

* Senior Researcher and Acting Director, International Poverty Centre, United Nations Development Programme.

1 INTRODUCTION

This Country Study examines the role of public finance in supporting a development strategy for Moldova that would accelerate economic growth, generate employment and direct resources toward poverty reduction. Although the government of Moldova has already succeeded admirably in reducing its external debt burden, its fiscal space will remain limited until it is able to refinance its remaining multilateral and bilateral Paris Club debt. In order to do so, it needs greater cooperation from its multilateral and bilateral creditors. Because of its own efforts to reduce its external debt, the government is in a stronger position when it begins negotiations with these creditors.

Independently of its debt problem, the government has both the flexibility and the ability to expand its range of options. In part, its success hinges on its ability to mobilize domestic resources. It has already done a great deal to reform its tax system, and more can be done to improve revenue generation. Some of the major recommendations of this study focus on ways to increase revenue and make the structure of taxation more progressive.

This Country Study also makes recommendations on the re-allocation of public expenditures. It argues that the government should assign a larger share of public expenditures to economic services, and to public investment in economic infrastructure in particular. Since much of the country's infrastructure has deteriorated, such investment is badly needed. Moreover, it could impart a significant stimulus to economic growth, because appropriately designed public investment can 'crowd-in' private investment. Public investment can also be used to focus more resources on economic services that disproportionately benefit poor households. This would be the case, for example, for public investment in irrigation and rural roads.

2 THE MOBILIZATION OF DOMESTIC REVENUE

Mobilizing tax revenue is crucial for implementing an investment-led Growth and Poverty Reduction Strategy in Moldova. However, revenues of the consolidated budget were 24.2 per cent of GDP in 2003, down by about 25 per cent from their highpoint of a third of GDP in 1997. Moreover, they are projected to decline further, to 22.5 per cent of GDP in 2007. Expenditures in the consolidated budget have been reduced even more drastically than revenues, from 40.5 per cent of GDP in 1997 to 22.7 per cent in 2003, a forty per cent decrease. During 2000-2002, the budget deficit ranged between zero and minus one per cent of GDP. In 2003, the budget ran a surplus of 1.6 per cent of GDP. Thus, the Government has been implementing a relatively tight, if not contractionary, fiscal policy in recent years.

At the same time that revenues are expected to decrease, contributions to social and medical insurance are programmed to increase. Contributions to state social insurance rose from 6.4 per cent of GDP in 1999 to 7.3 per cent in 2003, and are projected to increase steadily, reaching 8.3 per cent in 2007. Contributions to medical insurance were introduced in 2004, and are projected to be 1.1 per cent of GDP by 2007.[1] The rise in total contributions to the two insurance funds projected for 2007 contrasts with the decline in other forms of tax revenues. Revenues for social protection are increasing but not revenues to finance other essential public functions, such as providing public services and infrastructure.

Increases in expenditures for social protection can be pro-poor and are badly needed. However, as long as the combination of debt servicing and declines in tax revenue continues, public investment and the provision of essential public services will be constrained, as will the growth of income and human development. Further, sustained growth of the economy is critical for the financing of increased social protection. Although increases in current expenditure, such as on social and medical insurance, can stimulate aggregate demand, they do not expand the productive capacity of the economy.

In 2004, non-tax revenues represented about 18 per cent of all revenue. However, they are projected to decline, from 6.4 per cent of GDP in 2004 to 5.7 per cent in 2007. The Ministry of Finance regards the decline as a desirable objective to streamline and rationalize the revenue system. These revenues arise from an amalgam of various charges, such as road fees, charges for using state-owned trademarks, fees for extracting natural resources, and payments for licenses. They also include net income from the National Bank, which is variable from year to year. However, if non-tax revenue is declining, then tax revenue should be boosted to compensate for the decline.

Like other countries, Moldova has been advised to increase its reliance on indirect taxes, mainly the Value Added Tax. Indirect taxes now account for about 42 per cent of all state revenue. However, according to the Medium Term Expenditure Framework (MTEF), indirect taxes are projected to decline, as a ratio to GDP, from 15.2 per cent in 2003 to 13.8 per cent in 2007. The revenue generated from the Value Added Tax, which accounts for about two thirds of all indirect taxes, should be on the rise if it is an efficient form of taxation, but its revenue is projected to increase only marginally. These trends place an additional burden on direct taxes to raise revenue.

Value added taxes are often recommended as a substitute for trade taxes. But a recent study of VAT taxation and trade liberalization (Baunsgaard and Keen 2004) finds that value added taxes have been successful in compensating for the loss of trade taxes, as a result of trade liberalization, only in high income countries. Middle-income countries have been able to compensate for only about 45-60 percent of the revenue lost from trade liberalization. The most troubling finding, however, is that the VAT in low income countries has recovered, at most, only about 30 per cent of the revenue lost from trade liberalization.

