Republic of Moldova
Improving Public Expenditure Efficiency for Growth and Poverty Reduction
A Public Expenditure Review for the Republic of Moldova
February 12, 2007
Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank
CURRENCY AND EQUIVALENT UNITS
Exchange Rate Effective as of February 1, 2007

Currency Unit = Moldovan Lei (MDL)
US$1 = 12.96 MDL

FISCAL YEAR
January 1 - December 31

ABBREVIATIONS

ALOS - Average Length of Stay
ATU - Administrative Territorial Units
BNS - National Statistics Bureau
BRR - Bureau of National Statistics
BTR - Bad Turnover Rate
CAFA - Country Financial Accountability Assessment
CID - Capital Investment Directorate
CDA - Court of Accounts
CPAR - Country Procurement Assessment Report
DFID - Department for International Development
ECA - Europe and Central Asia
EFA - Education For All
EGPRSP - Economic Growth and Poverty Reduction Strategy
EGPRSP - Economic Growth and Poverty Reduction Strategy Paper
EU - European Union
FDI - Foreign Direct Investment
FCT - Fosté-Coste-Thorbecke
FMIS - Financial Management Information System
GDP - Gross Domestic Product
GGE - General Government Expenditures
GOM - Government of Moldova
IBRD International Bank for Reconstruction and Development
IDA - International Development Association
ILO - International Labor Organization
IMF - International Monetary Fund
IPSAS - International Public Sector Accounting Standards
IRF - International Road Federation
MEYS - Ministry of Education and Youth Services

MHI - Medical Health Insurance
MIF - Mandatory Health Insurance Fund
MOE - Ministry of Economy
MOF - Ministry of Finance
MPR - Ministry of Planning and Budget
NTEF - Medium Term Expenditure Review
NBIM - National Bank of Moldova
NPV - Net Present Value
NSHI - National Social Insurance House
OECD - Organization of Economic and Cultural Development
PDD - Public Debt Directorate
PEFA - Public Expenditure and Financial Accountability Assessment
PEMR - Public Expenditure Management Report
PMF - Public Finance Management
PFR - Public Finance review
PSF - Preliminary Feasibility Studies
PHC - Primary Health Care
PIS - Public Investment Program
PIU - Project Implementation Unit
PPG - Public and Publicly Guaranteed
PRGF - Poverty Reduction Growth Facility
RMP - Road Maintenance Fund
SIDA - Swedish International Development Agency
SSF - State Social Insurance Fund
UK - United Kingdom
UN - United Nations
VAT - Value Added Tax
VOC - Vehicle Operating Cost

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ACKNOWLEDGEMENTS

The Public Expenditure Review (PER) has the objective of addressing key issues in public finance confronting Moldova and recommending options for reform. Given the breadth of issues to be covered, the PER is being undertaken in a programmatic approach. This first phase explores expenditure allocation and efficiency in a number of key sectors – public investment, public administration, roads, health, education, pensions and social assistance.

The Public Expenditure Review was prepared by a World Bank team lead by Lawrence Bouton and Erwin Tiongson. The primary authors of the study are Lawrence Bouton (Chapter 1), Erwin Tiongson and Iaroslav Baclajanschi (Chapter 2), Svetlana Proskurovska (Chapter 3), Andreas Schliessler (Chapter 4), James Cercione (Chapter 5), Martin Godfrey (Chapter 6), Paulette Castel (Chapter 7) and Paolo Verme (Chapter 8).

Generous financial support to the study was given by the UK Government’s Department for International Development (DfID). Elena Nikulina prepared the update on public financial management issues for Chapter 1. Anca Dumitrescu provided useful inputs to Chapter 4 during the initial stages of the study. Hideki Mori provided valuable inputs and strong guidance throughout the course of this study. Andrew Keith (DfID) also participated in the overall preparation of the study and his contributions are gratefully acknowledged. Similarly, the PER benefited from the comments received by Hans Lundquist (SIDA), Thomas Richardson (IMF), Jose Leandro, Andreas Papadopoulos, and Lucio-Mauro Vinhas-de-Souza (EC), Andrew Bird and Simon Groom (DfID consultants).

The team gratefully thanks the Government Counterpart Team, led by the Minister of Finance, Mihail Pop, for guidance, cooperation, and support at all stages of the PER preparation. The efforts of the Ministry of Finance, the Ministry of Economy, and other agencies in helping prepare this report are gratefully acknowledged. The efforts of the counterpart team were coordinated by Vasile Bulicanu. The team itself consisted of Natalia Rata, Marina Semeniuc, Veaceslav Serbin, Liudmila Sverdlc, Svetlana Purici, Gheorghe Sircu, Svetlana Bogatu, Lilia Gantea, Nicolae Ciobanu and Vasile Botica. The team benefited greatly from numerous discussions with the representatives of the donor community, local think tanks, independent experts and numerous other stakeholders in Moldova. The advice and guidance of Edward Brown, Country Manager, throughout the study is also gratefully acknowledged.

Ulrich Lachler (LCSPE) and Edward Mountfield (PRMED) were peer reviewers for the study. Viorica Strah and Olesea Vinaga were instrumental in coordinating the consultation process in Moldova. Susana Padilla provided able support with the production of the report. Asad Alam was the Sector Manager supervising the preparation of the study. Cheryl Gray was the Department Director, and Paul Bermingham was the Country Director for Moldova.
Improving Public Expenditure Efficiency for Growth and Poverty Reduction

EXECUTIVE SUMMARY

I. Introduction

1. The Government of Moldova's Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) lays out an ambitious plan for sustaining growth and poverty reduction and reshaping the government to meet the needs of a market economy. The public expenditures envisaged under this ambitious plan, however, vastly exceed the domestic resources available to the Government. Additional foreign budgetary support may help alleviate some of that resource constraint. Recognizing that the share of tax revenues and expenditures to GDP in Moldova already greatly exceed comparable international levels, generating additional domestic tax resources risks crowding out the private sector and undermining growth prospects. This suggests that in order to finance higher order public expenditures priorities, the Government needs to create fiscal space from within the existing resource envelope. This will require inter and intra-sectoral reallocation of expenditures and an increase in the efficiency of public spending rather than increasing the relative size of government.

2. Fiscal space can be generated in a number of manners. Changes in tax policy and administration to broaden the tax base and increase revenue potential without distorting or undermining the private sector incentives to invest and save is one option. On the expenditure side, fiscal space can be created by shifting resources from less efficient to more efficient uses. On the financing side, fiscal space can be created by mobilizing grant aid, privatizing state assets, or by accelerating the reduction of public debt so as to reduce the amount of expenditures devoted to interest payments on debt. There is also a strong inter-temporal dimension to fiscal space. The effective use of public resources to improve human and physical capital will lead to increased productivity and income and, hence, expand the scope for private and public consumption opportunities in the future.

3. This Public Expenditure Review (PER) concentrates on some key reforms that are needed to improve the functioning and efficiency of public spending as well as create fiscal space for growth enhancing public expenditures.

II. Changing the Paradigm for Growth and Poverty Reduction

4. Moldova's strong growth performance since 2000 has reversed a decade of economic decline and rising poverty. The economy has grown by nearly 40 percent leading to a massive movement out of income poverty. Starting in 2004, however, poverty reduction has stalled despite continued vigorous economic growth. As highlighted in the recent Country Economic Memorandum (CEM), this trend has heightened concerns that Moldova's growth paradigm is no longer reducing poverty.
5. Up until now, growth in Moldova has relied primarily on the expansion of domestic household consumption and construction fueled by massive inflows of workers' remittances. Most of this increased demand has been met by foreign production and, as a result, the external accounts have widened progressively. In order to put growth and poverty reduction on a sounder footing, a stronger and more robust domestic supply response will be required. This will necessitate further improvements in the domestic investment climate in order to increase heretofore low domestic private investment and innovation. As with private investment, public investment has been very low with the result that public infrastructure has continued to deteriorate with negative implications for growth.

6. Economic management has been complicated by external price shocks - energy prices have increased rapidly with natural gas prices doubling since the beginning of 2006. In addition to the negative impact on economic growth and the external accounts, these shocks have put pressures on the fiscal accounts. It has directly raised the cost of electricity, natural gas and oil products procured by the Government at all levels. Further, to prevent the reemergence of the large quasi-fiscal deficits of the 1990s, higher energy prices have been largely passed on to final consumers. This has created rising pressures for additional subsidies and transfers that complicate the management of fiscal policy. From a policy perspective, to prevent monetary and exchange rate policy from bearing an excessive burden in achieving the needed macroeconomic adjustment, some support from fiscal policy will be required.

III. Fiscal Retrenchment and Recovery

7. Up to 1999, fiscal performance in Moldova was mixed. Poor economic performance combined with weak budget processes, low tax enforcement capacity and poor governance resulted in severe and unsustainable fiscal imbalances during the 1990s. Fiscal deficits, averaging more than 6 percent of GDP, were financed through a combination of external financing, domestic borrowing and domestic payment arrears. As a result, public external debt increased sharply raising concerns about debt sustainability.

8. The 1998 regional financial crisis forced the Government to tighten fiscal policy dramatically. With the negative shock to economic activity, government revenues dropped sharply. With limited domestic and external source of deficit financing, the regional crisis necessitated a sharp drop in expenditures. Most of this fiscal retrenchment resulted in deep cuts in health, education and social protection spending. This forced fiscal adjustment resulted in a sizable improvement in the overall fiscal (cash) deficit of the general government – moving from an average deficit of 8.4 percent in 1996-1999 to 3.5 percent in 2000 thereby setting the stage for the markedly improved economic and fiscal performance experienced by during the recovery that began in 2001.

Figure 1: Expenditures, Revenues and Deficit, 1995-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditures</th>
<th>Revenues</th>
<th>Deficit (percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>50%</td>
<td>45%</td>
<td>5%</td>
</tr>
<tr>
<td>1996</td>
<td>45%</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>1997</td>
<td>40%</td>
<td>35%</td>
<td>20%</td>
</tr>
<tr>
<td>1998</td>
<td>35%</td>
<td>30%</td>
<td>30%</td>
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<tr>
<td>1999</td>
<td>30%</td>
<td>25%</td>
<td>40%</td>
</tr>
<tr>
<td>2000</td>
<td>25%</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>2001</td>
<td>20%</td>
<td>15%</td>
<td>60%</td>
</tr>
<tr>
<td>2002</td>
<td>15%</td>
<td>10%</td>
<td>70%</td>
</tr>
<tr>
<td>2003</td>
<td>10%</td>
<td>5%</td>
<td>80%</td>
</tr>
<tr>
<td>2004</td>
<td>5%</td>
<td>0%</td>
<td>90%</td>
</tr>
<tr>
<td>2005</td>
<td>0%</td>
<td>-5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: MTEF and IMF Article IV Staff report
9. The economic recovery, which began in earnest in 2001, has resulted in a significant upsurge in fiscal revenues. By 2005, total revenues had recovered almost all of the lost ground at the end of the 1990s, growing to nearly 40 percent of GDP. The expansion in fiscal revenues has given the Government some room to increase expenditures, particularly social spending. Further fiscal space has been gained by rapid reduction in public and publicly guaranteed debt as a share of GDP as a result of growth, exchange rate appreciation and better debt management. With access to budget financing remaining limited, the increase in expenditures has been constrained by revenue mobilization. With taxes very buoyant, starting in 2003, the fiscal accounts of the general government have moved into surplus. While government has maintained sound macroeconomic policies, the quality and equity in access to public services and the efficiency of resource utilization has remained problematic.

Table 1: Revenues and Expenditures in Moldova, 2001-2005 (percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Revenues and Grants</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax revenues</td>
<td>29.2</td>
<td>29.6</td>
<td>34.0</td>
<td>35.4</td>
<td>39.5</td>
</tr>
<tr>
<td>Direct Taxes</td>
<td>24.4</td>
<td>25.8</td>
<td>27.5</td>
<td>29.8</td>
<td>32.3</td>
</tr>
<tr>
<td>Indirect Taxes</td>
<td>3.7</td>
<td>4.0</td>
<td>4.3</td>
<td>4.9</td>
<td>4.5</td>
</tr>
<tr>
<td>of which: VAT</td>
<td>13.9</td>
<td>14.6</td>
<td>16.0</td>
<td>16.1</td>
<td>18.5</td>
</tr>
<tr>
<td>Social and Health Fund Contributions</td>
<td>7.9</td>
<td>9.0</td>
<td>10.1</td>
<td>10.7</td>
<td>12.6</td>
</tr>
<tr>
<td>Non-tax revenues</td>
<td>6.8</td>
<td>7.3</td>
<td>7.2</td>
<td>8.8</td>
<td>9.3</td>
</tr>
<tr>
<td>Grants</td>
<td>0.9</td>
<td>0.6</td>
<td>0.3</td>
<td>0.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>...</td>
<td>...</td>
<td>3.6</td>
<td>3.2</td>
<td>3.4</td>
</tr>
<tr>
<td><strong>Total Expenditures and Net Lending</strong></td>
<td>29.4</td>
<td>31.5</td>
<td>33.3</td>
<td>34.6</td>
<td>37.9</td>
</tr>
<tr>
<td>National Economy</td>
<td>1.7</td>
<td>1.8</td>
<td>3.6</td>
<td>4.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Social sphere</td>
<td>16.6</td>
<td>19.5</td>
<td>20.9</td>
<td>22.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Education</td>
<td>4.8</td>
<td>5.5</td>
<td>6.7</td>
<td>6.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Social Fund expenditures</td>
<td>7.2</td>
<td>8.4</td>
<td>8.2</td>
<td>8.6</td>
<td>10.0</td>
</tr>
<tr>
<td>Health &amp; Health Fund expenditures</td>
<td>2.8</td>
<td>3.5</td>
<td>3.9</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Other social expenditures</td>
<td>1.7</td>
<td>2.0</td>
<td>2.2</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Interest payments</td>
<td>4.2</td>
<td>2.2</td>
<td>2.1</td>
<td>1.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Other Expenditures</td>
<td>7.1</td>
<td>8.3</td>
<td>6.7</td>
<td>6.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Balance of Special Accounts and statistical discrepancy</td>
<td>-0.1</td>
<td>0.6</td>
<td>-0.4</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Overall Fiscal Balance (cash)</strong></td>
<td>-0.4</td>
<td>-1.4</td>
<td>0.2</td>
<td>0.8</td>
<td>1.7</td>
</tr>
<tr>
<td><strong>Primary Fiscal Balance (cash)</strong></td>
<td>3.8</td>
<td>0.7</td>
<td>2.3</td>
<td>2.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Memo:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Debt (% of GDP)</td>
<td>77.0</td>
<td>61.1</td>
<td>52.5</td>
<td>35.3</td>
<td>28.2</td>
</tr>
</tbody>
</table>


IV. Key Challenges Confronting Public Expenditure Policy

10. Sustaining economic growth and poverty reduction will require a set of policies that will encourage stronger private sector investment and innovation as well as better and more efficient use of resources by the public sector. The key fiscal challenge will be finding the fiscal space to increase critical physical and human public investment without placing a greater burden on the private sector. This PER concentrates on some key reforms that are needed to achieve this through improving the efficiency of public spending in Moldova.
Reducing the Size of Government

- Reduce size of Government (as a share of GDP) to avoid undermining private sector’s incentives to save and invest.

- Within a smaller fiscal envelope, maintain a prudent fiscal policy stance that also supports monetary and exchange rate policies.

11. As the experience in Moldova during the 1990s has demonstrated, the inability to keep government expenditures in line with the available resource envelope can contribute to macroeconomic volatility and instability. Large fiscal deficits, by increasing policy and business uncertainty and crowding out the private sector, impede a country’s ability to attract the private sector investment and innovation so critical for economic growth. Moldova’s adherence to prudent macroeconomic policies since 2001 has been an important contributor to restoration of economic stability and the resumption of growth. The stance of fiscal policy will need to remain tight in order to support monetary and exchange rate policies.

12. While the fiscal deficit has been kept under control, the level of expenditures and revenues have grown rapidly and are now too high given Moldova’s income level and institutional development. It is estimated that expenditures and revenues are 7 to 8 percentage points of GDP higher than one would expect of a country of similar income levels. This suggests that the creation of fiscal space by further increases in revenue mobilization is not a desirable option. Instead, Moldova will need to focus its reform efforts on increasing the provision of quality public goods and services by improving the efficiency of tax revenues and expenditures.

13. The relatively large size of government is limiting economic growth and should be reduced. The ability of an economy to support a large public sector is, of course, related to the quality of public programs and institutions. Effective public institutions and good governance may mitigate the impact of a large public sector on growth. As shown in Figure ii, in countries where public institutions are weaker, a category that currently includes Moldova, the size of public expenditures has a decidedly negative impact on growth. The international empirical evidence suggests that in countries where expenditures levels exceed 35 percent of GDP, an increase in expenditures by 1 percentage point reduces growth by 0.3-0.4 percent per year. This suggests that the current size of Government in Moldova - 38 percent of GDP in 2005 - is reducing growth by an estimated 0.9-1.1 percent per annum. If the size of Government in Moldova were to increase further, this negative effect could potentially grow larger.

![Figure ii: Large Governments Limit Economic Growth](image-url)
14. Reducing the size of Government will require constraining the increase of expenditure relative to GDP growth. As shown in Figure iii, continued rapid increases in public consumption, as proposed by the MTEF expenditure plan, implies that the size of government will continue to grow over the medium term. If, however, the growth in public expenditures were constrained to be less than GDP growth, say 2 percent in real terms over the medium term, then the size of Government would decline over the medium term and approach the threshold level of 35 percent indicated above.

![Figure iii: Shrinking the Size of Government (percent of GDP)]

Reorienting Expenditures towards Growth Promotion

- Reduce public consumption spending and increase emphasis on growth-enhancing public investment in human capital and infrastructure.

- Introduce evidence-based setting of strategic priorities in the investment budget. Project screening, selection, and appraisal should draw from appropriate cost-benefit analysis, with an initial emphasis on larger investment projects.

15. From the perspective of expenditure allocation, the consumption orientation of the public spending has been crowding out growth-promoting public investment expenditures (i.e. infrastructure and quality improvements in health and education). For a given level of spending, changing the composition of overall expenditures in favor public investment will improve long-term growth prospects. In Moldova, the increase in public expenditures since 2001 has been dominated by the increases in consumption spending on the social sectors - social spending has not only increased as a share of GDP, it has consumed a growing share of the budget - from 58 percent of the budget in 2001 to nearly 63 percent in 2005.

16. In addition to large transfers to households in the form of pension and social assistance spending, a significant portion of current expenditures is devoted to staffing costs (i.e. wages broadly defined). The wage bill of public sector employees, including those in the MHIF, has grown sharply since 2003 and is now close to 11 percent of GDP or nearly 30 percent of total expenditures. The downward stickiness of nominal wages in the public sector and the lack of instruments for rationally downsizing the public payrolls make it difficult to adjust the wage bill during economic downturns, undermining the flexibility of fiscal policy. In the absence of reforms to increase the productivity of public workers, the growth in public sector wages risks crowding out government operational and capital expenditures. Any increase in real public sector wages will need to be offset by reductions in public employment so as to keep the public sector wage bill under control and avoid crowding out needed capital spending.

17. For upgrading infrastructure and sustaining economic growth, Moldova needs to invest more. Deficiencies in public infrastructure represent a considerable constraint to economic growth in Moldova. Despite the demand for upgrading and expanding the public infrastructure in
Moldova, public capital spending has remained quite low in recent years—only about 2 percentage points of GDP. The limited availability of public resources highlights the importance of strengthening the management of public capital spending in order to ensure that the available resources are utilized effectively and efficiently.

18. Because public resources are limited, there is a need to prioritize and plan government investment strategically. Over the last few years, the Government has significantly improved the budget preparation process and the strategic allocation of resources, mainly through the introduction of the Medium Term Expenditure Framework (MTEF). The Government has also taken steps to gradually integrate all public resources into the MTEF and the annual state budget. Despite these achievements, a number of weaknesses remain. The portfolio of investments being implemented remains too large compared to the available financing. In addition, investments are being undertaken without adequate consideration being given to the requirements for financing of downstream recurrent costs. For further rationalization of the public investment portfolio, a number of improvements are required in the identification, prioritization, preparation and appraisal of projects.

Reforming Public Sector Remuneration System

- Implement planned wage increases within the context of broader public administration reform.

- Implementing a transparent and uniform remuneration system and consolidate multiple salary supplements into the base pay.

19. Public sector salaries consume close to a third of total government resources. In 2005, the wage bill accounted for some 29 percent of total government spending, representing about 10.8 percent of the GDP. Across sectors, there are some variations in the share of wages and salaries in total spending: for example, as a share of total expenditures, spending on personnel is much higher in the education and health sectors (over 50 percent of total spending in those sectors). Moldova’s public sector wage bill is already among the highest compared to other countries in the region, including several advanced OECD economies. The wage bill, however, is programmed to continue rising through 2008 to keep pace, in part, with rising overall wage levels in the economy. In recent years, the stable level of public employment and rising level of public wages has made it difficult to increase other essential spending, especially operation and maintenance expenditures. As public sector wages are projected to rise and outpace economic growth in the short-term, the rising wage bill will likely create significant fiscal and macroeconomic pressures in the process.

20. Because the design of the public sector wage system also has significant implications on the quality and efficient function of government, the government has on its hands the delicate task of striking the right balance between a public wage bill that is fiscally affordable and a remuneration system that is able to attract qualified and motivated workers to the public sector. Despite the recent, rapid increase in public sector wages, compensation levels in the public sector are still very low when compared with the private sector. While civil servants are underpaid compared to the private sector at all levels, the relative undercompensation of middle and senior management is quite extreme. At the lower end of senior management, for example, the private sector compensation is more than six times the civil servant salary. In addition to low pay, the compression of salaries in the civil service remains quite high. As a result of low and compressed compensation levels, the public sector in Moldova has had a very difficult time in attracting and retaining skilled employees.
21. In addition to low remuneration levels, the composition of public sector compensations is very complex and lacking in transparency. Beyond the base salary level, public sector employees receive a number of additional payments including: a reward for taking on tasks of “major” importance; supplements for additional work resulting from the temporary absence of a coworker; a length of service bonus; and a bonus for knowledge of additional languages. These bonus and allowance payments can be considerable when compared to the base salary. By way of comparison, in other countries this type of compensation usually only amounts to 10-20 percent of the base salary. Although the system can provide higher compensation to qualified employees, it is completely lacking in transparency. This creates incentive problems (combined, to begin with, with low public salaries).

22. Increasing wage dispersion (or pay decompression) and consolidating multiple salary supplements into the base pay while keeping constant the overall wage bill, will be the key elements of a good reform program. The ongoing, government-led sectoral review, under a broader central public administration reform program, will be critical in identifying opportunities for reducing non-essential staffing, streamlining government processes, and promoting public sector productivity.

Restoring the Transport Network for Sustained Economic Growth

- Reform the existing road maintenance financing mechanism by considering the introduction of a second generation road maintenance fund to ensure a stable source of financing for the transport sector.

- Introduce competition in road maintenance by revising the contracting modalities for road maintenance works.

23. The lack of road maintenance and rehabilitation in the past 15 years has led to massive physical deterioration and to heavy loss of road network asset value. The present asset value of the Moldovan road network is only about US$ 8.4 billion, far short of the US$ 12 billion it would have been, had the existing road network been adequately maintained. This means that the loss of road network asset value which resulted from insufficient maintenance and rehabilitation is a shocking US$ 3.6 billion, equivalent to 1.4 times the entire GDP of Moldova in 2004.