The incidence of the VAT has shifted increasingly towards imported goods and away from domestically produced goods. In 2003, VAT revenue on imports was 8.7 per cent of GDP, while the revenue from domestically produced goods was 4.3 per cent. This was a reversal of the situation in 1997, when the ratio for imported goods was 1.8 per cent and that for domestic goods 8.8 per cent. This is partly explained by a change in 1999 to a destination method of VAT taxation, which was applied to imports from CIS countries as well as others. However, there is a VAT refund provided on imported goods. In 2003, for example, total VAT refunds amounted to 2.8 per cent of GDP.

Compared to trade taxes, sales taxes on domestic goods and services are limited in their revenue-raising potential in an economy with a large informal sector. Another possible explanation for their inability to generate revenue is that the minimum threshold for obligatory registration of VAT taxpayers has been raised, purportedly to make it more efficient.

A 2003 study of taxation in thirteen transition countries in Eastern Europe, the Caucasus and Central Asia found that in 2000 Moldova had a 10 percent effective VAT rate (i.e., actual

VAT collections as a ratio to the VAT base) (Stepanyan 2003, p. 15). This rate compared favourably to those in other countries, especially Russia, Azerbaijan and Georgia, but, nonetheless, it had declined from a high of seventeen percent in 1998. A similar trend characterized the VAT efficiency rate (the effective VAT rate as a ratio to the statutory rate): it had declined from 84 percent in 1998 to 52 percent in 2000.

Because VAT is levied on imports, foreign trade taxes have remained low, accounting, for example, for only 1.7 per cent of GDP in 2003. Part of the reason that VAT and trade taxes together are low is the establishment of free trade arrangements with countries in Southeast Europe and the CIS. Another part of the reason is that the Government has refrained from raising some import tariffs, even though it is allowed to do so under the WTO accession agreement. Average import tariffs are reported to be 6.5 per cent. There are no tariffs or VAT taxes on exports. For the purposes of generating badly needed revenue, rather than for trade protection, some import tariffs could be raised moderately without violating WTO rules.

The government has attempted to give the VAT a progressive structure by setting three rates below the standard twenty per cent. These are: eight per cent for bread and dairy products, five per cent for agricultural and unprocessed products, and zero per cent for heat, electricity and drugs. The revenue attributable to the five and eight per cent rates represents no more than one fifth of the total. It is difficult to administer differential rates for the VAT, especially in an economy with a large unrecorded informal sector.

Some tax specialists justify the lowering of tax rates as a means to encourage informal-sector activities to become part of the registered formal economy. But such provisions, by themselves, are unlikely to provide a sufficient motivation for such a change. Economic growth or the reduction of unnecessary government regulation is likely to be as, if not more, important. The lack of effective administration probably implies that the VAT is not as progressive as its nominal structure would suggest. While, in theory, consumption taxes can be made more progressive, the difficulty of collection makes it is easier in practice to render a tax system more progressive by placing more weight on direct taxes on income and wealth.

Excise taxes represent a significant share of total tax revenue, between fifteen and eighteen per cent of the total after 2000. But much of the revenue that they generate (over forty per cent) comes from taxes on gasoline and diesel fuel. Another thirty per cent comes from taxes on imported vehicles, and twelve per cent from wine and liquor. As a ratio to GDP, excise taxes conform to the previous patterns of decline, falling from 4.5 per cent in 1997 to 3.3 in 2003, largely because of a drop in revenue from wine and liquor. Excise taxes are projected to decline even further in coming years, to 2.2 per cent of GDP in 2007. Boosting revenue by levying excise taxes on luxury or non-essential consumption items should be a priority of tax policy. The direct impact on the poor is not likely to be substantial if the items that are taxed, such as imported vehicles or diesel fuel, are not directly used or consumed by the poor.

The government's strategy for boosting direct taxes is to radically reduce tax rates, on the assumption that such a reduction will help broaden the tax base. Such a Neo-liberal 'supply-side' approach to taxation will not only diminish the progressive structure of the tax system, but also run the risk of lowering total revenue. This is generally recognised outside the government; for example, the IMF has warned against reducing the rates for direct taxes unless other forms of revenue can be generated to offset the potential losses (IMF 2002, p. 13).

Various reasons are given for lowering the rates of direct taxes: increasing disposable income, encouraging informal-sector activities to become registered, and creating a tax haven for foreign investment. Lower tax rates can, in theory, have positive incentive effects, but are not likely to compensate fully for a substantial loss of revenue, especially from a radical and swift reduction of rates. Such supply-side experiments have proven themselves to be ineffective in other countries (a notable example being the United States in the 1980s and in the early 2000s). Ballooning government deficits are often the immediate and painful result. These necessitate inevitable cuts in social protection and essential public services.

The study of taxation in transition economies cited above (Stepanyan 2003) finds that lowering the top marginal tax rates on personal income and corporate profits has no discernible impact on increasing tax revenue. There is no reason to believe that savings will respond to the lowering of tax rates on personal income because individuals in countries with low incomes or depressed incomes save mostly for precautionary reasons. The study cannot find any evidence that business investment has increased because of lowered rates on corporate profits although one might expect at least some modest increase (other factors remaining constant). Lastly, in countries where unemployment and underemployment are already high, lowered tax rates on personal income do not induce individuals to supply more labour.

This study tends to put more emphasis on simplifying tax systems, reducing unnecessary exemptions or strengthening administration and compliance as a basis to raise more revenue. Since tax rates on personal income and corporate profits have already been substantially reduced in many of the transition economies, further reductions are more likely to have negative effects on revenue collection.

The government has already lowered the tax rate on corporate profits. This rate was a moderate twenty-eight per cent in 2001, falling to twenty per cent in 2004. In 2006, within just two years, it is programmed to drop to only fifteen per cent. This strategy is designed, in part, to induce enterprises to enter the formal economy and declare their full profit incomes. It is also designed to make Moldova an attractive tax haven for foreign investors, as allegedly happened in Ireland.

At the same time that the government sharply lowers the tax rate, it projects in the MTEF that corporate tax revenue will increase from 10.8 per cent of all revenue in 2004 to 12.2 per cent in 2007. However, if firms have successfully avoided a twenty-eight per cent tax rate, there is no guarantee that they will abandon such avoidance at a lower rate of fifteen per cent. Nor is it certain that foreign investors will move into Moldova principally because of low corporate tax rates. More crucial than the tax rate is the profit opportunities that the economy is generating, which in part depend on the ability of the government to use public expenditures, especially public investment, to stimulate the economy. As the economy grows and corporate profits increase, moderate rates on profit income, such as twenty-five per cent, should represent no significant disincentive to foreign investment.

Part of the problem with collecting corporate income tax is the extent of tax exemptions. According to 2003 tax returns, tax exemptions amounted to 315 million lei, and foreign investors received about 50 million of this total. About 145 million lei in exemptions were extended to domestic corporations to encourage investment in fixed assets and construction. International experience indicates that such tax incentives usually have a weak effect on private investment, and serve mainly to erode the tax base.

The reforms projected for the personal income tax are much the same as for the corporate income tax. In 2003, personal income up to 12,180 lei was taxed at a ten per cent rate, 12,180-16,200 lei at fifteen per cent, and higher income at twenty five per cent. The top rate reflects a reduction from the previous high of thirty-two per cent. The intention is that by 2007 the tax rate for low incomes will fall to seven per cent, for medium incomes to ten per cent, and for high incomes to fifteen per cent (see Table 1).

TABLE 1

Personal Income Tax Rates and Targeted Changes

Income level 2003	Tax rate 2003	Income level 2007	Tax rate 2007	Percentage Point Drop
Low income	10	Low income	7	3
Middle income	15	Middle income	10	5
High income	25	High income	15	10

Source: Republic of Moldova, MTEF 2004.

This change to very low marginal rates makes the system for direct taxes decidedly less progressive. While low-income persons will receive a three percentage points drop in their income tax rate, medium-income persons will benefit by a five percentage points drop, and high-income persons by ten, making the structure considerably less progressive in a country with high inequality. In 2003, the ratio of the middle-income tax rate to the low-income rate was 1.5, and that of the high-income rate to the low-income rate 2.5. In 2007, the first ratio will drop to 1.43 and the second to 2.14. These changes will weaken the vertical equity of the Moldovan tax system. Those taxpayers with a greater ability to pay will enjoy relatively lower taxes. In relative terms, lower-income taxpayers will be worse off.

If the government reduces its highest marginal tax rate for personal income, this rate will be well below the comparable rates for most other transition economies in Central and Eastern Europe and the CIS (Table 2). For example, in 2003 the highest marginal tax rate in Bulgaria was twenty-nine per cent, in Romania forty per cent, and in Slovenia fifty per cent. Only in Bulgaria would the highest rate be within twenty percentage points of Moldova's. In Western Europe the marginal tax rates tended to be higher than those for Central and Eastern Europe and the CIS: forty-five per cent for Italy, forty-nine per cent for Germany, and fifty-nine for Denmark (Table 2). Compared to other countries in the region, Moldova has programmed a Neo-liberal 'supply-side' experiment with its tax system that is most likely to be counter-productive.