24. Despite the considerable loss of asset value, the road network is still Moldova’s single most important national asset, certainly much larger in value than all power plants, railway lines and the electricity grid combined. An urgent and important effort is needed to save what is left and to gradually improve the road network, without which sustained economic and social development will not be possible. Two important institutional reforms appear necessary: (i) the reform of the existing road maintenance financing mechanism, and (ii) the contracting modalities for road maintenance works. There are several options for creating a stable funding mechanism for road maintenance in Moldova. There are, for example, good arguments for separating the financing of road maintenance (such as through earmarked resources) from those of new road investments (through the general budget), although experience from other countries suggest that a number of supporting conditions need to be in place to enable this system to work. Meanwhile, the present system of awarding and supervising road maintenance contracts suffer a number of weakness, although less apparent in recent years given the very low level of resources for road maintenance. In particular, the present system of sole-source contracts with the state-controlled local district road maintenance firms has several deficiencies which may result in a lower efficiency in the use of resources. As transport spending is projected to rise, these institutional features will become more critical in the efficient management of transport resources.
Increasing the Efficiency and Quality of Health Care

- **Ensure sustainable and equitable financing of health care by increasing collection rates and expanding insurance coverage in rural areas.**

- **Promote quality and user satisfaction in health care by further consolidating services and introducing efficiency oriented measures at the provider level.**

25. Moldova has made significant progress in reforming the health care system - health insurance has been introduced, hospitals have been transformed from budgetary institutions to self-governing entities, and primary health care has been strengthened. Since the end of the 1990s, expenditures on health have increased dramatically - from about 2.8 percent of GDP to nearly 4.3 percent of GDP in 2005. In per capita terms, spending on health is now at the highest levels experienced since independence. Nearly half of these expenditures are on wages, with spending on drugs and equipment still remaining quite low. Further, a substantial portion of the expenditures of the National Health Insurance Company (75% in 2005) is covered by transfers from the state budget. The sustainability of the system is further undermined by the weak participation in the system by Moldova’s most productive population – less than 50% of the 25 to 44 age group participates in the system.

26. All these factors helped reverse the unfavorable trends experienced in the 1990s and, as a result, a broad range of health indicators have improved. While mortality and morbidity rates are still far from the EU average, Moldova is making progress towards meeting MDG indicators on health. The introduction of health insurance has also increased the financial protection of the population with nearly 75 percent of the population covered by insurance. Some gaps in insurance coverage remain – coverage in rural areas and small towns are still below those in Chisinau. Formal and informal out-of-pocket expenditures – mainly allocated to purchase of drugs - still represent a large share of overall health expenditures (41 percent in 2005). Expanding the drug benefit package to reduce these out of pocket expenditures will require, among other things, increasing collection rates.

27. Despite the achievements in this sector, the hospital sector continues to be burdened by overcapacity. About 40 percent of inpatient health care facilities are outside the control of the Ministry of Health and Social Protection and, hence, have not been subject to recent reform effort. Poor performance is observed in a number of key productivity (i.e. discharges per physician) and cost-containment indicators. While hospital efficiency has improved, these indicators are still among the lowest in Europe. Efficiency gains can be achieved by improvements in utility management increases in ambulatory surgery, outsourcing of services (such as laundry) and further hospital consolidation. While public health expenditures have increased, hospital activity has decreased. This suggests the need to control expenses through improved resource allocation mechanisms and to emphasize the quality rather than quantity of spending. Clinical practices will need to be modified to promote more cost-effective care and quality based initiatives.
Enhancing the Efficiency of Resource Use in Education

- Consolidate school networks to promote the more efficient use of resources in the education sector. Such a program could create fiscal savings of up to 0.5 percent of GDP.

- Consider the best use of fiscal savings: invest in quality-enhancing inputs within the education sector, or reallocate resources to another sector.

28. With expenditures on education over 7 percent of GDP – levels broadly comparable to other countries in the ECA (Europe and Central Asia) region – issues related to the allocation of resources within the sector as well as those of technical efficiency are dominant. Because salary levels in education are among the lowest in the economy, the Government has emphasized the need to pay higher wages to attract better skilled teachers, with the goal of improving the quality of education. However, funds allocated to schools are on the basis of norms established by the Ministries of Finance and Education. As such, the flexibility of local governments and school managers in using the resources is severely limited. Indeed, higher wages will only be achievable by increasing the efficiency of spending in the sector.

29. A number of areas offer opportunities for achieving increased efficiency. First, many schools have very low numbers of students, small classes and low student/teacher ratios. These figures are low even by international, OECD standards. Moreover, there are wide variations between schools within and across județs. If student/teacher and student/non-teacher ratios were reduced to OECD levels, by closing down or relocating secondary classes from schools that are below an efficient size (while allowing pre-schools and primary classes to remain where they are, with multi-grade teaching if necessary) and the abolition of strict norms for the number of teaching and non-teaching staff in autonomous schools, fiscal savings totaling 277 million lei would result. Some offsetting increases in expenditure would of course be necessary to finance separation packages, retraining, and transport costs. The net savings, amounting to about [ ], could be applied to salary increases and quality improvement in the education sector or transferred to other sectors. Second, the extent to which decentralization of authority to autonomous schools will help address the allocation of inefficient education expenditures will be explored. The proper sequencing of reforms is of course an issue, to create the right incentives for merging schools while decentralizing the authority over school budgets.

Promoting the Fiscal Sustainability of Pensions

- The Government strategy to unify the contributory system should increase revenues over time. New regulations should be introduced gradually in the case of farmers, because many are poor and vulnerable; they can be implemented more quickly in the case of self-employed workers and wage employed workers in the agricultural sector.

- Develop and strengthen the NSIH reserves management capacity and monitoring institutional agencies.

30. Over the last four years, the National Social Insurance House (NSIH) has enjoyed a favorable economic and demographic environment. Although the NSIH experienced a deficit at the end of 2005, the pension system is currently on sounder financial footing with accumulated reserves of about 1.6 percent of GDP. Simulations also suggest that low pension benefits and favorable demographics trends should effectively allow NSIH to keep producing surplus and...
accumulating reserves in the medium-term. However, as the dependency ratio deteriorates, the long-term financial viability of the system will depend on how the reserves are managed and secured for the next generation. Setting up the regulations and supervisory institutions for this purpose is critical, given that moral hazard and agency problems typically lead to situations where funds mismanaged. While there are no obvious solutions to these problems, it is usually advisable convene a board of trustees that represents diverse groups and diverse interests. The most successful experiences are associated with pension fund tripartite boards.

31. The pension system currently faces two additional challenges: First, pension incomes at retirement are very low in comparison to current wages. Second, contributors' participation in the pension system is largely subsidized. In the first case, the strategy to upgrade the system has not yet been presented. In the second case, the government has developed a strategy towards the unification of the contributory system and the reduction of subsidies. Because poverty rates are extremely high among farmers, a gradual phasing in of new regulations should be considered. Self-employed workers, more than three quarters of whom are subsidized, have the lowest poverty rate. Because leakages are likely in this group, a more rapid enforcement of new regulations, including the payment of the desired minimum contribution, is desirable.

Maximizing the Benefits from Social Assistance

- Promote the targeting efficiency of social assistance. Simulations suggest as much as a quarter of social benefits or 0.3 percent of GDP accrue to the richest households.

- Create the legal, administrative, and institutional bases for transitioning the social benefits systems into a means tested program.

32. By international standards, total government spending on social assistance benefits in Moldova is about average. In 2004 such spending accounted for about 1.7 percent of GDP and 4.8 percent of total government expenditure. While spending in this sector is not particularly large, there are significant inefficiencies in this expenditure area when viewed from the perspective of poverty reduction. Social assistance benefits are, in general, not an importance source of income for households and, among poor households, such benefits are only marginally important. Almost all spending is based on categorical classifications, with the disabled, the war veterans and families with children constituting the largest groups of beneficiaries. The poor as a separate category appear only once across various types of benefits (under “material assistance”) and the share of beneficiaries is very small. There is little means testing in the allocation of benefits: while the system is meant to support the poor and vulnerable, in practice it supports selected categories of beneficiaries, irrespective of income. As a result, the benefits system is quite regressive, although there has been some improvement in recent years. In 2004, data from the Household budget survey indicates that the poorest households received only about 8 percent of all benefits while the richest households received 24 percent.

33. The ongoing government reform program—which includes the implementation of a pilot program for means-testing—represents a good platform for improving the targeting efficiency of the social benefits system. However, a number of accompanying steps and policy interventions will be critical. These include the following: the revision of the legal framework underlying a means-tested social benefits systems; clarifying the sequencing of reform and the categories of benefits that are to be phased out as the systems transitions into a means-tested program; creating an administrative division between the social insurance and social assistance functions of the present system; and enhancing the institutional capacity to manage, monitor, and evaluate the state provision of social benefits.
Conclusion

34. The increase in fiscal revenues that accompanied Moldova’s economic recovery has given it substantial room to increase Government expenditures. Despite devoting nearly 40 percent of GDP to public expenditures, and even accounting for the prospect of increased external grant assistance, there are a still a host of unmet demands on the budget. Roads are in dreadful shape, higher natural gas prices are increasing the demand on social safety nets, public sector wages and pensions are still very low and poverty - particularly rural poverty - is high. Almost all of fiscal space achieved during the recovery, however, has gone to increase public consumption – particularly, public sector wages, transfers and subsidies – expenditure items that have been severely eroding in the transition process. As a result, critical infrastructure needs are largely unmet and state assets, such as roads, hospitals and schools, continue to deteriorate at an alarming rate.

35. Moldova must confront the reality that the size of Government has grown too large. The tax burden needed to support high levels of government consumption spending negatively affects private saving and investment decisions and may limit Moldova’s future growth prospects. This burden is compounded by the fact that the public sector’s contribution to investment is critically low. As long as public expenditures are increased at a slower rate that GDP, the size and burden of government will gradually decline.

36. If Moldova is to accelerate growth and poverty reduction, it must curtail excessive public consumption spending and increase spending on public investment while at the same time reducing the overall footprint of Government. Cutting wasteful spending in the education and health sectors, for example, frees resources for more investment spending in those sectors. Increased spending on roads will put a halt to the deterioration of this vital infrastructure, and support increased private sector activity and greater international competitiveness. Improving the targeting of social assistance allows these programs to more effectively protect vulnerable groups by freeing up these misdirected resources. Completing the reforms to the pension system reduces the accumulation of future unfunded liabilities and puts public finances on a sounder footing. The reform to public financial management currently underway provides an opportunity to strengthen the linkages between spending prioritization and budget management. This process of fiscal adjustment is essential to put economic growth on a solid a sustainable trajectory.
1. CREATING FISCAL SPACE FOR ECONOMIC GROWTH AND POVERTY REDUCTION

A. INTRODUCTION

1.1 The Government of Moldova’s Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) lays out an ambitious plan for sustaining growth and poverty reduction and reshaping the government to meet the needs of a market economy. The public expenditure program envisaged by the EGPRSP, however, vastly exceeds the domestic resources available to the Government. Foreign budgetary support will help alleviate some of that resource constraint. Recognizing that the share of tax revenues and expenditures to GDP in Moldova already greatly exceed international norms, generating additional domestic tax resources risks crowding out the private sector and undermining growth prospects. This suggests that in order to finance higher order public expenditures priorities, the Government needs to create fiscal space from within the existing resource envelope. This will require inter and intra-sectoral reallocation of expenditures and an increase in the efficiency of public spending rather than increasing the relative size of government.

1.2 The ability of Government to increase expenditures or reduce taxation without endangering the financial sustainability of the public sector is limited. Indeed, from Moldova’s experience during the 1990s, the negative impact of large fiscal deficits on macroeconomic stability is well known. Even if, however, fiscal discipline is maintained, disproportionately high levels of government expenditures necessitate a high degree of taxation and, hence, may limit Moldova’s future growth prospects. If the Government is to more effectively utilize public resources to enhance economic growth and poverty reduction prospects, it must re-orient the budget towards growth-enhancing expenditures (i.e., public investment). In order to undertaken this re-orientation in a fiscally sustainable manner, increases in public consumption (i.e., public sector wages, transfers and subsidies) will need to be controlled and expenditure efficiency will need to be enhanced.

1.3 Fiscal space for increasing public investment spending can be generated in a number of manners. Changes in tax policy and administration to broaden the tax base and increase revenue potential without distorting or undermining the private sector incentives to invest and save is one option. However, this option is constrained by the need to reduce Moldova’s already high tax burden. This suggests that the burden of creating this fiscal space has to be on the expenditures side where fiscal space can be created by shifting resources from less efficient to more efficient uses. It should be noted that there is also a strong inter-temporal dimension to fiscal space. The effective use of public resources to improve human and physical capital will lead to increased productivity and income and, hence, expand the scope for private and public consumption opportunities in the future.

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1 The Government’s Medium Term Expenditure Framework covers only 30 percent of the expenditures included in the EGPRSP. Since the EGPRSP does not include cost estimates for a large number of investment projects, such as rehabilitating the road and rail network, this budgetary shortfall is likely even greater.
1.4 This Public Expenditure Review (PER) concentrates on some key reforms that are needed to improve the functioning and efficiency of public spending. This overview chapter presents a synopsis of the emerging macroeconomic challenges and summary of recent developments with the Government's expenditure framework. One of the key fiscal challenges will be finding the fiscal space to increase capital expenditures. Increasing public investment without improving capital budgeting, however, will result in the squandering of scarce resources. Chapter 2 explores how a better capital budgeting process would, in and of itself, create fiscal space since improvements in the planning, evaluation and allocation of the capital budget would channel more resources towards more productive investments. Critical to Moldova's growth prospects is increasing public investment in the maintenance and rehabilitation of the road infrastructure network. Chapter 3 details the negative implications of consumption orientation of the budget on the quality of the road network in Moldova and makes recommendations to improve financing mechanism and contracting modalities that will enable an increase in domestic funding of road works. In an effort to increase the capacity of Government to conduct economic policy, public sector wages have been increased in the hopes of attracting and retaining skilled workers. Chapter 4 examines the growing pressures this has placed on the budget and explores the need to reform the civil service pay system to improve incentives in public administration. Chapters 5 and 6 explore how fiscal space for human capital investment can be achieved through the more efficient use of resources within the health and education sectors. With poverty trends stagnating and the pressures on the budget to address the impact of higher energy prices growing, Chapter 7 examines the long-run sustainability of the pension system to determine the extent to which it poses a risk to future fiscal space. Finally, Chapter 8 addresses the significant inefficiencies in the Government's social assistance programs.

B. RECENT MACROECONOMIC DEVELOPMENTS

1.5 Since 2000, Moldova's strong growth performance has reversed a decade of economic decline and rising poverty. The economy has grown by nearly 40 percent since 2000 with average real growth of around 7 percent per annum. This economic recovery has led to a massive movement out of income poverty. Between 1999 and 2003, over 37 percent of the population moved out of poverty, the largest absolute decline in poverty in the Europe and Central Asia region over this period. The decline in absolute poverty was broad-based and poverty fell across all locations. Inequality, as measured by the Gini coefficient, has been on a slight downward trend since the late 1990s. Starting in 2004, however, poverty reduction has stalled despite continued vigorous economic growth. This latest trend in poverty, the increase in poverty rates seen in 2005, heightens concerns that rapid economic growth is no longer reducing poverty.

1.6 The major source of growth in Moldova has been domestic household consumption and construction fueled by massive inflows of workers' remittances – officially recorded at nearly 30 percent of GDP in 2005. While growing slowly as a share of GDP, private domestic investment has averaged only 17 percent of GDP since the beginning of recovery. During the economic recovery, the increase in domestic output has relied more on increased capacity utilization rather than significant additions to capacity. While remittance inflows are likely to continue to support strong consumption growth in the short run, over the medium-term Moldova will need to generate a stronger and more robust domestic supply response. Indeed, as the opportunities reaped from labor shedding and increased capacity utilization are exhausted, future gains in productivity will require increasing domestic investment and innovation. Similarly, public investment has remained very low with the result that key public infrastructure, particularly roads, has continued to deteriorate with negative implications for growth. Finding the fiscal space for increases in
growth-enhancing public investment will be an important part of the strategy to change Moldova’s underlying growth paradigm.

Table 1.1: Moldova: Macroeconomic Framework, 2001-2008

<table>
<thead>
<tr>
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<th>Actual</th>
<th>Estimated</th>
<th>Projected</th>
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<tbody>
<tr>
<td></td>
<td>2001 2002 2003 2004</td>
<td>2005 2006 2007 2008</td>
<td></td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>6.1 7.8 6.6 7.4</td>
<td>7.1 3.0 3.0 5.0</td>
<td></td>
</tr>
<tr>
<td>CPI Inflation (average, %)</td>
<td>9.8 5.3 11.7 12.5</td>
<td>11.9 12.3 10.5 8.9</td>
<td></td>
</tr>
<tr>
<td>Exchange rate (average, MDL/$)</td>
<td>12.9 13.6 13.9 12.3</td>
<td>12.6 .. .. ..</td>
<td></td>
</tr>
<tr>
<td>Real effective exchange rate, %</td>
<td>-1.2 -6.1 -5.4 12.8</td>
<td>-1.3 1.8 -6.5 -2.9</td>
<td></td>
</tr>
<tr>
<td>Revenues and grants, % of GDP</td>
<td>29.2 29.6 34.0 35.4</td>
<td>39.5 40.3 42.4 41</td>
<td></td>
</tr>
<tr>
<td>Expenditures and net lending, % of GDP</td>
<td>29.4 31.5 33.3 34.6</td>
<td>37.9 40.3 44.4 43.2</td>
<td></td>
</tr>
<tr>
<td>Primary balance (cash), % of GDP</td>
<td>3.8 0.7 2.3 2.7</td>
<td>3.0 1.3 1.0 0.7</td>
<td></td>
</tr>
<tr>
<td>Overall balance (cash), % of GDP</td>
<td>-0.4 -1.4 0.2 0.8</td>
<td>1.7 0.0 -0.5 -0.5</td>
<td></td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>-2.5 -4.6 -7.1 -2.0</td>
<td>-8.3 -10.4 -7.2 -4.2</td>
<td></td>
</tr>
<tr>
<td>Exports G&amp;S growth (percent)</td>
<td>14.7 19.1 20.9 27.3</td>
<td>13.3 2.1 14.6 12.6</td>
<td></td>
</tr>
<tr>
<td>Imports G&amp;S growth (percent)</td>
<td>12.0 18.9 33.5 22.8</td>
<td>29.1 18.1 11.1 9.0</td>
<td></td>
</tr>
<tr>
<td>Gross official reserves (months of imports)</td>
<td>2.1 1.9 1.7 2.1</td>
<td>2.2 2.3 2.4 2.7</td>
<td></td>
</tr>
<tr>
<td>Total External debt/GDP, %</td>
<td>105.1 100.8 88.7 63.8</td>
<td>54.7 51.6 55.1 53.7</td>
<td></td>
</tr>
<tr>
<td>of which, public and publicly guaranteed (PPG)</td>
<td>77.0 61.1 52.5 35.6</td>
<td>28.7 24.1 24.8 23.1</td>
<td></td>
</tr>
<tr>
<td>External Arrears (millions $US)</td>
<td>17.5 42.9 86.1 50.6</td>
<td>56.3 0.0 0.0 0.0</td>
<td></td>
</tr>
<tr>
<td>PPG debt service to exports of GNFS, %</td>
<td>24.6 27.9 19.8 21.0</td>
<td>20.3 16.7 14.4 14.1</td>
<td></td>
</tr>
<tr>
<td>PPG debt service to revenues, %</td>
<td>59.5 52.8 34.7 25.2</td>
<td>17.7 14.9 13.7 12.5</td>
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Sources: Moldovan authorities (MTEF), IMF Article IV Staff Report, December 2006.
Fiscal accounts in the table are for those of the general government.

1.7 While strong economic performance in Moldova’s main trading partners has encouraged a rapid increase in exports (averaging 19 percent over 2001-2005), the remittance-fueled increase in consumption has pushed up import growth even faster (averaging 23 percent over the same period). As a result, the trade deficit has continued to worsen, exceeding 40 percent of GDP in 2005. With large inflows of workers’ remittances (31 percent of GDP in 2005), the current account deficit has been more modest (averaging slightly over 4 percent of GDP since 2000). Over the longer run, with underlying pressures on the real exchange rate to appreciate, the increased international competitiveness needed to close this large trade gap will require an increase in domestic productivity. This will require significantly more domestic private and public investment, as well as foreign direct investment, than is currently undertaken.

1.8 Monetary policy has strived to achieve a number of objectives, including maintaining a competitive exchange rate, keeping inflation low and accumulating a precautionary level of international reserves. The large inflow of remittances has contributed to appreciation pressure on the real and nominal exchange rate underscoring the need for more rapid improvement in domestic productivity. The National Bank of Moldova (NBM) has actively intervened in the foreign exchange market and has been rapidly accumulating foreign exchange reserves. To rein in the monetary impact of these interventions – and the inflationary pressures - the NBM increased its sterilization efforts and slowed reserve money growth.

1.9 Economic management has been complicated by recent increases in natural gas prices. Since Moldova imports nearly all of its energy needs, the recent increases in energy prices have had a severe impact on Moldova. For most of the recovery period, Moldova paid significantly
lower prices for natural gas than the rest of Europe - $80 vs. $235/thousand cubic meters (mcm).
In 2006, Russia substantially increased the price of natural gas paid by Moldova - to $160/mcm by mid-2006 - with further increases in prices a possibility. The impact of this increase has been to put additional pressures on the underlying trade and fiscal deficits. It has directly raised the cost of electricity, natural gas and oil products procured by the Government at all levels adding pressures to the budget. Further, to prevent the reemergence of the large quasi-fiscal deficits of the 1990s, the Government has largely passed these higher energy prices on to final consumers. This has created rising pressures for additional subsidies and transfers that complicate the management of fiscal policy. Given that these energy price shocks have a high degree of permanence, the economy will need to adjust to the new reality of higher natural gas prices. From a policy perspective, preventing monetary and exchange rate policy from bearing an excessive burden of achieving the needed macroeconomic adjustment, some support from fiscal policy will be required.

1.10 The economic recovery has also greatly improved Moldova's external debt outlook. Combined with the impact of US dollar appreciation, net repayment to creditors and favorable rescheduling operations, the ratio of total external debt to GDP fell from 106 percent of GDP in 2001 to around 55 percent in 2005. At the end of 2005, Public and Publicly Guaranteed (PPG) debt amounted 28 percent of GDP (down from 65 percent of GDP in 2001). Debt to multilateral creditors, primarily the World Bank (International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)) and IMF (International Monetary Fund) amounted to nearly two-thirds of total PPG debt. Debt to bilateral creditors, primarily Paris Club creditors (and chiefly Russia) comprised the remainder of the total. Compared to 2001, debt to commercial creditors has declined to very small levels (less than 4 percent of total debt). In Net Present Value (NPV), PPG external debt is around 24 percent of GDP or 50 percent of exports. The NPV of PPG debt to revenues ratio is around 62 percent (88 percent including domestic currency public debt) while the ratio of debt service to revenues is around 9 percent. Consistent with the authorities' medium-term fiscal program, supported by the IMF's PRGF, a further decline in the debt-to-GDP ratio is projected, with the NPV of public sector debt-to-GDP ratio declining to 10 percent by 2025. It is largely as a result of the fiscal adjustments achieved since 2001 that Moldova has overcome what was previously thought to be a structural debt sustainability problem.

C. OVERALL FISCAL PERFORMANCE

1.11 Fiscal Deterioration during the Transition. Up to 1999, fiscal performance in Moldova was mixed. As was highlighted in the previous public expenditure review - World Bank (2003) Moldova: Public Economic Management Review (PEMR) - poor economic performance combined with weak budget processes, low tax enforcement capacity and poor governance resulted in severe and unsustainable fiscal imbalances during the 1990s. While on a declining trend for most of this period (see Figure 1.1), fiscal revenues and grants ranged between 35 and 40 percent of GDP. However, fiscal expenditures, at between 45 and 50 percent of GDP, were much higher. The resulting fiscal deficits, which averaged more than 6 percent of GDP, were financed through a combination of external financing, domestic borrowing and domestic payment arrears - mostly on social expenditures, including pensions.
With only a relatively small portion of external debt contracted on concessional terms, public and publicly guaranteed (PPG) external debt rose sharply from almost zero in the early 1990s to peak at 81 percent of GDP in 2000 making Moldova one of the most heavily indebted countries in the region and raising concerns about debt sustainability.

1.12 The 1998 regional financial crisis forced the Government to tighten fiscal policy dramatically. With the negative shock to economic activity, government revenues dropped sharply. As can be seen in Figure 1.1, government revenues fell from almost 40 percent of GDP in 1995-1999 to under 30 percent of GDP by 2001 as the economic recession contributed to the erosion of the tax base. More importantly, both the external source of deficit financing and the market for domestic T bills dried up. Given the need to consolidate the foreign reserve position of the National Bank, the Government's access to central bank resources was also curtailed.

1.13 The fiscal retrenchment necessitated by the regional crisis resulted in a sharp drop in expenditures. Between 1997 and 1999, expenditures dropped by more than 14 percentage points of GDP. With spending on health, education and social protection comprising the largest items in the budget, spending in these sectors fell steeply, both as a share of GDP and in real terms. This "forced" fiscal adjustment resulted in a sizable improvement in the overall fiscal (cash) deficit of the general government – moving from an average deficit of 8.4 percent in 1996-1999 to 3.5 percent in 2000 thereby setting the stage for the markedly improved economic and fiscal performance experienced during the economy recovery.

1.14 Economic Recovery and the Creation of Fiscal Space. The economic recovery, which began in earnest in 2001, resulted in a significant upsurge in fiscal revenues and a reduction in the external debt servicing burden. By 2005, total revenues had recovered almost all of the lost ground at the end of the 1990s, growing to nearly 40 percent of GDP. Interest and amortization payments, which had consumed nearly 30 percent of the general government budget in 2001, were cut sharp as a result of limited external borrowing, rapid economic growth, exchange rate appreciation and improved debt management. With access to budget financing remaining limited, these developments gave the Government the significant fiscal space to increase public expenditures. Total expenditures have increased by nearly 9 percentage points of GDP since 2001. With the brunt of the fiscal retrenchment falling on social programs, however, the government placed a heavy emphasis on increasing social spending during the economic recovery. As a result, to the detriment of Moldova’s future growth prospects, very little of the fiscal space achieved during the recovery has been used to increase growth-enhancing public investment.
### Table 1.2: Revenues and Expenditures in Moldova, 2001-2005

(Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Revenues and Grants</strong></td>
<td>29.2</td>
<td>29.6</td>
<td>34.0</td>
<td>35.4</td>
<td>39.5</td>
</tr>
<tr>
<td>Tax revenues</td>
<td>24.4</td>
<td>25.8</td>
<td>27.5</td>
<td>29.8</td>
<td>32.3</td>
</tr>
<tr>
<td>Direct Taxes</td>
<td>3.7</td>
<td>4.0</td>
<td>4.3</td>
<td>4.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Indirect Taxes</td>
<td>13.9</td>
<td>14.6</td>
<td>16.0</td>
<td>16.1</td>
<td>18.5</td>
</tr>
<tr>
<td>of which: VAT</td>
<td>7.9</td>
<td>9.0</td>
<td>10.1</td>
<td>10.7</td>
<td>12.6</td>
</tr>
<tr>
<td>Social and Health Fund Contributions</td>
<td>6.8</td>
<td>7.3</td>
<td>7.2</td>
<td>8.8</td>
<td>9.3</td>
</tr>
<tr>
<td>Non-tax revenues</td>
<td>3.9</td>
<td>3.1</td>
<td>2.6</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Grants</td>
<td>0.9</td>
<td>0.6</td>
<td>0.3</td>
<td>0.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Other Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenditures and Net Lending</strong></td>
<td>29.4</td>
<td>31.5</td>
<td>33.3</td>
<td>34.6</td>
<td>37.9</td>
</tr>
<tr>
<td>National Economy</td>
<td>1.7</td>
<td>1.8</td>
<td>3.6</td>
<td>4.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Social sphere</td>
<td>16.6</td>
<td>19.5</td>
<td>20.9</td>
<td>22.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Education</td>
<td>4.8</td>
<td>5.5</td>
<td>6.7</td>
<td>6.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Social Fund expenditures</td>
<td>7.2</td>
<td>8.4</td>
<td>8.2</td>
<td>8.6</td>
<td>10.0</td>
</tr>
<tr>
<td>Health &amp; Health Fund expenditures</td>
<td>2.8</td>
<td>3.5</td>
<td>3.9</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Other social expenditures</td>
<td>1.7</td>
<td>2.0</td>
<td>2.2</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Interest payments</td>
<td>4.2</td>
<td>2.2</td>
<td>2.1</td>
<td>1.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Other Expenditures</td>
<td>7.1</td>
<td>8.3</td>
<td>6.7</td>
<td>6.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Balance of Special Accounts and statistical discrepancy</td>
<td>-0.1</td>
<td>0.6</td>
<td>-0.4</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Overall Fiscal Balance (cash)</td>
<td>-0.4</td>
<td>-1.4</td>
<td>0.2</td>
<td>0.8</td>
<td>1.7</td>
</tr>
<tr>
<td>Primary Fiscal Balance (cash)</td>
<td>3.8</td>
<td>0.7</td>
<td>2.3</td>
<td>2.7</td>
<td>3.0</td>
</tr>
</tbody>
</table>

**Sources:** MTEF 2007-2009 and IMF, Staff Report for 2006 Article IV Consultations.

1.15 While the Government neglected the need for increased public investment, it has been very successful in improving of the overall fiscal policy stance. During the recovery the increase in public expenditures has been kept in line with the increase in revenues. Indeed, starting in 2003, the fiscal accounts of the general government have even moved into surplus. On average, during 2001-2005 the overall fiscal balance has been slightly positive (0.2 percent of GDP) while the primary balance has been decidedly so (2.5 percent of GDP). Since the adverse effects of fiscal deficit on economic growth is well documented in theoretical and empirical studies, it is not surprising that Moldova's adherence to prudent macroeconomic policies since 2001 has been an important contributor to restoration of economic stability and the resumption of growth.

### D. Is the Size of Government Too Large?

1.16 In addition to the fiscal stance, the recent empirical literature also suggests that the size of government itself may have important implications for economic growth. Even though overall fiscal discipline is being maintained, growing and disproportionately high levels of government expenditures raises some concern about the impact of fiscal policy on Moldova's future growth prospects. Large public expenditures require high levels of taxation. High tax rates are, in turn, thought to reduce the rate of saving and investment as well as distort the incentive to work. In the case of Moldova, the tax policy need to finance government expenditures may also contribute to the incentive to migrate, particularly among highly skilled workers.
### Table 1.3: Revenues and Expenditures Relative to the Predicted International Norm (percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Revenues</th>
<th>Over (under)-</th>
<th>Expenditures</th>
<th>Over (under)-</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Predicted</td>
<td>Performance</td>
<td>Actual</td>
</tr>
<tr>
<td>Armenia</td>
<td>13.0</td>
<td>23.6</td>
<td>-10.6</td>
<td>20.9</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>15.0</td>
<td>23.6</td>
<td>-8.6</td>
<td>27.9</td>
</tr>
<tr>
<td>Belarus</td>
<td>39.0</td>
<td>25.8</td>
<td>13.2</td>
<td>44.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>32.0</td>
<td>29.4</td>
<td>2.6</td>
<td>37.4</td>
</tr>
<tr>
<td>Georgia</td>
<td>14.0</td>
<td>22.4</td>
<td>-8.4</td>
<td>19.4</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>23.0</td>
<td>26.2</td>
<td>-3.2</td>
<td>22.4</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>18.0</td>
<td>20.9</td>
<td>-2.9</td>
<td>28.4</td>
</tr>
<tr>
<td>Latvia</td>
<td>28.0</td>
<td>28.4</td>
<td>-0.4</td>
<td>35.9</td>
</tr>
<tr>
<td>Lithuania</td>
<td>26.0</td>
<td>28.9</td>
<td>-2.9</td>
<td>31.9</td>
</tr>
<tr>
<td>Russia</td>
<td>35.0</td>
<td>27.6</td>
<td>7.4</td>
<td>27.4</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>15.0</td>
<td>19.3</td>
<td>-4.3</td>
<td>20.7</td>
</tr>
<tr>
<td>Ukraine</td>
<td>31.0</td>
<td>25.4</td>
<td>5.6</td>
<td>39.4</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>31.0</td>
<td>20.9</td>
<td>10.1</td>
<td>31.8</td>
</tr>
<tr>
<td>Moldova</td>
<td>28.0</td>
<td>20.5</td>
<td>7.5</td>
<td>34.5</td>
</tr>
</tbody>
</table>

Sources: OECD and World Bank database and staff estimates.

Note: Based on regression framework used by Lorie (2003). Includes 65 advanced, transition, and middle-income countries. Data refer to 2004. Double-log regression of expenditure to GDP ratio on PPP income per capita and regional dummies.

1.17 Compared to other countries with similar income levels, Moldova spends and taxes too much. Table 1.2 presents cross country data for 2004 for transition economies. In terms of the share actual tax revenues mobilized and expenditures in GDP, Moldova falls somewhere the middle of the group of transition countries. However, after taking into account Moldova’s low level of income, the predicted share of revenues and expenditures that would be expected in Moldova is among the lowest in the region (exceeding only Tajikistan). Thus, relative to this predicted “international norm”, Moldova is over performing on both the revenue and expenditure front.\(^2\) Revenues are nearly 8 percentage points of GDP higher than one would expect of a country of similar income levels, while expenditures are nearly 7 percentage points higher.

1.18 What is the impact of the size of government on economic growth? The ability of an economy to support a large public sector is not only related to the size of government, it is also related to the quality of public programs. Effective public institutions and good governance may mitigate the impact of a large public sector on growth. As shown in Figure 1.2, there is no negative relationship between the size of Government and economic growth in countries with strong public institutions.\(^3\) In countries where public institutions are weaker, a category that currently includes Moldova, the size of the public sector has a decidedly negative impact on

\(^2\) The econometric comparison is based on a large group of developed and developing countries and takes account of income differentials as a way to assess whether a country is over or under performing relative to some “international norm” (i.e. the predicted level of revenues or expenditures based on, among other things, per capita income in PPP terms).

growth. Further, this impact is even more acute as the size of government moves beyond a certain threshold. The empirical evidence suggests that in countries where expenditures levels exceed 35 percent of GDP, an increase in expenditures by 1 percentage point reduce growth by 0.3-0.4 percent per year. This suggests that the current size of Government in Moldova - 38 percent of GDP in 2005 – is reducing growth by an estimated 0.9-1.1 percent per annum.

Figure 1.2: The Size of Government and Economic Growth

1.19 How, then, does Moldova reduce the size of Government? A key element of this fiscal adjustment will be improvements to the business and fiscal environment that encourage private sector saving, investment and innovation and, hence, private sector led growth. In addition to reducing the administrative and regulatory burdens imposed on private entrepreneurs, the Government needs to support this growth effort by changing the composition of expenditures to emphasize growth-inducing public investment in human capital, infrastructure and economic services. Of course, reforming public expenditure policy in order to increasing the efficiency and quality of public spending is also critical and this topic is the main theme explored in the subsequent chapters of this report.

1.20 Reducing the size of Government will, however, also require constraining the increase of expenditures relative to GDP growth. As shown in Figure 1-3, continued rapid increases in public consumption, as proposed by the MTEF expenditure plan, suggest that the size of government will continue to grow over the medium term. If, however, the growth in public expenditures were constrained to 2 percent in real terms, then the size of Government would decline over the medium term and approach the threshold level of 35 percent indicated above.

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4 This analysis utilizes the expenditure plan envisaged under the MTEF, but alters the growth assumption so that economic growth will slow to 3-4 percent rather than remain at level of 6 percent assumed by the MTEF.
E. **Is Taxation Limiting Growth Prospects?**

1.21 With the economic recovery, total general government revenues and grants have increased by nearly 8 percentage points of GDP to reach 40 percent of GDP. Given Moldova's status as a low income country, the ability to mobilize this sizable amount of tax resources (i.e. over perform relative to the international norm) is a notable achievement. At the same time, however, it must be reiterated that this relatively large tax burden has the potential of discouraging all important private sector investment and innovation. The creation of fiscal space through further increases in taxation, therefore, is not a desirable option. The Government has already taken steps some important steps to reduce the burden of taxation, cutting personal income and corporate profit taxes. It has also strengthened tax administration - concentrating mainly on improving collection of indirect taxes. This PER concentrates on public expenditures. A separate note will focus on issues related to taxation and tax administration. For completeness, however, this section provides a brief overview of the revenue side of the budget.

1.22 The bulk of revenues come from tax revenues (as opposed to non-tax revenues) and have accounted from almost all the increase in revenues since 2000 (see Table 1.3). The growth in tax revenues has been the reflection of the rapid growth in GDP and foreign trade as well as the increase in nominal wages.

1.23 Since 2000, direct taxation has increased as a share of GDP, and comprising about one-third of total revenues and grants. Taxation of personal income and corporate profit, however, has not been a major contributor to overall tax revenue mobilization. Motivated by a desire to enhance the business environment, and broaden the tax base as well as by a need to avoid losing competitive ground to neighboring countries on tax competitions grounds, the government has in the last few years reduced personal income and corporate profit tax rates. The corporate tax rate has been reduced steadily from 28 percent in 2001 to 15 percent in 2006. Over the same period, the highest personal income tax rate has been cut from 28 to 20 percent. The trend toward lower
tax rates, in Moldova and elsewhere in the region, has not generally resulted in lower tax revenues leading some to suggest that this is evidence of a "Laffer curve" effect. While rate reductions may be conducive to growth, it heightens the need for improvements in tax administration enforcement mechanisms and simplifications of the tax structure.

### Table 1.4: General Government Revenue Trends (percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenues and Grants</td>
<td>34.8</td>
<td>32.1</td>
<td>33.2</td>
<td>35.3</td>
<td>35.6</td>
<td>40.0</td>
</tr>
<tr>
<td>Revenues</td>
<td>30.6</td>
<td>28.3</td>
<td>29.0</td>
<td>30.6</td>
<td>32.1</td>
<td>35.6</td>
</tr>
<tr>
<td>Tax revenues</td>
<td>25.8</td>
<td>25.2</td>
<td>26.6</td>
<td>28.1</td>
<td>30.6</td>
<td>33.0</td>
</tr>
<tr>
<td>Direct Taxation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit tax</td>
<td>11.3</td>
<td>11.5</td>
<td>13.8</td>
<td>13.8</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Income tax</td>
<td>11.5</td>
<td>11.5</td>
<td>13.8</td>
<td>13.8</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Social Fund contributions</td>
<td>11.3</td>
<td>11.5</td>
<td>13.8</td>
<td>13.8</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Health Fund contributions</td>
<td>11.3</td>
<td>11.5</td>
<td>13.8</td>
<td>13.8</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Indirect Taxation</td>
<td>16.1</td>
<td>14.7</td>
<td>15.3</td>
<td>16.6</td>
<td>16.8</td>
<td>19.9</td>
</tr>
<tr>
<td>VAT</td>
<td>8.4</td>
<td>7.9</td>
<td>9.0</td>
<td>10.1</td>
<td>10.7</td>
<td>12.6</td>
</tr>
<tr>
<td>Excise</td>
<td>4.1</td>
<td>3.6</td>
<td>2.9</td>
<td>3.2</td>
<td>2.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Taxes on foreign trade</td>
<td>1.4</td>
<td>1.2</td>
<td>1.5</td>
<td>1.7</td>
<td>1.5</td>
<td>1.9</td>
</tr>
<tr>
<td>Other taxes</td>
<td>2.2</td>
<td>2.0</td>
<td>1.9</td>
<td>1.5</td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>Non-Tax Revenue</td>
<td>4.8</td>
<td>3.1</td>
<td>2.4</td>
<td>2.5</td>
<td>1.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Special resources and funds</td>
<td>3.4</td>
<td>3.1</td>
<td>3.6</td>
<td>4.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Grants</td>
<td>0.8</td>
<td>0.8</td>
<td>0.6</td>
<td>0.3</td>
<td>0.4</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: MTEF and IMF Article IV staff report.

1.24 Most of the revenues from direct taxation are in the form of social and health fund contributions. The increase in this source of taxation is the result of the impact of high nominal wage growth (140 percent since 2001) on the collection of social insurance fund contributions as well as the introduction of mandatory health insurance contributions in 2004. The bulk of these contributions are paid by the employer. In the last few years, however, there has been an effort shift some of this taxation onto the employee's shoulders. In 2001, the social insurance premium was 32 percent, of which the employer paid 31 percent. By 2006, this premium had been reduced to 29 percent with the employer paying 26 percent. This trend is expected to continue over the medium term with the employer share dropping to 23 percent by 2009. The reduction in the social insurance premium also reflects the introduction in 2004 of a mandatory health insurance premium. This premium, currently at 4 percent - split equally between employer and employee – is expected to increase to 5 percent in order to expand the available package of health services.

1.25 One of the main features of Moldova’s tax system is the high degree of indirect taxation as well as the high taxation of labor. Social and health insurance premiums, combined with the personal income tax, represent a high tax wedge on labor income. As is well known, high labor income taxation impedes employment generation, particularly in the formal labor market.
Improved tax administration combined with the longer-term potential for the social and health funds to generate surpluses introduces the possibility of reducing the taxation of labor. Chapter 7 discusses this issue, and the implied tradeoffs, in the context of the financial sustainability of the Moldovan pension system.

1.26 Indirect taxation still contributes the most to tax revenues (nearly 50 percent). As evident from Table 1.3, the composition of this taxation has been shifting towards the VAT (Value Added Tax) which now collects (in net terms) nearly 13 percent of GDP. The standard VAT rate in Moldova is 20 percent with the number of goods and services (mainly in the agricultural sector) with zero rate VAT having been reduced in the last few years. The steep growth VAT collection (nearly 5 percentage points of GDP since 2000) is a reflection of the very rapid growth in imports. While duties collected on foreign trade are relatively insignificant, nearly 90 percent of VAT revenue is collected by Customs on imported goods. The VAT now constitutes nearly 38 percent of total tax revenue.

1.27 The appropriate balance between direct and indirect taxation in Moldova will be explored in a separate note. For now, however, suffice it to say that the Moldova needs to reduce the tax burden on the economy. The fiscal space for lower taxation will come from sustained fiscal discipline (thereby enabling a further reduction in the debt burden), better control and efficiency of primary expenditures, broadening the tax base and reducing the size of the informal sector.

F. COMPOSITION OF EXPENDITURES

1.28 The increase in fiscal revenues over the recovery has given Moldova the room to increase public spending. While the share of public expenditures in GDP is still below the levels achieved during the mid-1990s (reflecting many inherited expenditures programs from Moldova’s past), the current level of public spending in Moldova is high. Further, the consumption orientation of the public spending has been crowding out growth promoting public investment expenditures (i.e. infrastructure and quality improvements in health and education). For a given level of spending, changing the composition of overall expenditures in favor public investment will contribute to improved long-term growth prospects. At the same time, as the various sector-specific chapters of this PER will attest, the efficiency with which public resources are utilized must also improve. Given the need to contain the size of government so as to avoid crowding out private sector activity, the fiscal space needed to increase these growth-promoting expenditures can be only be obtained by containing growth in public consumption and improving the efficiency of these expenditures.

1.29 This section presents three different ways of looking at the composition of Government expenditures: by functional classification, economic classification and various parts of the general government.

1.30 Functional Classification of Expenditures. The increase in public expenditures since 2001 has been dominated by the social sectors – nearly 90 percent of the increase in public expenditures has been in those sectors (Table 1.4). As a result, social spending has not only increased as a share of GDP, it has consumed a growing share of the budget - from 58 percent of the budget in 2001 to nearly 63 percent in 2005. Overwhelmingly, the increase in social spending has been concentrated on social assistance and protection, mainly in the form of higher pensions. Chapter 5 examines health expenditures in greater detail, while Chapters 6, 7 and 8 look at education, pensions and social assistance spending.
Table 1.5: General Government Expenditures – Functional Classification (Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expenditures</td>
<td>30.6</td>
<td>34.4</td>
<td>33.3</td>
<td>35.2</td>
<td>38.0</td>
</tr>
<tr>
<td>General Public Services, External Activities and Judicial authorities</td>
<td>2.0</td>
<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
<td>2.5</td>
</tr>
<tr>
<td>Defense, Public Order and Safety</td>
<td>2.1</td>
<td>3.1</td>
<td>2.7</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Social Expenditures</td>
<td>17.8</td>
<td>21.5</td>
<td>20.8</td>
<td>22.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Education</td>
<td>5.7</td>
<td>6.9</td>
<td>6.7</td>
<td>6.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Recreation, Culture and Religion</td>
<td>0.5</td>
<td>0.7</td>
<td>0.7</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Health</td>
<td>3.2</td>
<td>4.1</td>
<td>4.0</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Social Insurance and Assistance</td>
<td>8.3</td>
<td>9.8</td>
<td>9.4</td>
<td>10.2</td>
<td>11.5</td>
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<tr>
<td>Economic, Environment and Science</td>
<td>2.2</td>
<td>3.8</td>
<td>4.0</td>
<td>4.8</td>
<td>6.0</td>
</tr>
<tr>
<td>Other expenditures</td>
<td>1.7</td>
<td>1.3</td>
<td>0.8</td>
<td>0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Interest payments</td>
<td>4.3</td>
<td>2.2</td>
<td>2.1</td>
<td>2.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Net lending</td>
<td>-0.1</td>
<td>-0.3</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

Source: MTEF and IMF, Article IV Staff Report

1.31 So-called economic expenditures - predominately spending on agriculture - have also increased significantly. As noted in World Bank’s Agricultural Policy Note on Public Expenditures (2006), however, the level of public spending on agricultural is low when compared to the importance of the sector in the economy and spending in other countries. There is ample international evidence of the strong positive impact of agricultural expenditures – particularly on public goods such as research and development, rural infrastructure and education - on pro-poor growth. In Moldova, however, this type of spending has been negligible with most the spending going toward product and input subsidies for larger operators. Under the reform program supported by the Poverty Reduction Support Credit program, the Government has committed itself to reducing wasteful recurrent agriculture subsidies and increasing growth-enhancing spending in the sector.

1.32 The share of expenditures devoted to interest payments on debt has declined significantly as a result of the accumulation of primary fiscal surpluses since 2001 as well as limited external borrowing. In 2001, interest payments consumed 14 percent of total expenditures. Adding amortization payments to this figure, total debt service paid by the budget was nearly twice that figure. By 2005, however, the burden of servicing current and past debts had fallen considerably. While rapid growth and the appreciation of the exchange contributed to this decline, the Government also created fiscal space for increased social spending by running arrears on some external debts owed to bilateral creditors.
As shown in Figure 1.4, over this period Moldova accumulated significant external payment arrears. Starting in 2004-2005, part of these arrears were cleared as a result of restructuring deals with bilateral creditors (Romanian and Turkey), cancellation of state guarantees on some EBRD loans (Giurgiulesti and Vininvest) and commercial creditors (Gazprom and Hewlet-Packard). In May 2006, a rescheduling agreement was reached with remaining Paris Club creditors that, in addition to restructuring future debt service payments, has also resulted in the clearance of these remaining arrears.

1.33 Economic Classification of Expenditures. Over ninety percent of public expenditure is on recurrent spending. The single largest category is transfers to households. Overwhelmingly, this is comprised of pension and social assistance spending. Chapters 7 and 8 explore these expenditure programs in greater detail. The increase in spending on Goods and Services reflects the introduction of health insurance and transfers to the MHIF, described in Chapter 5.

1.34 The rapid increase in public consumption has crowded out capital spending. As shown in Table 1.5, public sector capital expenditures appear to be a relatively significant and growing share of GDP. As shown in Chapter 2, however, the presentation of capital expenditures in the budget is complicated by a number of measurement issues - such as the inclusion of maintenance expenditures or spending on repairs that should be treated as current spending – that tend to exaggerate the extent of public sector capital expenditures. If one makes an effort to exclude some of this current spending from the investment budget, it is apparent that public investment, particular investment in infrastructure, is still very low (see alternative measure at bottom of Table 1.5). Further, a significant share of capital spending comes from foreign finance investment project which may not represent a sustainable source for needed capital spending. As already noted, the lack of investment in public infrastructure is detrimental to Moldova’s future growth prospects. Chapter 3 describes the inter-temporal trade-offs and economic costs implied by this limited investment effort as they pertain to road infrastructure.

1.35 The second largest portion of current expenditures is devoted to staffing costs (i.e. wages broadly defined). When the Government created the MHIF in 2004, healthcare workers previously recorded at public sector employees were moved “off the books” since the facilities operated by the MHIF were considered financially self-sufficient entities. One of the implications of this treatment is that, starting in 2004, the staff cost of most healthcare workers is no longer included in the public sector wage bill. Instead, these expenditures show up indirectly in Goods and Services, among other expenditure categories. The discrete downward jump in wages evident in Table 1.5, therefore, belies the growing pressures of public sector wages on the government. As noted in Table 1.5 (alternative measure), the wage bill of public sector, broadly defined, is closer to 11 percent of GDP, has grown sharply since 2003 and now comprises nearly 30 percent of total public expenditures. As international experience suggests, the downward stickiness of nominal wages in the public sector and the lack of instruments for rationally...
downsizing the public payrolls make it difficult to adjust the wage bill during economic downturns. Further, in the absence of reforms to increase the productivity of public workers, planned increases in public sector wages risks further crowding out government operational and capital expenditures. Chapter 4 examines the public sector wages in greater detail and underscores the need for reform to the pay system.