Table 2 also indicates that the highest corporate tax rate in Moldova in 2003 was already the lowest of the thirteen countries listed. There are other countries that have chosen the path of low corporate tax rates to attract foreign investment. Ireland has a tax rate of sixteen per cent on corporate income and Lithuania and Macedonia FYR fifteen per cent. However, the government should carefully study these experiments in order to determine whether Moldova enjoys some of the same advantages as Ireland, and how successful some of the countries, such as Macedonia FYR, have been. If Moldova joins the European Union, it will need a tax system that generates the revenue to finance public expenditures that are comparable to the EU norm. Moldova's entry into the EU would be severely undermined if it were viewed by existing members as a tax haven to which companies would be enticed to relocate.

TABLE 2

Highest Personal and Corporate Marginal Tax Rates by Country, 2003 (percentages)

Country	Personal	Corporate
Moldova 2004	25	20
Moldova Projected 2007	15	15
Bulgaria	29	24
Poland	40	27
Romania	40	25
Slovak Republic	38	25
Slovenia	50	25
Ukraine	40	30
Belgium	50	39
Denmark	59	30
Germany	49	27
Greece	40	35
Italy	45	34
Netherlands	52	35

Source: World Development Indicators 2004, Table 5.6.

Reducing the corporate income tax rate further, to fifteen per cent, would place it well below those prevailing in most other European and CIS countries. Moldova could probably return its highest marginal corporate tax rate to twenty-five per cent, maintain its highest marginal personal income tax rate also at twenty-five per cent, and still have a tax system relatively less progressive than those in most other countries in the region.

The challenge facing the Government is that direct taxes (excluding social and medical insurance contributions) have fallen as a percentage of total revenue since 1997. While corporate income taxes accounted for 8.3 per cent of total revenue in 1997, they fell to 7.7 per cent in 2003. Similarly, personal income taxes fell from 9.6 per cent to 8.3 per cent between 1997 and 2003. Given these declines, it is ill advised to lower tax rates on personal and corporate incomes. This study recommends that the 2003 structure for personal income taxation (namely, rates of 10, 15 and 25 per cent) be maintained, and that corporate profit taxes be returned to twenty-five per cent. This would contribute to a sustainable fiscal structure consistent with growth and poverty reduction.

Wealth taxes, such as real estate and land taxes, have also declined in Moldova. Together, real estate and land taxes fell from 1.3 per cent of GDP in 1999 to 0.7 in 2003. As the economy grows and asset values increase, revenues from wealth taxes should increase in importance. This depends on better registration and more market-based valuation of property, which the government is attempting to implement. It also depends on raising property tax rates. Such an effort could make the entire tax system more progressive, since property taxes disproportionately affect richer households.

Options worthy of serious consideration are concerted efforts to register and tax urban real estate and raise land taxes on large farming enterprises. The government has considered raising land taxes as a substitute for other forms of taxes, such as on farm incomes or agricultural products. This policy should be evaluated, in its own right, as an efficient means of raising revenue and shifting more of the incidence onto richer households. Land taxes are typically a more efficient method for raising revenue than taxes on farm incomes, which are more difficult to measure.

In summary, the government should concentrate on raising more tax revenue and doing so with a more progressive structure, instead of risking loss of revenue as a result of making the tax structure less vertically equitable. To this end, the government could initiate a concerted effort to strengthen the efficiency of the VAT, which it has chosen as the mainstay of its tax system, and ensure that its impact is indeed progressive. In order to guarantee the buoyancy of the tax system as average per capita incomes continue to rise, the government should maintain its current rate structure for personal income. Also, the rate on corporate profit income should return to twenty-five per cent to make it consistent with the top rate for personal income.

In the name of making the tax system more efficient, many orthodox tax reformers have sacrificed progressivity and weakened prospects for raising revenue. The justification is that the tax base will be broadened if tax rates are lowered, especially for high-income earners. The base for taxation is more likely to be broadened, however, by sustained and broad-based economic growth and improved tax administration than by the lowering of corporate and personal income rates.

3 EXTERNAL AND INTERNAL DEBT BURDEN

The government of Moldova continues to bear a substantial external debt burden that constrains its ability to allocate public revenue to stimulate growth and reduce poverty. The external debt is a tragic legacy of its early transition period, when its average income dropped precipitously to the level of a low-income country while international financial institutions did not offer it concessional terms for lending.