Table 1.6: General Government Expenditures – Economic Classification

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Expenditures</strong></td>
<td>31.5</td>
<td>33.3</td>
<td>34.6</td>
<td>37.9</td>
</tr>
<tr>
<td><strong>Current Expenditures</strong></td>
<td>26.9</td>
<td>28.9</td>
<td>29.8</td>
<td>31.7</td>
</tr>
<tr>
<td><strong>Wages</strong></td>
<td>9.5</td>
<td>9.6</td>
<td>7.8</td>
<td>8.0</td>
</tr>
<tr>
<td><strong>Goods and services</strong></td>
<td>6.9</td>
<td>6.2</td>
<td>7.8</td>
<td>8.1</td>
</tr>
<tr>
<td><strong>Interest payments</strong></td>
<td>2.2</td>
<td>2.1</td>
<td>1.9</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Transfers</strong></td>
<td>10.5</td>
<td>10.3</td>
<td>11.6</td>
<td>14.2</td>
</tr>
<tr>
<td><strong>Transfers to economy</strong></td>
<td>1.4</td>
<td>1.6</td>
<td>2.0</td>
<td>2.8</td>
</tr>
<tr>
<td><strong>Transfers to households</strong></td>
<td>9.1</td>
<td>8.8</td>
<td>9.7</td>
<td>11.5</td>
</tr>
<tr>
<td><strong>Other current expenditure</strong></td>
<td>-2.1</td>
<td>0.7</td>
<td>0.6</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Capital expenditure</strong></td>
<td>5.0</td>
<td>4.6</td>
<td>5.0</td>
<td>6.4</td>
</tr>
<tr>
<td><strong>Net credit</strong></td>
<td>-0.3</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

**Memo: Alternative measures**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Sector Staffing Costs</strong></td>
<td>9.5</td>
<td>9.6</td>
<td>10.4</td>
<td>10.8</td>
</tr>
<tr>
<td><strong>Public Investment</strong></td>
<td>2.9</td>
<td>2.8</td>
<td>3.0</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Sources: MTEF and IMF Article IV Staff Report

1.36 Intergovernmental Composition of Expenditures and Revenues. Total revenues and expenditures of the General Government are distributed organizationally between the State Budget, the Budgets of the Administrative Territorial Units (ATUs or local governments), the State Social Insurance Fund (SSIF) and resources of the Mandatory Health Insurance Fund (MHIF). It is not surprising that the Central Government - the State Budget - with its ability to raise taxes on a national or cross regional level collects the bulk of fiscal revenues (62 percent). Local governments, on the other hand, have been much more limited in their ability to mobilize the revenues they need to fund their expenditure requirements. In 2005, nearly 40 percent of ATU expenditures were financed by transfers from other budgets, primarily the State Budget. The SSIF has seen expenditures - primarily pensions - increase rapidly, reaching 10 percent of GDP by 2005. The SSIF has also been financing expenditures by drawing down accumulated savings (i.e. deposits with Banks). Mandatory Health Insurance was introduced in 2004, funded by a 4 percent payroll tax (split equally between employer and employee) as well as a 2% tax on other forms of remuneration. Spending by the MHIF has increased rapidly and by 2005 amounted to around 4.3 percent of GDP. (around 75% of total MHIF expenditures constituted transfers from the state budget).
Inter-governmental fiscal decentralization efforts in Moldova have been rather spasmodic, going through two contradicting modifications. In 1998, the old Soviet local government system of 40 rayons was transformed into a smaller system of 10 judets. While this initial effort put in place the foundations of a sensible legislative framework, it was followed by the absence of complementary regulation and poor implementation. As a result of the perceived inefficaciveness of decentralization, these modifications were reversed in 2003, leading to the return of the rayon administration and the abolishment of judets. Completing fiscal decentralization and reform of intergovernmental fiscal relations remains one of the key institutional and economic development challenges facing Moldova. Although many public sector functions have been pushed downward by the central government to subnational Intergovernmental fiscal decentralization efforts in Moldova have been rather spasmodic, going through two contradicting modifications. In 1998, the old soviet local government system of 40 rayons was transformed into a smaller system of 10 judets. While this initial effort put in place the foundations of a sensible legislative framework, it was followed by the absence of complementary regulation and poor implementation. As a result of the perceived ineffectiveness of decentralization, these modifications were reversed in 2003, leading to the return of the rayon administration and the abolishment of judets. Completing fiscal decentralization and reform of intergovernmental fiscal relations remains one of the key institutional and economic development challenges facing Moldova. Although many public governments, in practice this represents more a deconcentration of central government's fiscal administration than the decentralization of fiscal policy decision-making. Local governments are still highly dependent on the center with accountability remaining hierarchical and vertical, rather than directed at local constituents. As a result, the government's attempts to rationalize the state and improve the efficiency of expenditures have been hampered.

A more adequate fiscal decentralization may represent a great potential for increased efficiency and accountability in the Moldovan public sector. To be successful, however,
decentralization requires a harmonic system of proper revenue and expenditure assignments, an appropriate intergovernmental transfer mechanism to address vertical imbalances and horizontal fiscal disparities, as well as enhanced local autonomy and accountability. The examination of this topic will be undertaken in the future stage of the PER work in Moldova.

G. PUBLIC FINANCIAL MANAGEMENT

1.39 While this report doesn’t undertake an in-depth examination of public financial management, it is important to note that the Government has achieved impressive progress in consolidating the national budget formulation process. The introduction of the MTEF as a strategic planning framework for the regular budget cycle was the main vehicle for improvement. The MTEF has been developing gradually since 2002 as a comprehensive analytical framework. For a given set of macroeconomic assumptions, the MTEF provides decision makers with a projection of the expected national public budget (including the state budget, local budgets, state social insurance budget, funds for state health insurance) outcomes for a three year time horizon. The MTEF is currently updated annually at the initial stage of budget formulation and accompanies the annual budget laws presentation to the Parliament. The comprehensiveness of the MTEF approach has promoted adjustments in the coverage of the annual state budget law to incorporate extra-budgetary funds, as well as the donor funded investment projects. The Government is working on further improving the strategic policy focus of the budget through developing stronger linkages between the MTEF and strategic national policy documents (i.e. the EGPRSP and EU (European Union)-Moldova Action Plan). An important area for further improvement is the development of the capacity at the line ministries’ level to link expenditure planning to sectoral policy priorities.

1.40 Progress has also been achieved in strengthening of the national treasury system and preparing for its modernization. Controls over budget execution have been significantly tightened through the gradual expansion of the treasury coverage that includes by now the budgets of territorial administrative units, extra budgetary funds and means, and revenues of the social and health insurance budgets. The budget execution process is expected to be modernized in the next few years on the basis of internationally recognized methodologies simultaneously with the replacement of the existing patchy semi-automated treasury system with the modern FMIS. Further consolidation of the budget execution process and improvements in cash management are planned through implementation of the Treasury Single Account (TSA) concept. At the same time, the Government is preparing for important changes in public sector accounting and reporting. The new integrated budget classification and chart of accounts system is being developed on the basis of the GFS2001 standards to be launched with the new Financial Management Information System (FMIS). Multiple versions of the chart of accounts currently in use by different levels of budget entities will be replaced with a unique chart of accounts compliant with cash based International Public Sector Accounting Standards (IPSAS).

1.41 The development of the public sector auditing capacity has also been receiving growing Government attention recently. The concept for the development of the modern Government internal audit function in line with EU requirements was recently developed with support from the PFM project. At the same time, Moldova’s supreme audit body, the Court of Accounts (COA) has indicated a willingness to develop into a modern external audit institution along the EU counterparts through launching its medium-term strategic development plan.
H. CONCLUSION

1.42 The increase in fiscal revenues that accompanied Moldova’s economic recovery has given it substantial room to increase Government expenditures. Despite devoting nearly 40 percent of GDP to public expenditures, and even accounting for the prospect of increased external grant assistance, there are still a host of unmet demands on the budget. Roads are in dreadful shape, higher natural gas prices are increasing the demand on social safety nets, public sector wages and pensions are still very low and poverty—particularly rural poverty—is high. Almost all of fiscal space achieved during the recovery, however, has gone to increase public consumption—particularly, public sector wages, transfers and subsidies—expenditure items that have been severely eroding in the transition process. As a result, critical infrastructure needs are largely neglected and state assets, such as roads, hospitals and schools, continue to deteriorate at an alarming rate.

1.43 Moldova must confront the reality that the size of Government has grown too large. The tax burden needed to support high levels of government consumption spending negatively affect private saving and investment decisions and may limit Moldova’s future growth prospects. This burden is compounded by the fact that the public sector’s contribution to investment is critically low. As long as public expenditures are increased at a slower rate that GDP, the size and burden of government will gradually decline.

1.44 If Moldova is to accelerate growth and poverty reduction, it must curtail excessive public consumption spending and increase spending on public investment while at the same time reducing the overall footprint of Government. Cutting wasteful spending in the education and health sectors, for example, frees resources for more investment spending in those sectors. Increased spending on roads will put a halt to the deterioration of this vital infrastructure, and support increased private sector activity and greater international competitiveness. Improving the targeting of social assistance allows these programs to more effectively protect vulnerable groups by freeing up these misdirected resources. Completing the reforms to the pension system reduces the accumulation of future unfunded liabilities and puts public finances on a sounder footing. The reform to public financial management currently underway provides an opportunity to strengthen the linkages between spending prioritization and budget management. This process of fiscal adjustment is essential to put economic growth on a solid and sustainable trajectory.
Box 1: Issues in Public Expenditure Management: Summary of Previous Findings

This Public Expenditure Review builds on a knowledge base of issues in public finance in Moldova that has been accumulated over time through various studies and in the course of public-finance related project preparation and implementation. The scope and coverage of the PER is thus driven in large part by the availability of detailed information on aspects of public finance in Moldova. In particular, there have been several recent efforts to examine major issues in public expenditure management. We summarize some of their main findings below:

The World Bank's 2003 Public Economic Management Review (PEMR) conducted a comprehensive review of the budget process in Moldova, including strategic decision-making, budget coverage, budget formulation and execution. The report suggested measures for improving the comprehensiveness of budget coverage by, among other things, incorporating externally financed projects and extra-budgetary funds. In addition, the report suggested improvements to the quality of macroeconomic forecasts and revenue projects underpinning the budget process. It also suggested broadening the coverage of the expenditure commitment control system and procedures to strengthen budget execution. To support budget execution and monitoring further, the report encouraged the production of budget reports that comprehensive, timely and reliable. Similarly, the 2003 Country Financial Management Accountability Assessment (CFAA) found the financial accountability framework in Moldova to be weak, characterized by a fragmented budget framework process, inefficient cash management, weak internal control and internal and external audit.

The IMF has also been actively engaged in expenditure management issues in Moldova. The 2004 Report on the Observance of Standards and Codes—Fiscal Transparency Module assessed practices in fiscal transparency in Moldova and noted the lack of integration of extra-budgetary and donor-financed funds into the central government budget, the lack of coordination between state and local governments, weaknesses in the preparation and monitoring of the budget on a general government basis. The 2006 Report on Observance of Standards and Codes examined, among other things, the availability of fiscal data, its coverage, periodicity, and timeliness. It noted weaknesses in available fiscal data, including the absence of published information on expenditure by economic classification. Neither are consolidated central government data disseminated. Another recent paper (2005) notes the absence of comprehensive monthly budget reports. It also assesses the treasury system and noted weaknesses in cash management driven in large parts by the resources and funds not fully integrated into the treasury system.

The recently completed Public Expenditure and Financial Accountability (PEFA) Assessment documents many of the strengths, as well as remaining weaknesses, in the public finance management system of Moldova. In particular, the assessment noted the improved credibility of the budget and gave the system high marks in transparency and public access to key fiscal information. At the same time, the assessment observed the limited effectiveness of payroll controls, the lack of a consolidated overview of fiscal risk (including the financial performance of state-owned enterprises and joint stock companies), the weaknesses in financial and performance audit (including the lack of legislative scrutiny and involvement), and challenges in fully incorporating donor support into budget processes and management.

Many of the recent improvements in the budget process (also discussed in the main text) reflect key recommendations from these earlier studies. An ongoing World Bank-supported Public Finance Management project has also been working with the Government to improve the budget process.

2. INVESTING FOR ECONOMIC GROWTH: PUBLIC INVESTMENT PLANNING AND MANAGEMENT IN MOLDOVA

A. INTRODUCTION

2.1 Deficiencies in public infrastructure represent a considerable constraint to economic growth in Moldova. Despite the demand for upgrading and expanding the public infrastructure in Moldova, public investment has remained quite low in recent years—only about 2 percentage points of GDP. This underscores the need to increase the amount of public investment spending. The limited availability of public resources also highlights the importance of strengthening the management of public investment in order to ensure that the available resources are utilized effectively and efficiently.

2.2 Because public resources are limited, there is a need to prioritize and plan government investment strategically. Over the last few years, the Government has significantly improved the budget preparation process and the strategic allocation of resources, mainly through the introduction of the Medium Term Expenditure Framework (MTEF). The Government has also taken steps to integrate the investment budget into the MTEF and the annual state budget. The latest MTEF (2007-2009), for example, includes an investment annex reviewing actual spending in recent years and proposing an investment budget through 2009.

2.3 Despite these achievements, a number of weaknesses remain. Public investment planning and budgeting still remains fragmented. Furthermore, the portfolio of investments being implemented remains too large compared to the available financing. In addition, investments are being undertaken without adequate consideration being given to the requirements for financing of downstream recurrent costs. For further rationalization of the public investment portfolio, a number of improvements are required in the identification, prioritization, preparation and appraisal of projects. Nascent steps towards integrating externally financed investment expenditures need to be further strengthened.

2.4 This chapter aims to clarify weaknesses in the investment budget process and identify opportunities for increased efficiency. In particular, this chapter of the PFR seeks to describe the current public investment program in Moldova and examine the institutional features of public investment budgeting. First, it will document the present level and sectoral composition of ongoing investment projects. In addition, this section will examine the investment program’s current and projected sources of financing. Second, it will examine the budget preparation process, including the links between investment expenditures and budget allowances for future recurrent costs and debt service, the budget time horizon, the integration of investment projects into the annual budget (or the medium-term expenditure framework), and the measures in places to ensure investment projects are economically and technically sound. This section will also look at arrangements for managing project implementation, monitoring, and ex post evaluation.

II. Level and Composition of Public Investment

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5 There have been indications that both foreign and domestically financed investments will now be covered within the Ministry of Finance by a single agency, but this remains unclear.
The Measurement of Investment Expenditure in Moldova

2.5 There are three major issues in the measurement of investment expenditure for Moldova to conform to international practice. First, investment expenditures in Moldova have too narrow a definition, which needs to be broadened to correspond to best international practices. Second, with respect to budget presentation and budget preparation, investment budgeting remains fragmented, with local government investment spending, for example, often functioning as a residual. Finally, repair or maintenance spending, which are, in principle, recurrent spending, are often classified under capital or investment spending. This is somewhat related to the broader discussion on whether “public investment” should include not just the acquisition of fixed assets but also the development of institutional capacity, the development of management systems and procedures, and others. In this chapter, we generally use the term “public investment” in the narrower sense of capital spending, or the acquisition of fixed assets, and excluding maintenance spending, the training or the upgrading of systems and procedures.

2.6 “Objects” as units of measurement. In Moldova, public investment is typically understood in term of small, separate “objects.” In contrast, based on international practice, investment units are typically understood in terms of “projects.” A project may consist of distinct components (conceptually similar to ‘objects’ in the Moldovan context) necessary to achieve a project’s intended objectives; for example, a project that aims to provide additional secondary school facilities in a certain geographic area consists of several components including the construction of such facilities, the provision of the necessary equipment for these facilities, the connection of these facilities to network sources of energy, and so on. While such components may be financed separately or constructed by separate contractors, it is typically much more convenient for analytical and budgeting purposes to think of these outputs as components of a single project. Projects, in turn, are typically grouped under broader programs to facilitate budget analysis and clarify the cross-sectoral allocation of resources.

2.7 The fragmentation of the investment budget. Until recently, externally-financed investment projects as well as projects financed by “special fund and resources” were not clearly identified nor integrated into the annual budget. Domestically-financed capital spending, on the other hand, was identified as a single item. Local government investment expenditures continue to be reported separately. The fragmented presentation of investment budgets, and the lack of an integrated investment budgets reflect a more fundamental fragmentation in the budget preparation system, as described in the next section.

2.8 The classification of maintenance spending. For analytical purposes, maintenance expenditures or expenditures on standard repairs are typically classified under “current spending,” following international practice or the Government Finance Statistics (GFS) classification system. In Moldova, such routine maintenance spending has sometimes been classified under capital spending, leading to the overestimate of such spending.

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6 The information provided in this section is drawn in large part from Groom (2005) and confirmed by the consultations with national authorities.

7 Note that some of the foreign-financed expenditures may still include some training and upgrading of management systems.
Trends in Investment Expenditure: Level and Composition

2.9 Based on the preceding discussions, the level and trends in expenditure allocation depend on how narrowly or how broadly one defines “public investment.” Measuring public investment as broadly as possible, including expenditures that are typically understood in international practice as current spending (e.g., spending on the maintenance of existing assets), suggests that public investment has averaged about 5 percent of GDP in recent years. Meanwhile, a very recent attempt by the government to capital spending, excluding maintenance and other recurrent expenditures, over the last few years suggests that between 2002 and 2005, average capital spending was about 3 percent of GDP (Figure 2.1).

2.10 Measurement issues notwithstanding, a few things stand out from existing data on public investment. The include the following:

2.11 First, capital spending has been relatively low. Compared to other countries in the region, capital spending in Moldova is significantly lower, on average, in percent of GDP (Figure 2.2). Based on cross-country data for 2004 using comparable data across transition economies, capital spending in other countries in the region is close to 4-5 percent of GDP. Many of the EU accession candidates and CIS countries, in fact, spend over 5 percent of GDP.

2.12 Second, infrastructure spending has been low and has decreased as a share of total spending over time (Figure 2.3). Public spending on infrastructure currently amounts to about 2 percent of GDP. As a share of total public investment spending, infrastructure decreased from 72.7 percent in 2002 to 56.2 percent in 2005 (Figure 2.3).\(^8\) As defined in the MTEF, “infrastructure” includes public investment in agriculture, environmental protection, industry and construction; transports, road services, communications and information; utilities and residential services, fuel and power industry, among others.

\(^8\) Despite this decrease, the estimated levels of infrastructure spending may still be exaggerated as maintenance spending and capital spending are often blurred in the budget process. With respect to externally-financed public investment, much of this spending reportedly accrues toward capacity building activities and efforts to introduce new management systems and procedures.
2.13 Of total infrastructure spending, the gas network program accounts for the largest share. The gas network project (also known as the “gasification program” or the effort to connect rural households to the natural gas network), in fact, has accounted for about half of the central government’s investment spending and dominates planned central government investment program through 2010. As a result, there have been few investment opportunities for other sectors. Investment in the health sector has been mostly in the form of maintenance or repair of existing facilities. There has been little or non-existent investment in the transportation sector and as a result the road network has deteriorated with a substantial portion of the network classified as in poor condition. Starting with the 2007 budget, however, is projected to allocate more resources toward this sector.

2.14 Third, local budgets finance about a third of all investments. Domestic spending is increasingly dominated by local government spending. Local government spending has grown rapidly in recent years to account for most of domestic spending by 2002. Financing of capital investments from local budgets is not predictable, as they are basically not planned by local budgets. When state investment budget falls short, local authorities direct part of their resources towards investments. Not surprisingly, the medium term-budget over the 2007 to 2009 period excludes local budgets’ planned investments.

III. Public Investment Planning and Management

2.15 Public investment budgeting in Moldova has a relatively short history. In the 1990s, Moldova developed two Public Investment Programs (PIPs), with very disappointing results. Because they were mainly a tool for drawing external assistance, they were developed independent of the budget process and with no clear connection to the strategic priorities of the government. Some of the key weaknesses of the PIP process are summarized in Box 2.

2.16 There are notable improvements in the budget process in general over the last few years, including in particular, in the area of investment planning and management.

- First, the investment budget, covering both domestic and externally financed investment, has been gradually incorporated into the state budget with the budget annex providing details of the relevant projects.

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9 Local budgets are observed to “underestimate” own-revenues. During the budget rectification process, local governments then direct “extra” resources to investment purposes.
Box 2: Moldova’s Experience with PIPs, 1994-1997

Current practices and weaknesses in investment budget management mirror many shortcomings in Moldova’s previous two Public Investment Programs (PIPs). The first PIP was prepared in 1994 and covered the 1995 to 1997 period. It included 19 investment projects amounting to some $169 million. The second PIP was prepared in 1997 and covered the 1998 to 2000 period. The program consisted of some 36 projects amounting to $1.3 billion of which close to 40 percent of budgeted resources were allocated to the transport sector. Projects included in the PIP were typically proposed by line ministries and were examined by the Ministry of Economy. They were then submitted for approval to the Inter-Ministerial Committee on External Relations.

The notable weaknesses of the PIPs include the following:

First, the PIP represented one component in a fragmented investment budget. Like many of the PIPs initiated in transition economies in the 1990s and in many developing countries before then, these programs were mainly a vehicle for soliciting external financing. The Ministry of Finance had limited involvement in the PIP budget process and the PIP excluded projects that were completely financed by domestic resources. Instead, the PIPs covered only projects with external financing.

Second, the portfolio of investments was often too large and overambitious given available financing. The first PIP was prepared from a list of about 4,000 public investment "objects", many of which were inherited from the Soviet period. The number of “objects” was subsequently trimmed, reducing the cost of the program from an original $1.9 billion to $169 million, but overtime in the PIP process appeared to have quadrupled in size, expanding its sectoral scope and significantly exceeding available financing.

Third, many of the projects appeared to have been poorly selected, with little regard for their economic value and with little reflection on the proper public and private roles in the provision of these investments. A review of the first PIP revealed a number of projects that were private and commercial in nature, such as a cement factory at Rezina. The expansion of the gas network to connect rural households, proposed in 1994-95, was found to be of little economic value. In contrast, few resources appear to have been allocated to the rehabilitation of existing public assets, such as roads.

Fourth, the PIPs appear to have had a poor implementation record. Of the 19 projects listed in the 1995-1997 program, only one project was started by August 1997, with another project tendered around that same period. The Government’s review of the experience with the first PIP blamed “insufficient capacity to complete the preparatory phase of the new projects,” among other reasons.11 Little is known about the implementation record of the second PIP. However, it appears that the second PIP secured little of the financing request for implementation and was subsequently discontinued with the election of the new government in 2001.

- Second, the MTEF has also facilitated improvements in the annual budget process. Four MTEFs have been prepared since 2002 and has provided greater discipline in the annual budget process and improvements in sectoral planning and allocation within the overall resource envelope, as reflected in the budget proposals submitted by line ministries.12

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12 These weaknesses are described in the PFM project document and they include the lack of political commitment to the MTEF to make it more binding on the annual budget exercise, the quality of macroeconomic
• There are efforts to plan public investments more strategically. As mentioned, an MTEF technical annex was recently prepared on public investment.\(^\text{13}\)

2.17 Nonetheless several weaknesses remain, as documented below.

2.18 **Budget presentation.** Public investment projects are not integrated into a fully consolidated general government investment budget, as of the most recent Annual Budget Law (2007), reflecting the broader fragmentation of the general government budget. There is no consolidated general government investment budget. While budget information on investment expenditures exists separately for donor-financed spending, special funds and means, the National Social Insurance Fund and the Health Insurance Fund budgets, and local government budgets, they are not consolidated for presentational purposes. Investment spending is thus also currently included in several different places within the annual budget document. Projects financed by external credits and grants are listed in an annex to the budget. Domestically financed investments at the central government level are usually included as a budget line within the budgets of various line ministries.

2.19 **Budget preparation.** The investment budget process is best understood within the context of the annual budget process. The MTEF guides the annual budget process and provides the basis for the overall annual resources envelope and expenditure ceilings that in turn determine annual budget negotiations. It is not, however, submitted to the Parliament for discussion or approval, although it was sent for information in the latest round. While the MTEF provides broad guidance to the strategic allocation of resources, the basis for allocation of investment resources more narrowly is not explicit.

2.20 The procedures for selecting public investment projects, whether across sectors or within sectors, are not clear and there is no evidence that the analysis of expected benefits and costs of proposed projects (whether based on economic returns, poverty impact, or some other measurable goal) factor into project screening, selection and prioritization.\(^\text{14}\) Public investment is also hampered by the persistent overhang of uncompleted projects. The Government’s list of ongoing investment projects is derived from a list of uncompleted projects, some of which date back to the Soviet period. Of the total list of 449 projects (or ‘objects’) drawn up in 1999, the Government selected 251 projects and abandoned the rest. It is estimated that that the 198 projects abandoned would have required 3.3 billion lei to complete in 2000 prices, or 20 percent of GDP. In 2005, the list of projects was further trimmed down to 201.

2.21 **Multiple decision-making authorities.** The MTEF is prepared jointly by several agencies including the Ministry of Economy, Ministry of Finance, National Bank of Moldova and various line ministries. The Ministry of Economy takes the lead in preparing the macroeconomic forecasts. For the annual budget process as a whole, the Ministry of Finance is the lead agency in budget planning and budget preparation. It also leads the intersectoral working group that coordinates the sectoral allocation of resources. For the 2005 and 2006 annual budgets, the forecasting, and the lack of technical capacity to assess the immediate and future recurrent costs of policy intervention.

\(^\text{13}\) A capital investment program was reportedly prepared in 2005 by the Capital Investment Directorate (CID) within the Ministry of Finance but the document has not been made publicly available.

Capital Investments Division of the Ministry of Finance led the formulation of the capital investment program within the MTEF process. For the 2007 annual budget, a unit within the Ministry of Economy was leading efforts to introduce a more strategic setting of priorities in public investment across sectors. A technical annex on investment spending for the 2007-2009 MTEF has been prepared by the interministerial working group led by the Ministry of Economy and Trade with participation of other ministries, including the Ministry of Finance (see the new MTEF), with proposed expenditure ceilings for the relevant sectors. Defining the intra-sectoral priorities within these ceilings is an exercise to be carried out during the budget cycle.

2.22 The Role of Parliament. Significant reallocation of investment resources is carried out by Parliament, including the deletion of proposed projects and the addition of new projects. Prior to 2005, the investment budget law was passed separately by Parliament and included major revisions to the draft investment budget submitted by the Government. Line ministries report final allocation of investment resources that bear little resemblance to their original proposal. The process of mid-year budget rectification, and the significant amount of resources involved (initial revenue projections are typically conservative and, in recent years, budget rectifications increase actual expenditures to accommodate significantly higher actual revenues) leads to additional reallocation of resources, unrelated to the stated sectoral allocation indicated by the MTEF (see for example Table 2.1). In particular, while education appears to be the key priority area for investment within the EGPRSP, the energy sector (the 'gasification' project), in practice, has dominated the investment budget.

2.23 While the local government appears to have assumed a greater role in Moldova's public investments, it is not clear how local government budgets are prepared with respect to the aggregate investment budget. It appears that local government spending functions as a residual or a source of funding for bridging financing gaps in the proposed investment program of selected ministries.

2.24 Budget Execution and Monitoring. After the annual budget law is approved by Parliament, the Ministry of Finance distributes the allocation limits. Line ministries and spending agencies enter into contracts for procuring goods and services based on the appropriations; these contracts are in turn registered and verified by the Agency for Regional Development. With respect to investment projects, the work is verified by the Ministry of Finance in consultation with line ministries, spending agencies and local government units. Treasury verifies that request for payments submitted by line ministries and spending agencies are consistent with appropriations and the availability of funds. Payment orders are then processed by Treasury and transfers are made between accounts. Local government units conduct their operations through territorial treasury branches.

2.25 Main responsible agencies. For domestically-financed investments, the Ministry of Finance and its various directorates is the lead agency for managing budget execution and monitoring. With respect to externally financed investment projects, such projects, until recently, were not fully integrated into the budget monitoring processes. These projects, typically managed by Project Implementation Units (PIU), followed their own accounting and reporting practices (reflecting in part donor-specific practices in accounting and procurement) and were outside the treasury and mainstream fiscal operations. Efforts are underway to integrate these projects more fully into state budget monitoring. PIUs are now required to report activities to the Public Debt Directorate (PDD) within the Ministry of Finance, on a monthly basis. The PDD in turn reports to the treasury. There have been proposals to prepare comprehensive reports on budget execution, including by functional classification.
Table 2.1: Investment Budget Allocation 2005

<table>
<thead>
<tr>
<th>Sector</th>
<th>EGPRSP Costs (covered by the MTEF)</th>
<th>MTEF 2005-2007</th>
<th>Budget Law</th>
<th>Mid-Year Budget Rectification</th>
<th>Actual Budget</th>
<th>Ratio of EGPRSP Budget to Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>57,200</td>
<td>28,644</td>
<td>18,659</td>
<td>52,839</td>
<td>68,300</td>
<td>0.84</td>
</tr>
<tr>
<td>Sector</td>
<td>6,180</td>
<td>8,751</td>
<td>10,100</td>
<td>14,310</td>
<td>9,680</td>
<td>0.64</td>
</tr>
<tr>
<td></td>
<td>5,740</td>
<td>53,920</td>
<td>45,588</td>
<td>157,649</td>
<td>248,339</td>
<td>0.02</td>
</tr>
</tbody>
</table>

(In thousand MDL)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Education</th>
<th>Health</th>
<th>Energy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.16</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td></td>
<td>0.08</td>
<td>0.02</td>
<td>0.15</td>
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<td></td>
<td>0.05</td>
<td>0.03</td>
<td>0.12</td>
</tr>
<tr>
<td></td>
<td>0.14</td>
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<td>0.43</td>
</tr>
<tr>
<td></td>
<td>0.19</td>
<td>0.03</td>
<td>0.68</td>
</tr>
<tr>
<td></td>
<td>0.84</td>
<td>0.67</td>
<td>0.03</td>
</tr>
</tbody>
</table>

(In percent of GDP)

Sources: National authorities and World Bank staff estimates.

Weaknesses in Investment Budget Management

2.26 As reviewed in the previous section, there have been many notable improvements in investment budgeting, due in large part to the introduction of the MTEF process. However, as illustrated by the brief review of the experience with PIPs, several weaknesses in the PIP budget process reflect weaknesses that persist in current budget practices. The review further illustrates how the focus of the PIP process on securing external financing and its separation from the rest of domestic budget processes may have significantly limited its usefulness. Rather than reviving the PIP process, however, the Government should be exploring opportunities for strengthening current procedures, with the objective of facilitating the realistic planning and programming of the investment budget within the MTEF framework. The following are some persistent challenges in investment budgeting and opportunities for improvement:

2.27 There is no clear mapping of the investment program to EGPRSP priorities. The EGPRSP is an ambitious plan for sustaining growth and poverty reduction and undertaking the necessary structural reforms to meet the needs of a market economy. While the public spending envisioned by this development plan exceeds available financing, it does lay out a strategic direction for the allocation of scarce government resources. In practice, however, there is no clear alignment between these stated priorities and budget planning. In particular, in the case of public investments, weaknesses in the project selection process as well as multiple decision makers involved in the budget process have typically led to the final sectoral allocation of resources that are radically different from that intended by the EGPRSP (see for example Table 2.1). While the fundamental issues regarding the strategic allocation of resources are not specific to the investment budget process, improving the efficient allocation of scarce public investment...
resources is critical in light of massive investment and infrastructure upgrading needs of Moldova. This will require effort along the following fronts:

**Box 3: Investment Budget Preparation: Some Examples**

In South Korea, the authorities recently introduced the concept of preliminary feasibility studies (PFS) to promote efficiency in the selection of major infrastructure investment projects. Based on the new initiative, every large-scale project expected to exceed US$50 million is subject to a PFS, under the direction of the Ministry of Planning and Budget (MPB). The PFS consists of two sections: an economic assessment utilizing cost-benefit analysis and a policy analysis, covering social issues that are difficult to quantify. The policy analysis section, in turn, is subject to two different types of assessment, one based on “common criteria” (regional development impact, regional economic impact, environmental impact assessment, and others) and “project-specific criteria” based on the recommendations of the PFS Review Committee. To synthesize the results of the economic and policy analyses, MPB uses a multi-criteria decision-making process, with the results of the economic analysis typically more heavily weighted (65 percent) than the policy analysis (35 percent). Between 1999 and 2004, some 209 projects were evaluated of which about 129 were passed. For these projects, budgets were allocated for more detailed feasibility study and basic design. Proposals have been made to scale up this process, primarily applied to large construction programs, to other areas such as subsidy programs.

In Chile, a comprehensive evaluation of public investment projects is led by the Budget Department of the Ministry of Finance. Public investment project proposals are submitted by line ministries, which are then assessed and prioritized by the Department. Chile has some 30 years of experience in the use of economic analysis in public investment screening and appraisal and in the systematic evaluation of public spending, more broadly, it is considered by many to be a good practice example expenditure management. Some 60 percent of public spending is evaluated in a systematic way. Cost-benefit analysis of public investment began in the 1970s and has been sustained and improved over time. Chile is also reported to have been making an effort to strengthen ex post monitoring and evaluation.

In Latvia, based on a review of its investment planning and management in the 1990s, the Bank recommended the development and articulation of clear priorities and strategies to drive the allocation of investment resources. The review also recommended the rigorous application of cost-benefit analysis to all projects included in the public investment program. A preliminary assessment was also carried out, during the review process, of the share of high-priority projects (based on expected impact) and low-priority project in the existing public investment budget. They also compared these broad shares with available financing.

In the U.S., the General Accountability Office provides some useful guidelines for assessing proposed investments and their projected effects. The present a series of questions meant to address (1) the productivity-enhancing potential of a project; (2) the value of an investment; (3) whether the design contributes or hampers a project’s effectiveness; and (4) how to create the conditions for effectively evaluating the actual results of an investment.


- First, there is the fundamental need to clarify the Government’s priorities given multiple planning documents: In addition to EGPRSP, there are the EU Action Plan, the Moldovan Village Program and sector-specific strategic plans. While there is plenty of overlap in these planning documents, the multiplicity of planning documents also suggests that the list of strategic priorities may be overambitious.

- Second, a related point, many of these planning documents and list of priorities are not fully costed; not surprisingly, there is no full financing for these priorities. The Government thus needs to clarify, given limited domestic and external resources, what are the priorities for spending and for investment expenditure more narrowly. The
alternative—allocating inadequate financing to many investment projects—is not efficient. As such, investment projects are taking several times longer to complete due to inadequate funding provision. These projects, therefore, consume valuable public resources without providing timely economic benefits.

2.28 Third, submitting the MTEF to Parliament for information and discussion early in the budget preparation process may support greater fiscal discipline and closer alignment of the Government’s stated priorities and the final allocation of resources. The use of economic analysis of the costs and benefits on investment projects may provide a clearer ranking of investment priorities to support the Parliament’s decision-making process. Grouping smaller objects within wider projects, as suggested earlier, may also limit space for the micro-management of the investment budget, as currently practiced.

2.29 The investment budget remains fragmented (i.e., external versus domestic, central versus local). Despite recent gains in medium-term planning of investments and presenting more fully all investment projects in the annual budget law, there are a few challenges remaining. A complete list of investment projects, integrating domestically and externally financed projects, needs to be compiled and aggregated within major programs and sectors. Such a comprehensive list can then be reviewed for consistency with the broader government strategy. A consolidated general government budget on investment will facilitate improvements in policy and planning.

2.30 The budget preparation process does not involve systematic procedures for project screening and project selection. Project screening includes the initial project identification stage. This involves the careful initial screening of the project concept and scope, and its alignment with the Government’s stated priorities, before the proposed project advances into more detailed preparation and appraisal stages (including detailed feasibility studies, cost-benefit analyses, social and environmental impact analyses, where appropriate and an assessment of the financial viability of the proposed projects based on these studies). Project selection then selects for funding, within the MTEF/budget process, a subset of sound projects from among those previously screened, given that public resources are insufficient to finance every sound, proposed project.

2.31 In Moldova, some documented rationale is required for proposed projects, but otherwise no systematic economic evaluation, cost-benefit analysis or feasibility studies of project proposals are carried out although systematic assessments are required by the organic budget law. As a result, there is no technical assessment of lower-cost alternatives to the proposed public investment projects. Recognizing that the technical capacity required for conducting meaningful cost-benefit analyses can be quite demanding, an emphasis on the project identification stage—where the project concept and alignment with strategic priorities are assessed—may go a long way toward ensuring a better use public resources in Moldova.

2.32 There are also clear opportunities for greater efficiency and fiscal savings, where policy problems meant to be addressed by proposed investment projects may lend themselves to non-engineering solutions or lower-cost alternatives such as public-private partnerships or regulatory reforms to encourage greater private sector participation. In some cases, ensuring the sustained financing of non-wage, recurrent maintenance costs may be more economically viable that new

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15 Such an aggregation has previously been used in other countries leading to a substantial reallocation of resources across sectors and across programs, within sectors.
16 See Groom (2005) for a more in-depth discussion of various stages of the project cycle and how they are related to the budget process.
investment spending, in the long-run. In Moldova, however, many public assets have deteriorated in the absence of steady spending on maintenance. In other cases, other instruments for public intervention may be more appropriate. For example, experience with public infrastructure investments or investment in utilities in other economies in transition suggest that, in some cases, a policy of deregulation or price liberalization in transportation or the increase in energy prices to full cost-recovery—to create incentives for private sector investment—may make more economic sense than the public provision of infrastructure. These are of course related to the more fundamental review of the proper public and private roles in capital spending. In a number of economies in transition, such a review has helped weed out a number of proposed projects that were primarily commercial in nature and leftover from the central planning period. A similar review in Moldova may be productive and a normative framework for public investment, illustrated in Box 3, may be helpful.

2.33 First, wide disparities still exist in budget drafts submitted by line ministries and in draft budget submitted to Parliament, despite the reported greater realism in the budget submissions of line ministries and spending agencies. This could be an indication of the persistent of unrealistic budget planning and overambitious list of strategic priorities.

2.34 Building the technical and institutional capacity to facilitate the creation of an environment for evidence-based, strategic policymaking will involve, of course, non-trivial efforts. But the payoffs, with respect to reductions in the waste of resources and improvements in the efficiency of government spending, are well worth the cost.

2.35 While the Government has taken steps to introduce greater predictability in the budget process, many weaknesses remain. There are a number of opportunities for introducing greater discipline in the investment budget process:

2.36 Second, a more comprehensive assessment of the fiscal impact of new public investment will be useful, including its longer-term impact on public resources. There are currently no systematic efforts to estimate the implied future recurrent expenditure requirements of new investment projects, the so-called “r coefficients” or the ratio of incremental recurrent costs to total investment, for both domestically financed investments as well as externally financed investments. These coefficients reflect the amount of maintenance spending, repairs, and personnel expenditures required for the efficient functioning of a completed investment project. In some countries, the computation of these coefficients has served to demonstrate that some investment projects were unsustainable in the long run. Table 2.2 reports indicative r-coefficients by sector for selected World Bank-supported investment projects across countries. The coefficients reflect in large part significant differences in economic environments across countries and they should be interpreted as illustrative ranges. They suggest that the incremental recurrent spending requirements can be substantial. For example, a 0.03 r-coefficient suggests that a 40 million MDL investment projects requires additional recurrent spending each year of about 1.2 million MDL. Similarly, there are no efforts to explicitly identify the co-financing requirements of externally-financed investment. Such efforts, when introduced, may promote greater predictability and transparency in the budget process.

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**Box 4: A Framework for Public Investment**

The role of Government in investments is essentially about the rationale for state intervention in the national economy and the appropriate instrument for government intervention. There are two fundamental rationales for government interventions: market failures (and thus the need to provide public goods and services that promote social and economic development) and redistribution (and thus the need to protect the poor and vulnerable and promote greater equity). While there may be a clear rationale for government intervention, however, the government need not be the sole provider of public services and goods such as basic infrastructure, education and health services. Many examples of successful government intervention involved partnerships with private providers and with markets, more generally. These considerations lead to a decision tree illustrated below.

The challenge for any government is thus to know when to intervene, when not to intervene, and how best to intervene.


<table>
<thead>
<tr>
<th>Table 2.2: R-Coefficients: World Bank Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Projects</strong></td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Education</td>
</tr>
<tr>
<td>Energy</td>
</tr>
<tr>
<td>Environment</td>
</tr>
<tr>
<td>Health</td>
</tr>
<tr>
<td>Telecommunications</td>
</tr>
<tr>
<td>Transportation</td>
</tr>
<tr>
<td>Urban Development</td>
</tr>
<tr>
<td>Water supply sanitation</td>
</tr>
<tr>
<td>Average (unweighted)</td>
</tr>
<tr>
<td>Average (weighted)</td>
</tr>
</tbody>
</table>

*Source: Hood and other (2002)*

2.37 Third, there are no systematic efforts to assess expected future revenues (e.g., user fees) from investment projects. Where investment projects may be largely donor-driven, making explicit the net long-term financing cost (and benefits) of donor-financed investments may clarify whether these investments are indeed consistent with the government’s priorities and fiscal constraints.

2.38 **Clarify responsibilities and lead agencies.** As a critical component of the budget planning process, the primary responsibility for investment planning and budgeting should rest within the Ministry of Finance. In addition, realistic medium-
term planning and budgeting for the investment budget also needs to take place within the MTEF process, a process overseen by the Ministry of Finance. Furthermore, for fully taking into account the recurrent cost implications of investment decisions, investment budget processes built around single lead agency would make sense, and the Ministry of Finance again has a comparative advantage in assessing the future recurrent budget requirement of new investments.

2.39 However, as currently implemented in Moldova, investment planning's lead agency is not defined clearly. For example, the Ministry of Economy recently took the lead in preparing the first MTEF technical annex on the investment budget. The Government needs to designate the lead agency in investment planning and budgeting, and define more clearly the supporting role of other agencies and ministries. One possible arrangement would be for the Ministry of Economy to develop an overall strategy for public investment and identify the priority areas for public investment, while the Ministry of Finance is assigned to oversee the public investment management and financing procedures within the MTEF framework.19

2.40 **Efforts to integrate externally-financed investments in mainstream government monitoring are welcome.** The steps taken to integrate information on the budget execution of externally-financed investment into the treasury system should be sustained. The Government should also explore opportunities for improving budget execution and monitoring processes, such as the ex post evaluation of investments, which can then feed back into more realistic investment budget planning processes.

IV. Conclusions

2.41 Spending on some sub-sectors of the infrastructure remains low. For upgrading infrastructure and sustaining economic growth, Moldova needs to invest more. Deficiencies in public infrastructure represent a considerable constraint to economic growth in Moldova.

2.42 Many improvements have been carried out in recent years in the budget process in general and also for the investment budget process more specifically. Despite these gains, some weaknesses exist in the investment budget management system. The following are the main policy recommendations:

- **Align budget allocations with strategic priorities as articulated in the EGPRS.** A greater consistency between stated priorities and actual budget allocations is needed. While the MTEF has introduced greater budget discipline, the MTEF process by itself cannot be expected to allocate resources strategically A few difficult political choices will have to be made including clarifying the Government's main priorities in the context of multiple planning documents and trimming an ambitious list of priorities to match the Government's capabilities and resources. The framework described in Box 3 may be useful for clarifying the rationale for government intervention and the appropriate instrument for such intervention.

- **Introduce systematic project screening and project selection to ensure the more efficient use of public resources.** Project screening can draw from cost-benefit analysis, environmental impact analysis, or poverty impact analysis, as appropriate. Not every project needs to be subjected to rigorous analysis, and not all projects lend

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19 We thank Andrew Bird and Simon Groom for raising these points.
themselves to cost-benefit analysis and cross-sectoral comparisons. An emphasis on the identification stage, clarifying a project’s concept and assessing its broad consistency with the Government’s objectives may go a long way toward ensuring better use of resources.

- **Clarify the lead agency in managing the investment budget.** There are persistent overlaps in the functions of selected units within the Ministry of Economy and Ministry of Finance. Given current arrangements, institutional mandates, and technical capacity in Moldova, there are benefits to clearly designating the Ministry of Finance as the lead agency in investment programming and management while letting the Ministry of Economy take the lead in develop an overall strategy for public investment and identifying priority areas.

- **Calculate the forward fiscal costs of investment projects.** The required recurrent spending of new investments may be substantial. These should be reflected in the calculations of costs and benefits of investment projects, in a transparent manner.

- **Consider gradually setting up the institutions for ex post evaluation and monitoring.** Lessons of implementation, when properly documented, can then feed into subsequent investment planning and management.
3. SAVING THE ROAD NETWORK

A. THE DETERIORATION OF MOLDOVA’S ROAD ASSET VALUE

3.1 Moldova has a road network totaling about 16,800 km, of which 22% are classified as National Roads and the remainder of 78% as Local Roads. Considering the size of the country and its population, Moldova’s road network size is roughly adequate, with little or no need for expansion. It has been built up gradually over the past seven decades through massive public investments. If Moldova had no roads and today’s network needed to be constructed from scratch, it would cost at least US$ 13 billion. This figure shows the huge magnitude of investment and sacrifice which was made in the past in order to be able to reap the benefits from today’s road network.

3.2 However, Moldova’s road network is not in good condition. About 58 percent of National roads are classified as poor. For local roads the situation is worse, with 75 percent estimated to be in poor condition. Only 10 percent of National roads and about 5 percent of Local roads are in good condition. For any country, and especially for a European country, this is a catastrophic situation. It is the direct result of severe neglect of the road network, mostly during the past 15 years. Very little resources have been spent for road maintenance and rehabilitation since 1991. About 400 km of formerly paved roads have lost their pavement and have reverted to unpaved gravel or earth roads.

3.3 The lack of road maintenance and rehabilitation in the past 15 years has led to a massive physical deterioration and therefore to a heavy loss of road network asset value. The present asset value of the Moldovan road network is only about US$ 8 billion; instead of the US$ 12 billion it would be if the network was well-maintained. This means that the loss of road network asset value which resulted from insufficient maintenance and rehabilitation is a shocking US$ 3.6 billion, equivalent to 1.4 times the entire GDP of Moldova.

B. “SAVING MONEY” BY NOT MAINTAINING ROADS?

3.4 The severe reduction in Government spending for roads after 1990 were imposed in large part by the dramatic collapse of economic activity in Moldova, in the aftermath of the disintegration of the Soviet Union. On the other hand, in the political decision-making on Government spending over the past years, roads were clearly not a priority. Road spending thus became a victim of a true lack of resources and of policy decisions alike. Whatever the reasons were, it is certain that decision-makers felt that road maintenance expenditures where of lesser importance and needed funding for roads was redirected to meet other priorities. How much money should the Government have been spending on roads in order for them to be maintained adequately? Table 3.1 shows the difference (year by year) between the amounts which would have been needed in order to maintain the road network, and the actual amounts spent. The result is that the total amount “redirected” during the period 1991 – 2006 amounted to about US$ 1.47 billion. This calculation is based for one part on the actual expenditures presented in the tables for the period 1997 – 2006, and on rough estimates made by the Bank for the previous period between 1991 and 1996. While Moldova redirected an amount of about US$ 1.47 billion to other priorities, the road network gradually deteriorated, and with it the Road Network Asset Value.
3.5 As shown earlier, the road asset value deterioration between 1991 and 2006 was in the order of US$ 3.63 billion. It is thus simple to conclude that the Net Loss to Moldova was in the order of US$ 2.16 billion, which is equivalent to about 72 percent of Moldova’s GDP of the year 2005. For every one $ redirected in road spending, Moldova lost about $ 2.47 in road asset value.

3.6 The loss of road asset value is however only one of the consequences of the deficient maintenance of Moldova’s roads. While the roads were gradually deteriorating, the cost of operating vehicles on those roads also went up. Bad roads shorten the life of cars and trucks, and impose more repairs, spare parts, fuel, etc. An estimate of the additional road user costs imposed by the deteriorating road condition has been carried out and is shown on Table 3.2. The table compares how much money road users would have spent in Vehicle Operating Costs (VOC) between 1991 and 2006 if the road had been well-maintained, with the actual situation of higher VOC due to the steadily deteriorating road network. The result is that due to deficient road maintenance, road users in Moldova have spend about US$ 1.8 billion or 30 percent more than they would have spent if the road network had been maintained adequately. This amount is equivalent to about 60 percent of Moldova’s GDP of 2005. By reducing competitiveness of Moldova business, higher VOC also undermine private sector investment and, hence, undermine future growth prospects.