In 1992, the external public debt was only US$16.5 million; but by 1997 it had ballooned to over US$ 709 million (Table 3). It reached a peak of US$ 781 million in 2000. Since 2000, the government has worked to reduce this burden. It attempted to buy back, at large discounts, debt owed to Russia's Gazprom, the Hewlett Packard corporation, and Eurobond holders. At the same time, it sought to reschedule commercial credits held by banks and the remaining Eurobonds, and reschedule the debts owed to bilateral creditors that were not part of the Paris Club. As a result, external debt fell to about US$ 672 million in 2004, which was 25.7 per cent of Moldova's GDP. The government paid a high price in terms of allocating funds to debt reduction that could have been used to stimulate economic growth and foster poverty reduction. This trade-off was probably unavoidable in view of the constraints, and the government can be congratulated on its success in reducing the debt to more manageable proportions.

TABLE 3

External Public Debt, 1992-2004 (Million US$)

Year	Total debt	Year	Total debt
1992	16.5	1999	663.3
1993	188.5	2000	781.3
1994	345.1	2001	699.8
1995	401.3	2002	724.3
1996	540.2	2003	751.4
1997	709.1	2004	671.7
1998	719.6		

Source: Government of Moldova, Ministry of Finance.

In the wake of government's efforts, multilateral institutions now hold sixty-three per cent of Moldova's external debt, and bilateral lenders thirty-three per cent. The remaining five per cent is commercial debt. Moldova will continue to bear a substantial debt burden as long as the International Monetary Fund does not reach agreement with the government on a Poverty Reduction and Growth Facility. Without such an agreement, the government cannot begin negotiations with the Bretton Woods Institutions on its multilateral debt nor start negotiations on its Paris Club bilateral debt.

The government has secured temporary breathing room by accumulating debt arrears and rescheduling its Eurobond debt. For full and timely payment in 2002, it would have been necessary to allocate sixty-two per cent of total public revenue to debt servicing; but the actual allocation was limited to twenty-eight per cent. It should be clear that a burden of over sixty per cent was unacceptably large, given the other claims on public revenue. In 2003, full debt servicing would have taken half of public revenue, in contrast to the twenty-three per cent that was actually allocated. As a result, total arrears to external creditors rose from US$ 3.4 million in 2000 to US$ 69.9 million in 2003. Since its multilateral and large bilateral creditors refused to renegotiate their loans, the government had no alternative to accumulating arrears, unless it had instituted draconian cuts in social expenditure. In 2004, the government managed to clear most of these arrears through rescheduling or buyback arrangements with non-Paris Club members, multilateral creditors and Eurobond holders.

Once negotiations on the multilateral debt begin, the government has a strong case to argue that such debt, mistakenly set on IBRD terms, should be refinanced to reflect more favourable IDA terms. One 2001 estimate calculated the savings on interest payments alone at US$ 157 million (Olortegui 2001). The government can also seek rescheduling of its bilateral Paris Club debt, and use the new terms for this debt as a basis to renegotiate its remaining commercial debt.

In present value terms, Moldova's external debt represented 126 per cent of its exports in 2002 (Table 4). This places it in the ranks of other low-income transition economies (Armenia, Georgia, Kyrgyz Republic, Mongolia, Tajikistan and Uzbekistan) that have a substantial external debt burden. While such a debt burden severely hampers a country's ability to accelerate economic growth, almost none of these countries qualify as 'severely indebted' under the HIPC definition. Only Kyrgyz Republic, with a debt-to-export ratio of 221 per cent, would qualify. The debt problems of this group of low-income countries have received scant attention. Despite promises, the international development agencies have not launched initiatives to significantly relieve the debt burdens of these transition countries although such an initiative should be a priority.

Faced with the intransigent policies of multilateral and bilateral creditors, the Moldovan government was forced to find its own solutions. It managed to pay off its trade credits, renegotiate its Eurobond debt, and conclude agreements on bilateral debts with Romania and Turkey. It is not without irony that such countries have been more generous in debt relief than much richer countries. The government also bought back its RAO Gazprom debt owed to the Russian Federation, retiring US$ 15 million of an outstanding debt of US$ 111 million, and bought back its debt to Hewlett Packard, worth US$ 10-20 million. The buyback terms have been at slightly over forty per cent of nominal value.

TABLE 4

Debt-to-Export Ratios of Selected Low-Income Transition Economies

Country	Debt/Exports	Debt classification
Armenia	111	L
Georgia	144	M
Kyrgyz Rep	221	S
Moldova	**126**	**M**
Mongolia	107	M
Tajikistan	124	S
Uzbekistan	136	M

Source: World Development Indicators 2004, Table 4.17. 'L' (less indebted); 'M' (moderately indebted); 'S' (Severely Indebted).

Despite the absence of support from international financial agencies, the government has succeeded in making its total debt burden, both external and domestic, more manageable. In 2004, its *total* public debt represented about thirty-seven per cent of GDP, down from fifty-seven per cent in 2002 (Table 5). The decline in external debt, from 44.4 per cent in 2002 to 25.7 per cent in 2004, accounted for almost all of the fall in total debt.

TABLE 5

Total State Debt, External and Domestic (% of GDP)

Type of debt	2002	2003	2004	2007 (Projected)
Domestic debt	12.5	10.7	11.5	8.3
External debt	44.4	36.4	25.7	25.9
Total debt	56.9	47.1	37.2	34.2

Source: Republic of Moldova, MTEF 2004 and Ministry of Finance.

Once discussions with its Paris Club bilateral creditors and its multilateral creditors begin, the government should be in a stronger position than previously to negotiate debt relief or refinancing. Russia, a Paris Club member, is Moldova's largest creditor, followed by the United States. Germany, Italy and Japan hold relatively small outstanding loans. Some relief on multilateral debt is appropriate since Moldova was forced to accept commercial terms on its borrowing when it should have received concessional terms. Moldova became eligible for concessional terms only in 1997, well after its deep economic crisis.

In order to finance its budget gap in the 1990s, which was generated primarily by external debt servicing, the government had little alternative but to increase domestic debt. This causality, namely, the external debt burden forcing more domestic debt at high interest rates, emphasises the problematical nature of the original IBRD-terms loans that did not create assets that would generate an income stream to repay them. The government has subsequently reduced the domestic debt, from 12.5 per cent of GDP in 2002 to 11.5 in 2004, and projects a further reduction to 8.3 per cent in 2007. This would be accomplished by reducing security issues, lengthening the maturities, and repaying outstanding credits to the National Bank of Moldova. Domestic debt became a serious problem during the Russian financial crisis when the government was forced to borrow from the central bank in order to finance the expenditures that were not covered by revenue. In 1998, the domestic debt had hit a peak of 17.2 per cent of GDP.

Receipts from privatisation have not been and will not be adequate to reduce the domestic debt. There are few state-owned assets to be privatized; and, in any case, it is not clear whether privatisation would be the best option. More successful has been the lengthening of the maturity of many of the government's domestic securities from 1-2 years to 3-4 years. In late 2004, there was an unexpected surge in demand for government T-bills, perhaps due to remittances, even though their interest yield was below the inflation rate. As long as the maturities of securities lengthen and the demand for them maintains itself, servicing the domestic debt should be manageable. The problem is that such financing is being used, in effect, to reduce the external debt instead of financing domestic public investment.

A significant remaining debt problem is caused by more expensive energy imports from Gazprom, a privately owned Russian company. This debt had its origins in 1994, when Gazprom raised its gas prices to world levels and began charging more for its gas supplies to Moldova Gas, which is also a private company. Because the government refused, on equity grounds, to raise user prices to households and also to some productive activities, it began to incur large losses. As a result, the government found it necessary to assume the debt owed to Gazprom (which rose to 11.2 per cent of GDP in 1994). This debt increased alarmingly in 1998 and 1999, reaching a peak of 39.1 per cent of GDP in 1999. Since 1999, the government has reduced this ratio, down to 14.5 per cent of GDP in 2003. However, this percentage remains a substantial financial burden on the government.

In summary, the government has managed to bring its external and domestic debts under control. It has done so at a high cost—one that could have been substantially lessened had official lenders been more forthcoming with assistance. The Bretton Woods Institutions could have easily been more generous in their dealings with Moldova. They delayed approval of the Economic Growth and Poverty Reduction Strategy until late 2004, and when the endorsement came, it did not allow for access to key concessionary instruments. Should full support be received, especially from the IMF, the government could seek reduction and rescheduling of the external debt owed to multilateral institutions and Paris Club bilateral creditors.

Since the government has endured much of the pain in reducing the commercial and non-Paris Club bilateral components of its external debt, it should be in a stronger position to lobby for favourable terms for rescheduling the remaining part. The starting point for such negotiations is the general recognition that Moldova should have been provided with concessional lending, instead of non-concessional lending, beginning with the first loans it contracted in the early 1990s. Thus, the accumulated interest rate differential between the two should immediately be forgiven. In addition to the interest resulting from the difference between IBRD and IDA terms, the maturities of the non-concessional debt should immediately be rescheduled. The result would be that the net present value of Moldova's debt should drop substantially, facilitating the prospects for growth, employment and poverty reduction.

This study recommends that negotiations resume on no worse than Houston terms, with the applicable rescheduling and grace periods for repayment and interest rates. Such terms, it should be noted, are hardly generous. Reaching a settlement would be in the interests of both the government of Moldova and its creditors, and serve the commitment of both to growth, employment and poverty reduction. It would benefit the Moldovan people because funds that have been earmarked for debt servicing could be released to finance badly needed public investment in economic and social infrastructure and the provision of essential public services.