3.7 In summary, for every one US$ “saved” by not maintaining the roads adequately between 1991 and 2006, the induced loss was about US$ 3.70, composed of (i) the additional Vehicle Operating Costs road users had to pay of US$ 1.23, plus the deterioration of road network asset value of US$ 2.47.

C. ECONOMIC EFFECTS OF MOLDOVA’S DETERIORATED ROADS

3.8 The effects of Moldova’s deteriorated road network are described well in the transport section of the World Bank’s (2003) Moldova Trade Diagnostic Study:

- Located strategically, Moldova is becoming increasingly important as a future border between the European Union and Eastern Europe. Moldova could become a transport hub for the region, were it not for its deteriorating infrastructure and high logistics costs in comparison to neighboring countries. Moldova’s economy is largely based on agriculture and agro-industry, which depend on a solid road infrastructure, well functioning road transport and adequate storage facilities. Many farmers are unable to commercialize their production due to poor road access between domestic market places, storage facilities and the settlements.
- The poor quality of the road infrastructure severely affects mobility of goods and people especially in rural and poor areas. It is also a significant impediment to expanded trade by imposing additional costs on exporters and importers: over 30 per cent of responding firms in Exporter/Importer survey indicated that Moldovan transport infrastructure had become more of an impediment to their operations during the past five years. Transport costs can affect economic growth in several ways. First, higher transport costs reduce rents earned from the exports of primary products, lowering an economy’s savings available for investments. They push up import prices of capital goods, directly reducing real investments.
Table 3.1: Moldova – Road Sector Expenditures 1997 – 2006 (actual vs. needed)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total actual Road Sector Spending** (Maintenance &amp; Rehabilitation)</th>
<th>Required Spending for Road Maintenance &amp; Rehabilitation</th>
<th>Money &quot;saved&quot; by not maintaining the Roads adequately</th>
<th>Calculation parameters used</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>as share of GDP (%)</td>
<td>as share of Road Asset Value** (%)</td>
<td>as share of Road Asset Value** (%)</td>
<td>Exchange Rate</td>
</tr>
<tr>
<td>Lei (million)</td>
<td>US$ (million)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>106.1</td>
<td>22.97</td>
<td>1.19</td>
<td>0.19</td>
</tr>
<tr>
<td>1998</td>
<td>79.9</td>
<td>14.88</td>
<td>0.88</td>
<td>0.12</td>
</tr>
<tr>
<td>1999</td>
<td>85.9</td>
<td>8.17</td>
<td>0.70</td>
<td>0.07</td>
</tr>
<tr>
<td>2000</td>
<td>88.1</td>
<td>7.09</td>
<td>0.55</td>
<td>0.06</td>
</tr>
<tr>
<td>2001</td>
<td>83.1</td>
<td>6.45</td>
<td>0.44</td>
<td>0.05</td>
</tr>
<tr>
<td>2002</td>
<td>97.9</td>
<td>7.21</td>
<td>0.43</td>
<td>0.06</td>
</tr>
<tr>
<td>2003</td>
<td>103.5</td>
<td>7.43</td>
<td>0.37</td>
<td>0.06</td>
</tr>
<tr>
<td>2004</td>
<td>171.3</td>
<td>13.90</td>
<td>0.54</td>
<td>0.12</td>
</tr>
<tr>
<td>2005</td>
<td>182.0</td>
<td>14.44</td>
<td>0.48</td>
<td>0.12</td>
</tr>
<tr>
<td>2006*</td>
<td>261.0</td>
<td>20.55</td>
<td>0.59</td>
<td>0.17</td>
</tr>
</tbody>
</table>

Total for Period 1997 - 2006: 13,712 1,226
Estimate for Period 1991 - 1996 ***: 2,742 245

The consequences of not having maintained roads adequately:

<table>
<thead>
<tr>
<th>Description</th>
<th>UOM</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total amount &quot;saved&quot; 1991 - 2006:</td>
<td>US$ million</td>
<td>16,455</td>
</tr>
<tr>
<td>Total Road Asset Value lost 1991 - 2006:</td>
<td>Leis</td>
<td>46,191</td>
</tr>
<tr>
<td>Net Loss to Moldova (millions):</td>
<td>Leis</td>
<td>29,736</td>
</tr>
</tbody>
</table>

* - Figures for 2006 are estimates
** - The "Optimal Road Network Asset Value" used as basis: 12,048 US$ million
*** - Estimate based on declining actual expenditures between 1991 and 1996

Sources: MoTRA, MoF, National Bank of Moldova, WB estimates

Average: 7.45 of GDP (needed)

35
Table 3.2: Moldova – Losses to Road users due to inadequate Road maintenance

<table>
<thead>
<tr>
<th>Year</th>
<th>Vehicle Park (Source: Statistical Yearbook 2005)</th>
<th>Vehicle-km (million)</th>
<th>Road User Costs (in US$ million)</th>
<th>Loss to Road Users (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Passenger cars</td>
<td>Buses</td>
<td>Trucks</td>
<td>Passenger cars</td>
</tr>
<tr>
<td>1997</td>
<td>205,973</td>
<td>11,189</td>
<td>56,924</td>
<td>2472</td>
</tr>
<tr>
<td>1998</td>
<td>222,709</td>
<td>12,917</td>
<td>57,404</td>
<td>2673</td>
</tr>
<tr>
<td>1999</td>
<td>232,278</td>
<td>13,562</td>
<td>52,430</td>
<td>2767</td>
</tr>
<tr>
<td>2000</td>
<td>238,282</td>
<td>12,769</td>
<td>46,351</td>
<td>2861</td>
</tr>
<tr>
<td>2001</td>
<td>256,459</td>
<td>14,703</td>
<td>45,809</td>
<td>3078</td>
</tr>
<tr>
<td>2002</td>
<td>268,882</td>
<td>15,777</td>
<td>46,277</td>
<td>3227</td>
</tr>
<tr>
<td>2003</td>
<td>265,841</td>
<td>15,723</td>
<td>46,905</td>
<td>3190</td>
</tr>
<tr>
<td>2004</td>
<td>280,075</td>
<td>13,407</td>
<td>47,171</td>
<td>3361</td>
</tr>
<tr>
<td>2005</td>
<td>250,000</td>
<td>13,000</td>
<td>47,000</td>
<td>3480</td>
</tr>
<tr>
<td>2006</td>
<td>300,000</td>
<td>13,000</td>
<td>47,000</td>
<td>3600</td>
</tr>
</tbody>
</table>

Average annual mileage by type of vehicle (Source: WB estimate)

<table>
<thead>
<tr>
<th>Year</th>
<th>Cars</th>
<th>Buses</th>
<th>Trucks</th>
</tr>
</thead>
<tbody>
<tr>
<td>km/year</td>
<td>12,000</td>
<td>21,000</td>
<td>21,000</td>
</tr>
</tbody>
</table>

Average Vehicle Operating Costs (Source: MoTRA) (US costs per veh-km, excluding depreciation)

<table>
<thead>
<tr>
<th>Vehicle type</th>
<th>on poor roads</th>
<th>on fair roads</th>
<th>on good roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cars</td>
<td>7.9</td>
<td>7.2</td>
<td>6.6</td>
</tr>
<tr>
<td>Trucks</td>
<td>18.6</td>
<td>16.6</td>
<td>15.2</td>
</tr>
<tr>
<td>Buses</td>
<td>19.1</td>
<td>17.1</td>
<td>15.4</td>
</tr>
</tbody>
</table>

Average Vehicle Operating Costs (US costs per veh-km, including depreciation)

<table>
<thead>
<tr>
<th>Vehicle type</th>
<th>on poor roads</th>
<th>on fair roads</th>
<th>on good roads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cars</td>
<td>20.9</td>
<td>18.7</td>
<td>16.6</td>
</tr>
<tr>
<td>Trucks</td>
<td>38.1</td>
<td>33.85</td>
<td>30.2</td>
</tr>
<tr>
<td>Buses</td>
<td>45.1</td>
<td>40.1</td>
<td>35.4</td>
</tr>
</tbody>
</table>

Total Loss to Road Users due to lack of road maintenance (US$ millions) Period 1997 - 2006 1,812
• All other things being equal, countries with higher transport costs are likely to devote a smaller share of their output to trade. Those countries are also less likely to attract export-oriented foreign direct investment (FDI). Since trade and FDI are key channels of international knowledge diffusion, higher transport costs may lead an economy to be farther removed from the world technology frontier and slow its rate of productivity growth.

3.9 Poor households in Moldova, and especially those in rural areas, spend a significant percentage of their income on transport. This is either for the transport of family members, to access markets and social and administrative services, or to transport goods produced by the household to local markets for selling them there. If the road network and more specifically access roads to villages are in bad condition, transport operators charge higher transport prices than they otherwise would. This affects poor households much more than non-poor households. A household survey carried out in 2003 in rural communities in Moldova showed that poor roads and transportation was considered the worst problem faced by communities and villages.

D. CURRENT SYSTEM OF FINANCING FOR ROADS

3.10 The single largest Government revenue source from the Road Sector has traditionally been the fuel excise tax. In 2005 the total amount collected through the fuel excise tax was 415.2 million Lei (US$ 32.95 million), but only a relatively small percentage of the fuel excise tax is actually allocated to the road sector (15 percent in 2005). Import duties for road vehicles have risen sharply over the last few years because of the increase in the number of vehicles imported, in particular of passenger cars. The amount collected in 2005 reached 426.8 million Lei (US$ 33.87 million), which was higher than the revenues from fuel excise taxes in that year. However, none of the import duties for road vehicles is allocated to the road sector. Other Government revenues from the road sector, and allocated to the road sector through the Road Fund, amount to 118 million Lei (US$ 9.36 million).

In summary, the Government’s total revenues in 2005 from the road sector amounted to 960 million Lei (US$ 76.2 million or 2.6% of GDP).

3.11 Government spending in the Road sector can be separated into three categories. First, there is spending through the Road Fund which is entirely used for the maintenance and repair of the network of National roads. Second, there are allocations for the maintenance of local roads. Finally, there are allocations for road investments, although in actual practice these have been almost non-existent during the past years.

3.12 Moldova’s total annual road sector spending varied between a low US$ 6.45 million in 2001 and a maximum of about US$ 23 million in 1997. The tendency since 2001 is towards an increase in road spending. In 2005, the latest year for which actual figures are available, the

Figure 3.1: Revenue Sources

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Government spent an amount of US$ 14.44 million in the road sector, which is equivalent to 19 percent of the resources it has collected from road users through the various forms of taxation, fees and duties.

3.13 It is estimated that because of the poor overall condition of Moldova’s roads, a sustained spending level of approximately US$ 135 million per year would be necessary to fully stop the degradation of Moldova’s road network and to carry out backlog maintenance works. This necessary annual amount would correspond (i) to 1.1 percent of the road network asset value, and (ii) to about 4 percent of the GDP. For a full recovery of the network, the required annual spending levels would be even higher, because of the need to carry out heavy rehabilitation works on parts of the network.

3.14 How do the specific GDP-related indicators for Moldova compare to generally accepted benchmark figures for those countries which do maintain their road networks adequately? Statistics compiled by the International Road Federation (IRF) show that industrialized countries, which in most cases maintain their roads adequately, (i) spend on average about 1.6 percent of their GDP on roads, and (ii) spend between 2 and 2.5 percent of the road network asset value on road maintenance and rehabilitation. Conditions in Moldova are however very different from those in industrialized countries, with much lower indicators for overall wealth expressed through GDP per capita, traffic level on roads, funds collected by the Government from road users, etc. In addition, Moldova needs to recover from many years of severe under-spending on roads. For the preparation of a future financing strategy for Moldova’s roads, it would thus be of little help to simply apply the benchmark figures of developed countries.

3.15 The analysis of the present situation of Moldova’s road infrastructure sector reveals a situation which can only be described as an acute crisis. The question is how to overcome this crisis and bring about a turnaround of the road network. A full and immediate recovery of Moldova’s entire road network to an “as new” condition would require about US$ 4.3 billion - - which is of course not realistic, because Moldova is unable to mobilize and afford such a level of financing. A more realistic approach would be to gradually rehabilitate destroyed road sections over a medium-term (10-year) period, while at the same time maintaining all other roads as well as possible. It is almost certain that Moldova will not only need to raise more domestic funding through road user fees, but also substantial external loans, credits or grants in order to finance the needed investments. In any case, the recovery of Moldova’s Road infrastructure sector will require at least two elements, which are: (i) a financing plan to mobilize additional resources, and (ii) institutional changes.

3.16 Any financing plan to be defined with the objective of improving Moldova’s road network will first have to satisfy the annual needs for road maintenance (routine and periodic). It is estimated that around US$ 95 million which would need to be allocated every year to this task just to avoid further deterioration of the road network. More resources will be required to finance backlog maintenance works\(^{21}\) and heavy rehabilitation. To achieve a clear improvement in the road network within a 10-year period, it is estimated that some $160 million a year will need to be spent. In 2005, the Government allocated $14.4 million for road maintenance and rehabilitation. This implies that there is nearly a $146 million shortfall between the resources needed and those actually allocated and spent for roads in Moldova. The most recent MTEF

\(^{21}\) Backlog Maintenance works are those works carried out to offset the lack of maintenance in earlier years. Backlog Maintenance mostly consists of spot repairs and light rehabilitation works. If Backlog maintenance is not carried out within a reasonable time, road conditions deteriorate so much that heavy rehabilitation becomes necessary.
foresees only minor increases in budget allocations for road maintenance, of about 20 million Lei per year, which is equivalent to a rate of growth of about 12 percent. It is clear that the planned level of road expenditures would result in a further decline of the road network.

3.17 A general principle for road financing is that road users should pay at least for the long-term maintenance cost for roads. This should also be the guiding principle for any road financing plan for Moldova. One possible source of financing with the best potential and lowest collection cost would be a fuel levy included in the price of gasoline and diesel, to be collected directly by the Road Maintenance Fund.

**Box 5: The Experience with Second Generation Road Funds**

A large body of evidence has emerged over the past several decades demonstrating clearly that in road systems across countries, road maintenance is often underfunded. Because road users may be identified and because they can and are levied selected taxes (e.g., gasoline tax), road funds were set up in many countries, earmarking arrangements for road maintenance or construction. These arrangements were typically opposed by macroeconomists, on grounds that such arrangements can undermine fiscal flexibility and efficient management of government resources. In addition, in practice, many of these first road funds failed to guarantee an appropriate level of road maintenance or construction.

In response, over the last decade or so, the so-called “second-generation road funds” have emerged, with an emphasis on creating a transparent, predictable, and accountable framework for road maintenance. In principle, a second-generation road fund involves road users in the management of roads, secures sufficient financing for road maintenance each year, ensures all parties are aware of their responsibilities; establishes clear accountability rules; and identifies charging instruments that are clearly related to road use, separable from other taxes, and administratively simple to administer.

This promising approach can serve as an efficient means of managing road systems. Macroeconomists also welcome second-generation funds, “provided the right conditions are met,” including sufficient capacity, management by a board free from producer and contractor interests, and others (Potter 1997). However, because second-generation road funds are relatively new, only preliminary appraisals and evaluations currently exist. A recent assessment of road funds in Africa (Gwilliam and Kumar 2003) suggests that such funds have not undermined fiscal flexibility and have in fact improved road management. Nonetheless, the assessment strongly recommends keeping road funds under review, such as through technical and efficiency audits.


3.18 Given sufficient resources, at the end of the 10-year period would be a much improved overall condition of Moldova’s road network, which would be able to sustain a growing economy. About 60 percent of the entire road network and about 85 percent of National Roads would be in fair or good condition. The remaining portion of poor roads would be on the less traveled part of the network. Most roads would be in a maintainable condition, and the trend would be towards further gradual improvement. Average Vehicle operation costs (VOC) to be borne by road users would be significantly reduced. Most importantly, road maintenance financing would be assured at an acceptable level and could be entirely financed by road users through road user charges.
E. CONCLUSION

3.19 In addition to the need to greatly augment funding for roads, there are two important institutional changes which would appear necessary. These are (i) the reform of the existing road maintenance financing mechanism, and (ii) the contracting modalities for road maintenance works.

3.20 One lesson which can clearly be learned from Moldova’s past experience with road funding is that there is a need to separate of financing for road maintenance (through earmarked resources) from those for new road investments (through the general budget). During the past 15 years, successive Governments and the Parliament have not been able to agree on a level of road maintenance expenditures anywhere near the required levels. This failure of political will suggests that there is a need to consider replacing the existing Road Fund with a so-called “Second-generation Road Maintenance Fund (RMF)”.

3.21 While the lack of funding for road maintenance is clearly and by far the biggest problem in Moldova’s road sector today, solving the funding problem alone would be insufficient. A second problem is the present system of awarding and supervising road maintenance contracts. This impact of this problem is less apparent today, because of the very low level of resources for road maintenance, but will certainly become very important once there is more money available for road maintenance in Moldova. The present system of sole-source contracts with the state-controlled local district road maintenance firms has several deficiencies which may result in a lower efficiency in the use of resources. It would therefore seem that in parallel with the reform of the funding mechanism for road maintenance, the introduction of competitive bidding for all road maintenance contracts could bring important benefits to Moldova.
4. MANAGING CIVIL SERVICE PAY REFORM

A. INTRODUCTION

4.1 Moldova's public sector wage bill in percent of total government expenditures is among the highest in the region, including several advanced OECD economies. The public sector wage bill, however, is programmed to continue rising through 2009 to keep pace with rising overall wage levels in the economy. In recent years, the stable level of public employment and rising level of public wages has made it difficult to increase other spending, especially operation and maintenance expenditures as well as capital expenditures. As public sector wages are projected to rise and outpace economic growth in the short-term, the rising wage bill will likely create significant fiscal and macroeconomic pressures and continue crowding out essential spending.

4.2 However, the design of the public sector wage system also has significant implications on the quality and efficient function of government. Despite the recent, rapid increase in public sector wages, compensation levels in the public sector are still very low when compared with the private sector. In addition to low pay, the compression of salaries in the civil service remains quite high. The composition of public sector compensations is also very complex and lacking in transparency. Recognizing this, the Government has articulated a program ("Modernization of the Country – Welfare of the People") that envisages a system of remuneration that is able to attract and retain qualified personnel, fosters greater professionalism in the civil service, and strengthen the efficient functioning of government.

4.3 The fundamental challenge then is to strike the right balance between a public wage bill that is fiscally affordable and a remuneration system that is able to attract qualified and motivated workers to the public sector. This chapter reviews recent developments in public sector pay and identifies opportunities for reducing complexity and promoting greater transparency in the pay system. It focuses on the civil service remuneration system rather than on the broader public sector remuneration system that covers public sector workers in the education, health, and other sectors. While the civil service accounts for a relatively small share of total public sector employment, the focus on civil service is pay is driven in large part by the ongoing central public administration reform program. In addition, sector-specific employment issues are covered in the respective chapters.22 Finally, because the civil service remuneration system serves as a benchmark for the rest of the public sector, the issues discussed in the chapter are effectively crosscutting.

B. RECENT DEVELOPMENTS IN PUBLIC SECTOR PAY

4.4 Public sector salaries consume close to a third of total government resources. In 2005, the wage bill accounted for some 29 percent of total government spending, representing about 10.8 percent of the GDP. Across sectors, there are some variations in the share of wages and salaries in

22 For example, the education sector employs 71 percent of total public sector employment. By any international comparison, the education sector is overstaffed. The structural reforms required in the education sector to rationalize government expenditures are discussed in Chapter 6.
total spending. For example, as a share of total expenditures, spending on personnel is much higher in the education and health sectors (over 50 percent of total spending in those sectors).

4.5 Public sector salaries have grown rapidly over the last several years. According to data drawn from the National Bureau of Statistics, between 1998 and 2004, average salaries in the public administration grew from around 400 to 1200 MDL per month. As a result of the gradual implementation of the Law on Determining Salaries in the Public Sector (in force since March 3, 2006), average remuneration in the public administration grew even further during the first six months of 2006 (reaching 2275 MDL per month in June 2006), nearly doubling the 2004 level in June. Similarly impressive was the rate of growth of the average monthly pay in the public education, a 50 percent year on year through mid-2006.

4.6 As a result of rapid wage increases, there has been a substantial growth in public sector wage bill. Between 2004 and 2005, public sector remuneration (i.e. wages and all other compensation and benefits) grew by about 20 percent. Following projections of wage growth in the MTEF, the wage bill is expected to amount to over 13 percent of GDP by 2009. The price of such an increase of the wage bill is the reduction in capital expenditure from 12.4 to 7.2 of total government expenditures percent between 2007 and 2009 respectively, as estimated by the Ministry of Finance. It may mean severe decreases in maintenance and capital expenditure which impacts the level of public sector performance. Increasing salaries will require some rationalization of employment.

Figure 4.1: Wages and Salaries in Percent of Total Government Expenditure 2003

Sources: OECD database and World Bank staff estimates for NIS countries.

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23 This estimated wage bill includes the imputed wage bill for health sector workers. In 2004, the Government implemented a healthcare reform that initiated the financing of healthcare services through a separate healthcare fund. Consequently, from 2004 onwards, reported general government expenditure do not include expenditures on health fund personnel. This effectively deflates the public sector bill and masks issues of sustainability and affordability in public sector pay. To facilitate budget analysis, we have included the health sector wage bill to the total public sector wage bill.
4.7 Moldova’s public sector wage bill is currently among the highest in the region. Figure 4.1 compares Moldova’s personnel expenditures with those of selected OECD and NIS comparator countries. On average, wages and salaries in percent of total government expenditure amount to about 21 percent, nearly a third lower than that of Moldova.²⁴ Moldova’s wage bill was larger than all other countries, except Denmark.

C. CIVIL SERVICE REMUNERATION SYSTEM

4.8 Rapid wage increases in the public sector were driven, in part, by the need to keep pace with rising aggregate wage increases. Indeed, while public sector wages have increased sharply in recent years, workers in non-agricultural sectors of the economy have experienced even higher increases in averages salaries (Figure 4.2). Compensation levels in the public sector are still very low when compared with the private sector. While civil servants are underpaid compared to the private sector at all levels, the relative under compensation of middle and senior management is quite extreme. At the lower end of senior management, for example, the private sector compensation is more than six times the civil servant salary.²⁵ In addition to low pay, the compression of salaries in the civil service remains quite high. As a result of low and compressed compensation levels, the public sector in Moldova has had a very difficult time in attracting and retaining skilled employees.

![Figure 4.2: Index of Monthly Salary (2002=100)](image)

Sources: National authorities and World Bank staff estimates.

4.9 Recognizing the need to improve the remuneration of public sector employees to attract and retain highly qualified staff, the Government initiated a functional review of the central public administration in 2005, covering 28 ministries and other central government agencies. The broad objective was to identify opportunities for reducing non-essential staffing, streamlining government processes, and promoting public sector productivity. The functional review should

²⁴ For cross-country comparability, the chart uses 2003 data (which in the case of Moldova includes the wages of all public sector workers, including public health employees).

²⁵ In 2004, over 59 percent of the public servants in the public administration earned between 750 and 2000 MDL. A third of public servants received between 100 and 750 MDL, while only 8 per cent – those in senior management – earned over MDL 2000. In comparison, about a third of financial sector employees in the private sector earned as much, or more than, senior public sector managers.
determine if staff redundancy could provide sufficient savings so as to allow for improvement of remuneration conditions in the reformed public sector. The early indications reveal functional overlaps, inefficiencies, and duplication of functions among subordinate agencies. Apart from inefficient use of public resources, maintaining fragmented and weakly coordination organizations with the very similar functions create confusion among consumers and economic agents, and dilute accountability for policy implementation. Therefore, institutional restructuring could (i) produce savings and (ii) improve technical efficiency of the public administration.

4.10 The initial functional review revealed that elimination of functional overlaps and inconsistencies in functional allocation could lead modest personnel cuts. However, personnel cuts have not been fully implemented in the wake of the second stage of the functional review in 2006. The analysis of the second and broader in scope functional review, covering subordinated and deconcentrated services, is expected to reveal the relevance of functions, budgets and staffing in five major sectors. Redundancy is expected to be identified through better alignment of mandates, functions, organizational structures and staffing.