4 THE COMPOSITION OF PUBLIC EXPENDITURES

As stated above, the government of Moldova has implemented a relatively tight fiscal policy, with a deficit near zero during 2001-2002. In 2003, it ran a surplus of 1.6 per cent of GDP. Taking into account expenditures for the social insurance and medical insurance funds, total public expenditures were, according to the MTEF, 33.8 per cent of GDP in 2003. The ratio of current expenditures to GDP rose during 2000-2003, to a peak of 27.2 per cent (Table 6), and is projected to rise further to 29.6 per cent in 2007 (Table 7). Conversely, the ratio of capital expenditures to GDP is slated to decline from 5.1 per cent in 2000 to three per cent in 2007 (Table 7). This does not bode well for sustained economic growth in Moldova because public investment can be a powerful stimulus to private investment. Moreover, its absence tends to depress private investment.

Part of the problem is that one third of public capital expenditures have been financed by external grants. But Moldova has no Public Investment Programme to rationalize these investments. In order to advance national development priorities, public investment should be reliant on the mobilization of domestic revenues. This depends in turn on the mobilization of domestic savings, which remain very low in Moldova. Beyond revenue generation, there is a more general problem of the lack of domestic accumulation of capital, both private and public, which is a foundation for long-term growth.

Moldova's heavy reliance on external assistance to finance public investment contributes to the fragmentation and lack of coherence of public investment, which is partly driven by domestic priorities and partly by donor priorities. Moldova needs a consolidated and coordinated Public Investment Programme that is more ambitious, more geared to investing in growth and employment and more focused on poverty reduction.

TABLE 6

Composition of Public Expenditures (% of GDP)

Expenditure Category	2000	2001	2002	2003	2004 (approved)
Total Expenditures	36.4	31.4	33.9	33.8	34.9
Debt Service	6.4	4.2	2.2	2.1	2.9
Net Lending	-0.2	-0.1	-0.3	-0.2	-0.1
Current Expenditures	25.1	23.8	27.1	27.2	28.1
Capital Expenditures	5.1	3.6	5.0	4.6	4.0

Source: Republic of Moldova, MTEF 2004.

An additional problem is that not all of the capital investment that is allocated in the budget ends up being disbursed. In 2003, only sixty-one per cent of allocated public investment funds were disbursed (IDIS Viitorul 2004, p. 25). A further problem is that Chisinau received about seventy per cent of all capital investment (Ibid, p. 25), leaving rural areas, where infrastructure is sorely lacking, with a small share of the total.

The public sector wage bill is not a major factor in increasing current expenditures: it is projected to increase only slightly, from 7.7 per cent of GDP in 2000 to 8.1 per cent in 2007. Between 1998 and 2002, there was a fifteen per cent reduction in the number of employees, with eighty per cent of this reduction comprising employees in education and health. This is

surely not a pro-poor approach to public sector reform. However, the government did raise the wages of these low-income employees. Nonetheless, overall wages in the public sector remain low.

Other small categories, such as subsidies to enterprises, are expected to decline or remain roughly constant in coming years. Two categories expected to increase are the general expenditures on goods and services and social transfers. Expenditures for medical insurance went from zero in 2003 to 3.5 percent of GDP in 2004. This is the main explanation for the projected rise in expenditures on goods and services from 5.9 per cent in 2002 to 8.5 per cent in 2007. The projected increase in social transfers from 8.8 per cent of GDP in 2000 to 11.0 per cent in 2007 is explained by the rise in its major subcategory, social insurance expenditures, from 8.2 per cent to 9.7 per cent.

TABLE 7

Current and Capital Expenditures (% of GDP)

	2000	2001	2002	2003	2006 (Proj.)	2007 (Proj.)
Current Expenditure	25.1	23.8	27.1	27.2	29.7	29.6
Capital Expenditure	5.1	3.6	5.0	4.6	3.3	3.0
Total Expenditure	36.4	31.4	33.9	33.8	35.0	34.3

Source: Republic of Moldova, MTEF 2004.

Juxtaposing the increases in expenditures for social and medical insurance with the decline in capital expenditures highlights current budget priorities. The government has been forced to favour social protection and welfare over growth-inducing public investment because of the disastrous collapse of social provision in the 1990s. The low capital expenditure is due partly to a projected decline in external grants and credits for capital expenditures. However, if external assistance increases, it is likely to favour, in line with common donor priorities, expenditures on health and education rather than on economic services and investment. The official intention of the government is to maintain a constant level of domestic financing of public investment during 2005-2007, and direct much of it to critically needed construction activities. However, the general downward trend of financing for investment portends a government focus on the short-run amelioration of poverty instead of its long-run substantial reduction.

An examination of trends in expenditures on social and economic services during 2000-2004 underscores the relative neglect of the economic services. Expenditures on both education and health increased during this period (Table 8). By contrast, expenditures on agriculture, transport and communication edged downward. Overall, the share of social services in GDP increased from 19.6 per cent to 21.3 per cent while the share of economic services declined from 4.3 to 4.0 percent. Economic services are programmed to decline further, to 3.2 per cent in 2007, while social services will remain virtually constant at 21.4 per cent.[2]

Given the importance of agriculture and agro-industry to future pro-poor growth, the lack of expenditures on economic services for the sector, particularly public investment, is not optimal. Moreover, the lack of public investment in infrastructure for transport,

communication and energy implies an erosion of the basis for long-term sustainable growth. Rural and agricultural infrastructure is essential for Moldova's industrial development as well as its agricultural development. Even compared to neighbouring transition economies, Moldova is allocating relatively less attention to economic services and relatively more to social services. While this is due in part to the depth of the recession that the country has endured, such an allocation of public resources suggests that the full recovery from such a catastrophic decline will be more protracted than anticipated.

TABLE 8

Public Expenditures by Sector (percent of GDP)

Budget Category	2000	2001	2002	2003	2004 (Appr'd)
General Services	**5.0**	**4.9**	**6.0**	**5.9**	**5.8**
Social Services	**19.6**	**18.1**	**21.2**	**21.2**	**21.3**
- Education	5.7	6.0	6.8	6.7	6.4
- Health	3.2	3.2	4.0	4.0	4.5
- Social Assistance	10.0	8.4	9.6	9.7	9.8
Economic Services	**4.3**	**3.2**	**3.7**	**3.7**	**4.0**
- Agriculture	1.3	0.6	0.8	1.1	1.0
- Transp. &Commun.	0.9	0.5	0.5	0.5	0.8
- Communal Services	0.9	1.3	1.7	1.3	1.1

Source: Republic of Moldova, MTEF 2004.

5 CONCLUDING REMARKS

This Country Study has analysed Moldova's public finances, covering the topics of revenue generation, debt relief and expenditure allocation. One of its major objectives is to help the government expand 'fiscal space' to promote growth, employment and poverty reduction. However, by following the standard Neo-liberal advice often dispensed by international financial institutions, the government has been implementing fiscal reforms that are, by contrast, hampering its ability to mobilize and effectively disburse public resources.

Hence, this study takes issue with the government's current efforts to dramatically lower rates on direct taxes. The study predicts that these reforms will not only weaken the vertical equity of Moldova's tax system but also prove to be ineffectual in raising public revenue. Hence, it offers a series of alternative recommendations, covering both indirect and direct taxes, on how to raise more revenue and make the tax system more progressive.

The study notes that the government of Moldova has succeeded remarkably in unilaterally reducing its external debt burden, but at tremendous cost—namely, not being able to safeguard or advance the well-being of its own citizens. In this regard, the study pointedly criticizes international donors for making the mistake of not offering the country concessional lending during the wrenching years of its transition during the 1990s.

Blind to the real condition of the country, international financial institutions calculated Moldova's GDP per capita to be higher than it was. But, during the early 1990s, the country had plummeted, in fact, to the level of a low-income country. Such a mistake created a much larger external debt burden for Moldova when it had to borrow internationally to try to mitigate

the widespread misery due to its deep recession. The study urges multilateral and bilateral creditors to rectify this gross mistake and reschedule Moldova's debt, taking into account the additional, and unnecessary, burden that the country shouldered when it had to resort to borrowing at interest rates closer to market levels.

The study also recommends that while the government should continue devoting resources to social protection, especially since incomes remain low, it should disproportionately allocate resources to economic services, precisely in order to stimulate more growth of incomes. The study emphasises the importance, in general, of public investment, which can expand the productive capacity of the economy as well as stimulate aggregate demand. Well-designed public infrastructure can promote more private investment and, thus, play a central role in generating more growth and employment and reducing widespread poverty in Moldova.

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NOTES

1. If social and medical insurance contributions are added to the calculations, the total revenue to GDP ratio was 31.5 per cent in 2003, and projected to be 31.9 per cent in 2007.

2. Public investment trends reflect the general priorities accorded to social services. In 2003, for example, when public investment was 4.6 per cent of GDP, a 13.5 per cent share was allocated to agriculture. For the same year, 11.6 per cent was allocated to healthcare and 17 per cent to education. Hence, together health and education accounted for 28.6 per cent of all public investment. Another 11.5 per cent went to community services and housing.

International Poverty Centre
SBS – Ed. BNDES,10º andar
70076 900 Brasilia DF
Brazil

povertycentre@undp-povertycentre.org
www.undp.org/povertycentre
Telephone +55 61 2105 5000
Fax +55 61 2105 5001