4.11 In addition, the World Bank with the financial support from the Department for International Development of the United Kingdom (DFID) recently conducted a study of civil service pay. The study reviewed weaknesses in the present personnel management system and deficiencies in the pay structure. The sheer difficulty of obtaining data on salaries during the course of the study suggests serious inadequacies in the payroll management system. More broadly, the absence of centralized timely and accurate information on actual individual earnings of public servants is not conducive to effective public expenditure management. With the public wage bill representing a third of total government expenditures, the absence of efficient monitoring and control mechanisms in public sector pay weakens overall government fiscal control.

4.12 The review of civil service pay indicates the following:

4.13 First, the structure of civil service pay in Moldova is complex and, as a result, not sufficiently transparent. The total (take home) remuneration of civil servants consists of three components: basic pay related to grade, pay supplements, and performance-related bonus. Prior to the enforcement of the new public sector remuneration law, the basic pay accounted for less than a third of total pay, on average. The variable component of total pay, consisting of supplements and bonuses, was large, not transparent, and unpredictable. The unpredictability is driven by the lack of formal criteria for performance bonuses, substantial managerial discretion in awarding bonuses, the absence of systematic prior or post review of salary levels, and budget contingency. However, the situation has been improved somewhat by the new law, mainly by raising basic pay levels to about 50 percent of total civil service pay, as indicated a pay analysis of some 900 posts.

4.14 Second, considerable discretion, the lack of uniform criteria for setting the wage bill for budget organizations, and the lack of independent oversight provide little assurance that civil servants receive equal pay for equal work. In contrast to international (OECD) practice, where total pay closely reflects the position in the civil service, and where the base pay is consistent with systematic assessment of the value of jobs based on job descriptions, in Moldova, individual qualities of employees weigh heavily in the determination of total pay. The supplements for seniority, rank, and the length of public service, along with discretionary monthly bonuses represent a substantial share of the total pay. This effectively distorts the link between job value and total pay. OECD experience suggests that the base pay, related to grade, should reach 80-90 percent of total pay. Furthermore, the underlying principle in international practice is the matching of civil service grade with job complexity, as specified in the job description, rather
than rewarding personal attributes of the jobholder. In Moldova, the seniority supplement is not related to the formal assessment of skills and performance, thus distorting the incentives for professional growth, willingness to assume more responsibility, and undertaking tasks that are more complex. The pay system therefore fails to provide incentives for improving the quality of the public administration.

4.15 In Moldova, job classification is only indirectly related to the job content. Positions in Moldovan civil service are categorized by rank and class. There are three ranks, each subdivided by three classes. Ranks are essentially related to jobs, while classes reflect individual achievements. The analysis of the classification of some common job titles in two central agencies reveals that similar positions are typically categorized differently. Thus the position of ‘deputy head of division’ as well as ‘main specialist’ can be found in rank 2 and rank 3 with full choice of classes. Similarly, ‘heads of division’ can be found in ranks 1 and 2. This illustrates that ranks and classes cannot be a good indication of pay levels. This lack of consistency between job content and its hierarchy leads to the distortions of pay levels across the public administration and distortion of the principle equal pay for equal job. When job classification, pay and job content are not related, employees feel distressed with the pay and are not motivated to be more productive. In light of international experience, Moldova should consider introduction of a uniform position grading system linked to standardized job descriptions that, in turn, determine base pay. A methodology of assessing job values based on objective and measurable criteria should be developed to support this standardization.

4.16 Third, salaries in the civil service remain significantly compressed. The decompression ratio, calculated by dividing the highest level of pay by the lowest pay, is about 8.8. While this ratio is comparable with international averages, a more in-depth analysis reveals that among the 85 percent lowest paid civil servants, the decompression ratio is only 2.5. Such a result is driven by top managers having significantly high pay rates, but where little distinction is made between salaries of the majority of civil servants. Like the other characteristics of the remuneration system, low decompression rates provide weak incentives for career development and retention in the civil service.

Figure 4.3: Compression of Civil Service Wages

![Graph showing compression of civil service wages](image)

4.17 Indeed, young, well-educated and speaking foreign languages civil servants are more attracted to higher-earning private sector positions. Alternatively, they seek higher paid employment as consultants of government organizations implementing donor-financed projects.
This has adverse effects on the capacity building prospects of the public administration. In addition, an important consequence of salary compression at lower levels is the inability of senior public sector managers to rely fully on staff for high quality work. As a result, public sector managers in Moldova do much of what more junior staff would ordinarily do in OECD and other comparator countries. Little delegation of responsibility takes place in Moldovan public administration. This triggers a vicious circle of overwork by senior civil servants, the lack of attention to more strategic issues at senior levels and dissatisfaction with routine tasks at junior levels, and constrained opportunities for knowledge and experience transfer down the hierarchy.

4.18 Finally, performance bonuses as currently implemented in the civil service pay system do not generate better performance. In practice, additional bonuses can be paid monthly based on managerial assessment (mostly undocumented) on civil servant's performance over the past month. There are no formal criteria in place regarding performance appraisal, or the size and frequency of awarding performance bonuses. The funding for such allowance-type bonuses is from savings drawn from vacancies within the organization.

4.19 Managers exercise significant discretion in awarding bonuses. Bonuses, which are not linked to formal performance appraisal, are expected as a more or less permanent pay supplement by all civil servants regardless of actual performance. This sense of entitlement creates a serious disincentive to improve performance. In contrast, robust performance management systems in other countries ensure that performance is planned, monitored, formally assessed and rewarded, usually on annual basis. In Moldova, a process called “attestation” comes close to what may be considered performance appraisal. It is conducted once every three years to decide on the promotion to the next class or rank. The new class designation then leads a permanent supplement to the base pay, independent of actual performance.

4.20 It is of course expected that efficient performance management systems take time to develop. They require clear rules, effective personnel management systems, internal controls and some degree of central oversight by the civil service managing body. Based on experience in OECD countries, the role of performance management should not be overstated. Transparent pay systems, proper job grading, and clear rules of career progression linked to performance that create the conditions for attracting and retaining civil servants, rather than a system of ad hoc bonuses exercised without clear rules and oversights. The priority for Moldova should be to improve the current civil service pay system and the next section identifies opportunities for doing so.

D. OPTIONS FOR CIVIL SERVICE PAY REFORM

4.21 In sum, the current civil service pay system is complex, not transparent, uncompetitive, and does not provide the right incentives for greater public sector productivity. The Government has problems assessing reliable individual pay data for the analysis and design of a better pay system. The centralized payroll management, which in principle should ensure horizontal compatibility and transparency of pay, cannot be implemented due to the design of the current system, which allows significant discretion. Job descriptions are not structured around clearly identifiable and measurable criteria linked with the job value. The culture of effective performance management system is absent. Multiple supplements and bonuses do not provide right incentives for professional growth and improved performance. Therefore, without radical changes of the civil service pay system, it is unlikely that the quality of the public administration can be improved.
4.22 To make civil service pay motivating, it is not sufficient to increase salary levels. It is necessary to achieve a direct link between the pay level on the one hand and employee effort, qualifications, and outcomes, on the other hand. Increasing wage dispersion (or pay decompression) and consolidating multiple salary supplements into the base pay while keeping constant the overall wage bill, will be the key elements of a good reform program. There are a number of steps that can be taken, following other countries that have successfully instituted effective remuneration systems:

4.23 First, to realign the present pay and grading practice with a more effective civil service pay, an approach should be developed that is founded on the following principles:

- regular guaranteed monthly pay is based on the agreed pay for the job (or position), rather than is being "assembled" from a number of pay elements which have little relevance to the job;
- the pay system is designed around a clear job grading structure and recognized methodology and process for grading jobs;
- the job grading structure allows for a greater degree of career progression through promotion to higher non-managerial jobs;
- job grade-related pay ranges (or scales) provide for regular pay progression based on length of service and allow for accelerated progression to reflect individual performance while in the job;
- includes limited discretion for additional performance-related bonuses within common funding arrangements across the service; and at a later stage
- performance appraisal system is developed to underpin the performance reward and career development process.

4.24 Second, because the design of a new pay system is an extensive technical exercise, it should be undertaken with guidance of experienced specialist in designing pay systems. The recommended sequence of pay system reform is described below:

A. Preparing job descriptions for all typical positions within the civil service. The job descriptions could be created by a trained group of job analysts, based on a structured job questionnaires, covering such elements as:

- job purpose;
- key responsibilities;
- main duties;
- responsibility for job organization, staff management and resources;
- decision-making;
- contacts and representation; and
- required knowledge, skills and experience.

B. Designing job evaluation system, which guides how to assess the value (or level) of certain job factors.

C. Evaluating sample jobs and grouping jobs according to the value and weight of job factors to establish parameter for a grading structure.

D. Determining parameters of the grading structure: required number of grades, relevant number of points within the grade to allow for a gradual pay progression and for distinguishing between concrete jobs under the same title; the appropriate size of steps
from one point to another within the grade; the degree of overlap of the adjacent grades, etc.

E. Slotting in typical jobs into the grading structure.

F. Conducting a pay determination simulation exercise to determine pay levels corresponding to typical jobs within the realistic civil service wage bill volume.

G. Conducting the reclassification of jobs across the public administration and creation of the job database. Further validation of the pay grading system through a simulation exercise.

H. Drafting a normative act determining the pay system and the rules of career progression linked to performance appraisal.

I. Training of personnel managers in assessing jobs.

J. Developing rules and procedures for performance management.

4.25 The proposed approach will require abandoning the old tradition of length of service supplements as not the length of service but competences to perform a job will determine what position a civil service can take and what pay to receive. In the new system, monthly bonus payments will be eliminated. Instead, a formal annual performance appraisal will lead to a revision of civil servant’s grade and pay level. Currently administered pay supplements for “high intensity of job” should cease, but intensive conditions of a job will be reflected in the job description and result in a higher base pay level (e.g., assigning a higher point within the grade). Thus, the suggested measures will lead to better alignment of pay with jobs and the realization of the principle: equal pay for equal job. When the salary will take account of factors important to the job, rather than some personal attributes, the pay system will be perceived as more just. Moreover, by rewarding competences and performance, the new pay system will provide incentives for professional development, initiative and better performance.

4.26 The amount of work involved in developing a new pay system is considerable. It may probably require at least two years in order to conduct all the necessary steps to develop and implement analytically justifiable pay system. It is also important that personnel management system is being further developed to support effective execution of job grading, career planning, performance appraisal and career management within the new pay system.
5. INCREASING THE EFFICIENCY AND QUALITY OF HEALTH CARE SERVICES

A. INTRODUCTION

5.1 Health sector indicators deteriorated rapidly during the 1990s and public health care expenditures fell to only 2.9 percent of GDP by 2000. In addition, health care providers were experiencing high levels of debt which undermined the functioning of the health system and created the conditions for increasing levels of informal payments. While donor and bilateral financing partly eased the burden, satisfaction with the system was low and 33 percent of all people that were ill were unable to access health services for a lack of money.

5.2 At the end of the 1990s Moldova embarked on a health sector reform which focused on strengthening primary health care (PHC) and restructuring the hospital sector. Notable progress has been observed in introducing health insurance, transforming hospitals from budgetary institutions to self-governing entities, and strengthening primary health care. Public health expenditures have recovered to 4.3 percent of GDP by 2005 and per capita health spending figures are now at the highest levels experienced since independence.

5.3 All these factors helped the system in reversing the unfavorable trends experienced at the end of the decade and beginning of the new millennium. Health outcomes have improved - in terms of a broad range of health indicators, financial protection of the population, responsiveness of the system to the needs of the population and their overall satisfaction. Between 2000 and 2005, for example, infant mortality rates decreased by 32 percent (from 18 infant deaths per 1000 live births to 12 in 2005). Over roughly the same period, maternal mortality decreased by 60 percent (from 43.9 maternal deaths per 100,000 live births in 2001 to 18.6 in 2005). However, mortality and morbidity rates in Moldova are still far from the EU regional rates. Infant mortality rates (IMR) are 2.5 times higher in Moldova than in the EU, while maternal mortality rates are 4 times higher, TB incidence rates are 11 times higher and HIV-AIDS incidence rates are 1.3 times higher. Significant efforts will be required if Moldova is to approach EU rates in the medium and long term.

5.4 Despite these significant achievements, the hospital sector continues to be burdened by overcapacity. Informal payments still constitute an important source of revenue in the system, and clinical practices have been only slightly modified to promote more cost-effective care and quality based initiatives. Further investment in the health care system will require additional reforms to improve the functioning and cost-effectiveness of the system. Intra-sectoral changes in expenditure allocation will be needed to achieve the fiscal space to build upon recent successes. This chapter concentrates on a number of selected issues related to health sector performance, with an emphasis on improving the efficiency of health expenditures. It lays out the strategic directions for health reform that can be integrated into the budget over the short and medium term.
C. CURRENT SYSTEM OF HEALTH EXPENDITURES

5.5 Total health expenditures, public and private, in Moldova have been increasing since the 1999 regional crisis. As a share of GDP, total health expenditures have increased from 6.5 percent of GDP in 2001 to 9.8 percent of GDP in 2005, which is above the average level of EU countries. As significant portion of this increase is the result of the resurgence in public health spending. Total public health care spending has increased from 2.8 to 4.3 percent of GDP (including all Ministries/Agencies and levels of Government). As of 2005, public health expenditures represented about 11.3 percent of total general government expenditures.

Table 5.1: Composition of Health Expenditures in 2005
(Million of Lei)

<table>
<thead>
<tr>
<th>Source</th>
<th>2005</th>
<th>% of THE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ministry of Health</td>
<td>267.8</td>
<td>7.8%</td>
</tr>
<tr>
<td>National Health Insurance Company</td>
<td>1,108.0</td>
<td>32.5%</td>
</tr>
<tr>
<td>Local Expenditures</td>
<td>35.3</td>
<td>1.0%</td>
</tr>
<tr>
<td>Other Ministries (Defense, Transport, State Chancellery, Ministry of Internal Affairs, etc.)</td>
<td>161.3</td>
<td>4.7%</td>
</tr>
<tr>
<td>Public Health Expenditures sub-total</td>
<td>1,571.8</td>
<td>46.1%</td>
</tr>
<tr>
<td><strong>Donors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Formal co-payments</td>
<td>224.1</td>
<td>6.6%</td>
</tr>
<tr>
<td>Informal co-payments</td>
<td>443.5</td>
<td>13.0%</td>
</tr>
<tr>
<td>Pharmaceutical Private</td>
<td>711.1</td>
<td>20.8%</td>
</tr>
<tr>
<td>Private Insurance and Non-profit</td>
<td>56.1</td>
<td>1.6%</td>
</tr>
<tr>
<td>Private Health Expenditures sub-total</td>
<td>1,434.8</td>
<td>42.0%</td>
</tr>
<tr>
<td>Science and Innovation</td>
<td>59.1</td>
<td>1.7%</td>
</tr>
<tr>
<td>Medical education</td>
<td>18.3</td>
<td>0.5%</td>
</tr>
<tr>
<td><strong>Total Direct Health Expenditures</strong></td>
<td>3,335.1</td>
<td></td>
</tr>
<tr>
<td><strong>Total Health-Related Expenditures (THE)</strong></td>
<td>3,412.5</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Source: Ministry of Health and Social Protection*

5.6 The introduction of the medical health insurance system in 2004 significantly change the composition of health spending in Moldova, and contributed to the increasing participation of the Government in overall health spending. Further, the importance of the Central Government in health has greatly increased: from 61 percent of the total in 1995-2003 to 88 percent of in 2005 — leaving municipalities and local authorities with marginal participation (Table 5.1). By 2005, total expenditures coming from the National Health Insurance Company (NHIC) are estimated to represent almost 39 percent of total health spending and 80 percent of total public spending in 2005. It is important to note, however, that 63 percent of NHIC funding still comes from budget transfers.

5.7 Private health expenditures are comprised of largely of formal and informal co-payments under the health insurance scheme and private purchases of pharmaceuticals. Despite the increasing participation of public health spending, out-of-pocket expenditures still represent a
large share of health financing. In 2005, Private health expenditures represented 41.8 percent of
total health spending. By comparison, the average across the CIS countries was 35 percent, while
in the EU this figure was 23 percent. While on a declining trend, informal co-payments are
nearly 2 times larger than formal co-payments. Finally, with the low public share of spending on
drugs (public sector spending represents only 20 percent of total spending on drugs), the private
purchase of pharmaceuticals represents the bulk of private sector expenditures on health. Drug
costs are the major contributor to the lack of financial protection.

5.8 By budgetary category, half of the total public expenditures are allocated to personnel
costs (Figure 5.1). Along with the education sector, the health sector has among the highest
proportion of personnel costs within the central government. Total staff in the public health
sector has been declining in the last two years (falling to 48,498 in 2005). While nearly half of
public health staff still works at the rayon level, health insurance has resulted in a sharp shift in
public sector health employment from Rayons and Municipalities to Republican institutions.
Nationally, the bulk of staffing is composed of Nurses (43 percent of total), followed by
attendants and other workers (39 percent) and Doctors (18 percent). While by international
comparisons, remuneration in the sector is still low (average monthly wage of around $60), real
wages in the sector have grown rapidly (42 percent between 2003 and 2005).

Figure 5.1: Composition of Public Health Expenditures by Budgetary Account,
2003-2005 average

Source: MoHSP

5.9 The lower share in drug spending can be explained by the recurrent acute shortage of
drugs at in-patient facilities; most hospitals possess only few very basic centrally purchased drugs
and small quantities of donated medicines. Across institutions, however, Republican facilities
allocate some 21 percent of their budgets to drug purchases. International evidence suggests that
there is room for improved efficiency gains. Similarly, in best practices systems spending on
utilities represent around 5 percent of the budget - 3 percentage points lower that seen in
Moldova.
5.10 Moldova has made important progress in the hospital consolidation process by reducing the total number of facilities from 265 hospitals in 1995 to 65 in 2002. The consolidation of facilities has been a key step in reducing the fixed costs in the system. Despite this significant reduction in infrastructure, very little resources are devoted to infrastructure maintenance and equipment purchases. Most of the remaining hospitals have exceeded their expected lifespan. While international parameters indicate that full depreciation of a hospital is between 25 to 33 years, the average age of a typical Moldovan facility is around 45 years. A recent survey of health facilities in three rayons revealed that one-third of the evaluated units had damaged roofs, doors and windows, one fourth had broken floors and almost half had damaged furniture.

D. HEALTH SECTOR PERFORMANCE

5.11 The provision of universal health insurance coverage is one of the key objectives of the Moldovan Health Insurance system. With health insurance premiums currently only covering one-fourth of total public health expenditures, the financial sustainability of the health system is threatened by the weak participation rate among productive groups of the population. As of 2005, 74.8 percent of the Moldovan population was covered by mandatory health insurance. While children under 18 years old and pensioners were reported fully covered by health insurance, less than half of the 25 to 44 year age group was affiliated to the MHI. Among the 25 percent of the population that is uninsured, nearly 70 percent (or about 17 percent of all workers) are formally employed (largely in the agricultural sector) with the remainder being unemployed. The larger cities or municipalities have much higher coverage rates due to the higher rate observed in Chisinau, where 85 percent of the population is covered. Differences across the various Rayons are significant. The top 10 Rayons/Municipalities have on average 81 percent of their population covered by health insurance, while the 10 Rayons/Municipalities with the lowest rates showed an average rate of 63 percent. Increasing the participation of payroll contributions in total NHIC revenues, thereby lessening dependence from budget transfers, is one of the key challenges of the system in the coming years.

5.12 Access to Care. The evidence provided by different sources suggests that access to health care services in Moldova is satisfactory and that the MHI system has improved access of the insured population. In Moldova, 97.1 percent of households live within five km of the nearest health facility, 93.5 percent of households need less than an hour to reach a health service provider and 87 percent of households are within five km and need less than one hour to reach primary health care facilities. The health insurance “removed or significantly reduced” barriers and allowed insured persons to have better access to care. Evidence from household surveys shows that insured people not only receive higher family doctor (FD) coverage (87 percent of the insured are covered by FD services versus 48 percent of the non-insured) but, as a result, they make more intensive use of FD services (3.2 visits per year to FD versus 2.8 visits among non-insured).

5.13 Quality of Care. While access has improved, analysis of quality of health care indicators suggests that the Moldovan healthcare system performs poorly. In-patient mortality rates in Moldovan hospitals grew by 10 percent between 2002-2005. Coverage rates are very low in cholesterol measurement, mammography and flu vaccination, and moderate in blood pressure measurement. For all these quality indicators, Moldova lags behind international benchmarks. Over 80 percent of the Moldovan population believes that the quality of the health care is a problem and that the sector requires considerable changes to improve its performance. Some additional problems persist, such as the absence of clinical management approaches (protocols, integral pathways, etc), an inadequate payment system to promote quality of care and unmet demand for family doctor services in approximately 30 percent of the Rayons.
Table 5.2: Selected Quality and Health Care Indicators

<table>
<thead>
<tr>
<th></th>
<th>% Measured Cholesterol in Blood</th>
<th>% Measured Blood Pressure</th>
<th>% received Flu Vaccine in last 2 years</th>
<th>% Mammography in last 2 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moldova</td>
<td>8.8</td>
<td>69</td>
<td>16.6</td>
<td>13.3</td>
</tr>
<tr>
<td>Benchmark</td>
<td>75</td>
<td>55-90</td>
<td>70</td>
<td>70</td>
</tr>
</tbody>
</table>

5.14 *Resource Efficiency.* While public health expenditures have increased significantly since 2000, the overall efficiency of the sector has not improved correspondingly (see Table 5.3). Hospital efficiency can be measured from three perspectives. The first deals with productivity, as measured by the number of discharges per doctor. In 2005, Moldovan hospitals reported an average 58 discharges per doctor with little improvement in the last few years. The second measure relates to resource utilization and average length of stay (ALOS). The average occupancy rate in Moldovan hospitals was 66 percent in 2005, considered moderate to low by international standards. Some 44 percent of hospitals have excess bed availability. While the average length of stay has declined in the last few years, they are some 17 percent higher than in the EU. The existing payment mechanism has increased incentives towards longer hospital stays. A final measure considers the perspective of cost-containment, measured by cost per discharge. Over the last few years, the cost per discharge has been increasing, the result of increasing budgets and declining discharges. On balance, poor performance is observed in productivity and cost-containment indicators. There have been little incremental gains in productivity while all cost-related indicators have increased over time due to the combination of increased budgets with reduced number of beds and hospital activity.

5.15 There is a wide range of areas where efficiency gains can be achieved by implementing specific cost-control policies. Some key areas are:

1. **Utility management**: utilities represent around 8 percent of total hospital expenditures. In best-practice systems, utilities represent around 5 percent of the budget.

2. **Ambulatory surgery**: international practices suggest that countries should increase ambulatory surgeries as a way to reduce overall costs. In some countries, such as the USA and Canada, ambulatory surgeries now represent more than 50 percent of total surgeries.

3. **Consolidation of central services like sterilization and laundry**: hospitals can move from the current practice of supplying services like laundry and security to outsource them by contracting private firms.

4. **Hospital consolidation**: consolidating hospitals represents a significant source of savings by reducing fixed costs, especially infrastructure-related ones. Some estimates suggest that in Chisinau area alone, 1000-1250 hospital beds (13% of current) could be closed by improved management procedures without affecting level of services provided. This would enable the closing of 4 hospital buildings, with associated saving in infrastructure related costs such as utilities.
<table>
<thead>
<tr>
<th>Table 5.3: Efficiency Indicators of the Moldovan Hospital Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Productivity</strong></td>
</tr>
<tr>
<td><strong>Hospital Occupancy</strong></td>
</tr>
<tr>
<td><strong>Intensity of use of hospital beds</strong></td>
</tr>
<tr>
<td><strong>Cost-containment</strong></td>
</tr>
<tr>
<td><strong>Length</strong></td>
</tr>
</tbody>
</table>

**E. RECOMMENDATIONS**

5.16 Many of the issues considered require long-term consideration, but there are some problems that need immediate attention because they either take a long period to be fully implemented or because the severity of the situation affects key outcomes of the system. Among the most important issues that need immediate action are:

A. **Hospital efficiency and consolidation:** Since about 40 percent of the health care facilities belong to other Ministries/Departments, these facilities have stayed outside the current reform effort.\(^{26}\) It is critical that the Government adopts a strategy for

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\(^{26}\) Based on statistics from Ministry of Health, there were in 2004 a total of 107 inpatient health care facilities in Moldova, of which 65 were municipal, rayonal and republican and 42 were categorized as "other ministries and departments".
restructuring/consolidating these facilities and to define how freed resources would be allocated. For instance, given that infrastructure conditions of most hospitals are unsafe; buildings are old, and equipment is far from the best technology currently available, those could be areas of interest for future investments. As part of a restructuring plan, the MoH should pay attention to generate adequate incentives to enhance efficiency through the selection of the best performers, leaving behind less efficient providers.

B. Cost control: Public health expenditures have been growing significantly during the last years despite the fact that hospital activity decreased. As a result of both increasing budgets and reduced hospital activity, cost-related indicators increased. This situation points to the need to control expenses through improved resource allocation mechanisms and to emphasize the quality rather than quantity of spending. As part of a cost-control strategy, the government should pay attention to the exceptional growth of the National Programs and analyze productivity, cost-effectiveness, and appropriateness of programs.

C. Fiscal sustainability and coverage: The largest part of health expenditures comes from the central budget, therefore it is critical to ensure the fiscal sustainability of these funds. There is a need to increase the collection of mandatory health insurance contributions to and include more working age people as contributors in order to reduce the level of budget transfers to NHIC. Despite the high rate of coverage achieved in just two years, there are 12 Rayons where coverage rates fall significantly below the rest of the country. Increasing coverage in those Rayons should be a short-term policy goal given the positive outcomes in terms of access and equity for the population. Moreover, the expansion of health insurance to cover the poorest population plus the introduction of mechanisms to convert informal payments into formal co-payments, and the introduction of governance mechanisms (through community awareness on co-payment structure) could further reduce the burden of out-of-pocket payments.

D. Quality of health services: The development of programs to improve quality and focus providers on user satisfaction has lagged behind the changes in financing and provision. Quality indicators, both at hospital and primary health care levels, deteriorated over time or were far from matching international standards. Some additional problems persist such as the absence of clinical management approaches (protocols, integral pathways, etc), an inadequate payment system to promote quality of care, and unmet demand for FD services in approximately 30% of the Rayons.

5.17 There is still considerable opportunity to further consolidate services and introduce efficiency-oriented measures at the provider level. At the same time, innovations need to focus on improvements in quality and the development of a culture oriented to satisfy the needs and expectations of patients. Policy options along this line include the preparation of a hospital consolidation/restructuring strategy, continuation of efforts to enhance primary care facilities and ensure availability of basic medical equipment in all centers as well as the strengthening of health management to focus on performance/results and to learn to develop management structures in hospitals.
6. ENHANCING THE EFFICIENCY OF RESOURCE USE IN EDUCATION

A. INTRODUCTION

6.1 Education spending in Moldova is broadly comparable to other countries in the ECA (Europe and Central Asia) region. However, the sector suffers from a number of weaknesses, including low enrollment rates, persistent problems with the quality of services, and institutional arrangements that do not facilitate the most efficient use of public resources.

6.2 First, Moldovan enrollment rates lag behind many of its neighbors. At the crucial pre-primary level, the enrollment rate among 3-6 year olds, after falling during the 1990s, has revived recently and, at 62 percent in 2004, it was close to the average in Russia, Ukraine and Belarus but still well below the average in the EU member and candidate countries of Central and Eastern Europe. The basic education (primary and lower secondary - grades 1 to 9) gross enrollment rate was 94 percent in 2004 – lower than rates in the EU member and candidate countries of CEE, but higher than in other western CIS countries. At the upper secondary level (grades 10 to 12), however, the overall enrollment rate of 45 percent is not much more than half that achieved by CEE EU members and well below that in the other comparator countries. This reflects the collapse of vocational/technical education (obsolete and no longer attractive to students and their parents), where enrollment now represents only 16 percent of the age group, and a relatively slow expansion of general secondary education over the past ten years to an enrollment rate of 28 percent in 2004. Inter-country comparisons of higher education enrollment rates are made difficult by definitional problems, but Moldova's enrollment rate of 28 percent is less than half that in the CEE EU members. There are also inequities in access to education. As far as gender is concerned, boys, rather than girls, seem to suffer from inequity in access to the higher levels of education, but data on enrollment rates by age group reveal inequities between income groups and between rural and urban areas, which are particularly acute in the 3-6, 16-18 and 19-25 age groups.

6.3 Second, recent data on learning outcomes suggest that there are still quality problems at lower secondary level, but the relatively good results of the TIMSS 2003 grade 4 tests suggest that there is hope for improvements arising from the reforms of curriculum, textbooks, teacher training and assessment that are already in train. The TIMSS report showed that the shortage of resources for teaching materials and equipment is still acute. Secondary vocational schools are in particular trouble, and the quality of higher education has deteriorated considerably in recent years.27

27 The 2005 World Bank note on Education ("Moldova - Education policy note - analysis in support of improvements in quality, equity, and efficiency in the education sector.") notes that the draft strategy paper (Ministry of Education 2004) recognizes that quality of higher education (including teacher training) has deteriorated considerably in recent years, owing partly to the big fall in the real value of allocations from the government budget and partly to internal factors. These include: the continued orientation of the curriculum towards memorization; the prevalence of inefficient teaching techniques; the absence of criteria and mechanisms for objective assessment; and the marginal use of information technology.
6.4 Third, there is a crisis in public finance of education, reflected most dramatically in the increasing number of schools that receive less total funding from the state than the amount that they need to pay staff salaries. The low level of teachers' salaries has an adverse effect on quality of learning outcomes at all levels, making it difficult to attract good young teachers into the profession. This problem is due primarily to inefficiency in the use of the sector's budget. With funds allocated to schools on the basis of specific guidelines (on classroom hours per week, minimum class sizes, and others) established by the Ministry Education together with the Ministry of Finance the flexibility of local governments and school managers in using the resources is severely limited.

6.5 In light of these challenges, issues related to the allocation of resources within the sector as well as those of technical efficiency are dominant. A first step in any movement towards a more efficient education system is to define exactly what the state undertakes to provide free to Moldovan residents in the way of education services. What is the 'basic package' that they can expect from their government? In Moldova, however, where education at all levels and of all types has traditionally been regarded as a public good, many of these and related issues are currently unsettled, vague or subject to unpredictable change, as reflected in conflicting legislation. And while there has been some progress with educational reform, the draft law on education is ambivalent on further reforms necessary for achieving greater efficiency in the sector. No mention is made of network optimization nor of reform of vocational education. Moreover, any argument over the appropriate level of funding for education is pre-empted by the statement that 'the primacy of education is guaranteed by the government through priority funding of the education system at the level of 10 percent of the Gross Domestic Product' (Framework Law, Art. 45).

6.6 This chapter explores the opportunities for fiscal savings in the sector, while identifying measures to help ensure that there is no deterioration in the level and quality of services provided and that there are adverse poverty and distributional consequences. It focuses on a number of areas where increased efficiency of resource use can be achieved, including the rationalization of the school network (class/school size and high level of non-teaching staff), and estimates their likely fiscal impact. The extent to which decentralization of authority to autonomous schools will help address the allocation of inefficient education expenditures is also explored.

B. COSTS OF EDUCATION

6.7 Education expenditures currently amount to over 7 percent of GDP, steadily rising from about 5.7 percent of GDP in 2001. Expenditure on education is projected to fall to below 6 percent by 2009. Because of GDP growth, the education budget will still be increasing, but only by about 4 percent in real terms over the whole 2004-2008 period. Over the same period, the number of school-age children is expected to fall – by 9 percent in the case of 3-6 year olds, 24 percent for 7-15 year olds and 18 percent for 16-18 year olds – and the number of 19-24 year olds is expected to rise by only 6 percent. On the face of it, these demographic trends may help the search for fiscal space in the education budget.

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28 For example, the draft education law says that 'public education is free of charge', but also that 'institutions of public secondary vocational education, post-secondary vocational education, and higher education are allowed to charge fees for educational services' (Framework Law, Art. 7).
29 World Bank 2005: section III.
30 These are unofficial projections based on estimates of population by age group. Official census-based projections are not yet available.
6.8 The proportion of public educational expenditure that goes on personnel (salaries, social contributions and medical insurance) has increased since 2002, to 67 percent of current and 61 percent of total expenditure in 2004. Other important categories of expenditure are heating and fuel (6 percent of the total in 2004), electricity and gas (5 percent) and food (5 percent). Capital expenditure (including purchase of equipment and repairs to buildings as well as construction) accounted for about 9 percent of total spending in 2004 (about the same as the OECD average), but only 10 percent of the total could be regarded as directly relevant to quality of education (teaching materials, books and magazines, maintenance, repairs and purchase of equipment, professional retraining, IT works and repairs to buildings).

6.9 Primary and secondary general schooling absorbs most of the education budget. This includes primary schools (grades 1-4), gymnasias (grades 1-9), general secondary schools (grades 10-11) and lyceas or high schools (grades 10-12), which cost 897 million lei – more than half of total public spending on education in 2004. Personnel expenditure accounts for 70 percent of the sub-sector total, with teachers alone accounting for around 53 percent of the total, managers 5 percent and other non-teaching staff 13 percent. Capital expenditure accounted for 9 percent of sub-sector spending, as did quality-related expenditure. Electricity, gas, heating and fuel together consumed 11 percent of the budget. No publicly-funded stipends or scholarships are awarded at this level. Obvious areas in which to look for fiscal savings in primary and secondary general education are personnel expenditure, where student/teacher ratios and the ratio between non-teaching and teaching staff need to be reviewed, and spending on heating and fuel.

6.10 The next largest area of public education expenditure is pre-schools, on which 277 million lei, 16 percent of the total, was spent in 2004. At this level, personnel expenditure represents only 51 percent of total spending, while the provision of food (13 percent) is a relatively large item. Secondary vocational education, including both vocational and trade schools, is now a relatively small sub-sector (4 percent of the total education budget): over a quarter of its budget goes on stipends to students (received by 83 percent of them, predominantly from disadvantaged backgrounds), 40 percent of whom are accommodated in hostels. Students pay for food from their stipends. Other institutions of secondary education include some expensive institutions, the general and the special-needs boarding schools (internats), and accounts for 8 percent of total education expenditure: food and other items associated with fully-subsidized boarding (heating, fuel and other utilities) feature disproportionately in the budgets of these institutions. A relatively small proportion of total education spending goes to colleges (3 percent) and universities (6 percent) which now rely heavily on extra-budgetary revenue, particularly fees. Quite a large proportion of public expenditure at these levels (10 percent for colleges, 16 percent for universities) goes on scholarships/stipends, received by 74 percent of college and 14 percent of university students. In general, exploration of fiscal space in these institutions should focus not only on personnel spending but also on expenditures associated with boarding and on scholarships/stipends.

6.11 Also relevant to fiscal saving possibilities is the amount of public spending per student at each level. Of the educational institutions for which unit cost figures are available, the most expensive per student to the taxpayer are the secondary vocational schools. They spent 2,943 lei of public money per student in 2004 – exceeding pre-schools by 16 percent, colleges by 25 percent, general schools by 76 percent and universities by 185 percent.

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C. FINANCING SYSTEM FOR PUBLIC EDUCATION

6.12 Most public educational institutions are the responsibility of local governments, the main exceptions being most vocational schools and all colleges and universities, which are funded directly from the state budget. However, a large part of the finance for locally managed institutions comes in the form of budget transfers from higher levels. The Ministry of Education is involved in the process only as a recipient and supplier of information. The Ministry of Finance drafts the budget, and monthly transfers are made from the state to the territorial treasuries.

6.13 The amount transferred from the state budget to the raions (for onward transmission to mayors’ offices and thence to schools) is determined by the number of students. Table 6.1 shows the norms per student (excluding funding of school meals and the organization of examinations) that have been used since 2003 and projected to 2008. As can be seen, norms are higher for pre-schools than for general schools and highest of all for the internats – boarding schools for disadvantaged children and those with special needs.

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-schools</td>
<td>1021</td>
<td>1367</td>
<td>1565</td>
<td>2642</td>
<td>3026</td>
<td>3166</td>
</tr>
<tr>
<td>Primary schools, gymnasium &amp; high schools</td>
<td>963</td>
<td>1151</td>
<td>1232</td>
<td>1725</td>
<td>1816</td>
<td>1895</td>
</tr>
<tr>
<td>Complementary (extra-curricular) institutions</td>
<td>3963</td>
<td>96</td>
<td>100</td>
<td>144</td>
<td>156</td>
<td>161</td>
</tr>
<tr>
<td>Family-type orphanages</td>
<td>5441</td>
<td>6707</td>
<td>6707</td>
<td>6847</td>
<td>7249</td>
<td>7326</td>
</tr>
<tr>
<td>General boarding gymnasium (internats)</td>
<td>4584</td>
<td>5315</td>
<td>8342</td>
<td>10900</td>
<td>14650</td>
<td></td>
</tr>
<tr>
<td>Special-needs boarding gymnasium</td>
<td>6515</td>
<td>8313</td>
<td>11389</td>
<td>14182</td>
<td>18171</td>
<td></td>
</tr>
</tbody>
</table>

Table 6.1: Allocation of State Funds to ATU budgets: Norms per Student, 2003-2008 (lei)

Source: Ministry of Finance.

6.14 While these are simple formulae for allocating public money to schools, a school director is not allowed to use her allocation flexibly, thus constraining the efficient use of resources. The amount that a school director must spend on salaries is determined by the number of teaching hours in her school, which is, in turn, determined by the number of classes (however few students they may contain). In the increasing number of schools with very small classes, the salary bill (based on the number of classes) thus exceeds the total allocation (based on the number of students); in many schools, it leaves little or no public money for furniture, materials, repairs, etc. The formula funding system is generating signals but they cannot be acted on. In 2005, only about 59 percent of schools’ budget needs are estimated to have been covered by these transfers from the state budget (CASE Moldova: Table 1.2). Funds have to be supplemented at the village level by local taxes, extra-budgetary revenue or transfers from other budget headings.

See CASE Moldova (2006: 43) for a more detailed description of the flow of funds from the centre to the administrative territorial units.
6.15 Schools vary in the extent to which they enjoy managerial autonomy. In some cases, directors, working closely with the local mayor's office or with raion financial officers, agree and set annual budgets, appoint non-teaching and (less often) teaching staff, distribute teaching workloads, etc. In other cases, directors are kept out of the budget-setting process. In all cases, responsibility for managing funds lies with the local authority, the number of classes (and hence of teachers) can only be changed with permission and the number and type of non-teaching staff are governed by norms (Langton 2006: 11).

6.16 A new Government project will initiate (via pilot schemes) a move towards decentralization of authority to fully autonomous schools, in which school directors have flexibility in the use of budgets, and school bank accounts, with a managerial role for school councils and with full involvement of communities in school affairs. This would be accompanied by a broadening of the funding formula to include some additional factors. A pre-project study (Langton 2006: 18) has suggested, as possible candidates for inclusion, in addition to student numbers, age-weighting to give more money to younger students, a measure of poverty in the area, the state of school buildings, and school size, but the debate on this has hardly begun.

D. SCOPE FOR IMPROVEMENTS IN EFFICIENCY

6.17 What scope is there for improvements in efficiency? Some orders of magnitude can be estimated. In the next two sections, existing weakness will first be identified then options for more efficient use of resources will be specified, with a view to outlining a possible 'basic package' for the education sector. Then, the MTEF will be used to explore their impact and implications for fiscal space.

6.18 First, many schools have very low numbers of students, small classes and low student/teacher ratios, as Table 6.2 shows. The figures are particularly low, in comparison with OECD averages, for gymnasia, which account for some 23 percent of enrollment in general schools. Moreover, there are wide variations between schools in these indicators. For instance, Pau (2004) showed that, of the 15 gymnasia in Edinet judet in 2003, five had student/teacher ratios of between 5.1 and 6.4, five of between 9.4 and 9.8 and five of between 13.8 and 13.9; while, in Bălțăt judet, class sizes varied from 5.0-9.9 (11 classes) to 10.0-14.9 (20 classes) to 15.0-19.9 (24 classes) to 20.0-24.9 (28 classes) to 25 or more (3 classes). As for school size in rural areas, nearly two thirds of gymnasia have 200 students or less, while 14 percent have fewer than 100: in urban areas the comparable figures are 21 and 7 percent. At secondary general and lyceum level, 38 percent of rural schools have fewer than 401 students, 14 percent fewer than 281, compared with 18 and 9 percent respectively in urban areas.

6.19 The optimization of the school network in general education (from primary to upper secondary) thus represents an opportunity for generating substantial fiscal savings. As the school-age population continues to fall, it becomes more urgent to focus on schools and classes that are below optimal size. Political realities have to be faced, however. It is highly unlikely, given the importance of the village school to the community that any government would decide to close small schools in villages that already have them. A suggested model that could be explored is to retain pre-schools and primary schools (with multi-grade teaching) in these villages (where possible sharing a building) and to optimize at the secondary level, including the secondary classes shifted from these small villages. In the absence of the full school-mapping information, it is impossible to estimate accurately the possible savings from such a move. However, it can be assumed (particularly if school autonomy allows directors to hire and use teachers flexibly) that it would allow an increase in student/FTE teacher ratios to around OECD levels (16.6 in primary and 13.6 in secondary schools). This would be offset by a need to provide transport for students.
in grades 5 and higher to the nearest school, involving the hire of vehicles with drivers rather than purchase, and by the cost of \textit{training teachers in multi-grade teaching} methods and other restructuring costs.

\begin{table}[h]
\centering
\caption{Selected Education Indicators by level, general schools, 2005}
\begin{tabular}{|c|c|c|c|c|c|}
\hline
 & \textbf{Primary Schools} & \textbf{Gymnasia} & \textbf{Lycea} & \textbf{Secondary General Schools} & \textbf{Total} \\
\hline
Student/FTE Teacher ratio & 15.3 & 1.4 & 3.1 & 13.0 & 12.7 \\
\hline
Students per class & 22.5 & 8.5 & 24.6 & 22.4 & 22.2 \\
\hline
Students per institution & 147.3 & 87.6 & 641.6 & 444.8 & 358.9 \\
\hline
Number of classes per grade & 1.6 & 1.1 & 2.2 & 1.8 & 1.6 \\
\hline
\end{tabular}
\end{table}

\textit{Source: Langton (2006: Appendix 8).}

6.20 Second, non-teaching staff represent a disproportionate share of total staff, about 37 percent of total staff in general schools, compared with the OECD average of 27 percent. \textbf{Norms for non-teaching staff}, which are laid down centrally, could be relaxed in autonomous schools. Reducing non-teaching staff levels down to the OECD average represent a further opportunity for generating fiscal savings.

6.21 Third, \textbf{heating costs} are inflated by the poor insulation of most school buildings, the duration of heating (sometimes 24 hours a day, seven days a week during term time), and the large amount of space utilized per student (Tibi et al., 2002: 35ff.). While the number of students in each school is falling, the size of school buildings remains the same: between 2001 and 2003, the proportion of school space utilized in primary and secondary schools fell from 85 to 79 percent, and it is expected to fall further to 54 percent by 2007 and 50 percent by 2010 (Paiu, 2004). While the scope for reducing heating costs is reduced by the rising price of energy in international markets, various options and measures for containing heating costs can be explored. These measures include the following: where cost/benefit analysis justifies it, equipping schools connected to district heating with meters that have valves, and modifying fixtures to reduce heat loss; merging schools to make more efficient use of premises; changing the school year to allow long vacations during winter; and, in the longer run, reviewing the choice of fuel and technology and progressively replacing old schools in poor condition with new buildings designed for energy efficiency.\textsuperscript{34}

6.22 Fourth, \textbf{textbooks}, which had been excluded for the past few years from the free basic package for general school students in favor of a rental scheme, are once again being provided free of charge to all primary grade students. There is a case for reviewing this decision. The virtue of the textbook rental scheme and associated extra-budgetary textbook fund was not only that they saved public expenditure: they also ensured the availability of high-quality textbooks to

\textsuperscript{34} See Tibi et al.: 36-37.
students. A selective subsidy to enable children from disadvantaged families to obtain textbooks is certainly justified on equity grounds but a blanket subsidy to all primary students is likely to threaten quality by reducing the number of good textbooks available and to squeeze other components of school budgets.

6.23 Finally, opportunities for fiscal savings exist at various levels of education, but they need to be offset by social and distributional considerations. The following is a summary of key opportunities at each level, while qualifying the scope and limits for fiscal savings:

- **Pre-schools** absorb an unusually large proportion of total education expenditure (16 percent, equivalent to 1.1 percent of GDP compared with 0.5 percent on average in OECD countries) and their unit costs are 52 percent higher than those of general schools. In response to this, Tibi et al. (2002: chapter 8) recommended full cost recovery for pre-school children between the ages of one and five, but free pre-school education for six-year-olds in general secondary schools. However, the equity implications of this recommendation have to be taken into account. Early childhood development is particularly important to the future academic achievement of children from disadvantaged families: continued subsidy of pre-schooling for younger children from such families would be justified on these grounds.

- There is a major question about the viability of **vocational schools** in their traditional role of providing ready-to-work recruits with specialized skills for the economy’s enterprises. They are chronically under funded in relation to this objective and, even so, are the most expensive and least efficient secondary educational institutions. Although male vocational school graduates do better in the labor market than their general school counterparts, this is not the case for females. As secondary students increasingly seek routes to higher education, enrollment in vocational schools is steadily falling, equipment and curricula are outdated, and there is a shortage of competent technical teachers. Re-equipment would be too costly. In the past, also, they were used as a repository for the less able, on the assumption that such children had reached the limits of their academic absorptive capacity by their early teen-age years. That assumption has been increasingly questioned: the benefits of avoiding premature allocation of students to academic and vocational streams are acknowledged, particularly since a sizeable proportion of those classified as “less able” tends to include students from disadvantaged backgrounds with unrecognized potential. Training (wherever possible, in-plant and on-the-job and financed as far as possible by beneficiaries), after a high-quality general education has been completed, is a more promising alternative model.

- Another area in which a change in model would be useful (and would save taxpayers’ money) is that of the general and special-needs **boarding schools** (internats). In general, the educational, developmental and future-employability needs of many of the children in such schools are more likely to be fulfilled by their inclusion in mainstream schooling systems than by isolating them in separate institutions. Others could be more efficiently served by local day placement facilities.

- **In higher education**, a “dual-track” system of fees and stipends provides inadequate academic funding and is inequitable. Fee levels vary by subject (in Moldova State University they range from 2,800 to 7,000 lei per year, depending primarily on the ratio of applications to places), but budget students (accounting for 51 percent of the total in public colleges and 24 percent in public universities in 2005/6) do not pay fees. Stipends are paid to budget students, who are chosen primarily on academic merit. An alternative package is worth
exploring, along the following lines: First, all students at public higher education institutions could be required to pay fees (Tibi et al. suggested a fee level of between 50 and 70 percent of average unit costs). Second, in place of existing stipends and fee remission, grants, to cover fees and living expenses fully or partially, would be made available by the Ministry of Labor and Social Protection only to students (with adequate qualifications, of course) from disadvantaged backgrounds. Universities could still use their own money to give some merit-based scholarships, but they would not get allocations for this purpose

E. Fiscal Space?

6.24 The budgetary envelope for education is provided by the Medium Term Expenditure Framework (MTEF) for 2007-2009, and projections made for the purposes of this chapter break down the MTEF totals further by category of expenditure and combine them with statistics on enrollment, staffing, etc. The driving force behind the projections is the expectation, already mentioned, that the number of 3-6 year olds will fall in 2004-2009 by 9 percent, 7-15 year olds by 24 percent and 16-18 year olds by 18 percent – and that the number of 19-24 year olds will rise by only 6 percent. At the same time, it is assumed that progress will be made towards the enrollment rate targets of the Economic Growth and Poverty Reduction Strategy (EGPRSP), and the Education for All (EFA) National Action Plan. Otherwise, it is assumed at each level that staff/student ratios, the number of institutions and the distribution of expenditure between different categories will remain unchanged.

6.25 On these assumptions, expenditure on publicly owned pre-schools is set to increase by 92 percent over the period. A steady increase in enrollment rate to 80 percent by 2009 will more than offset the fall in numbers in this age group, yielding an increase in the number of pupils and staff over the period of 6 percent. Total expenditure per student and average personnel expenditure per staff member will thus increase, on these assumptions, by around 80 percent – compared with the 54 percent rate of inflation projected by the MTEF.

6.26 The second category of institutions is public general schools teaching at primary, lower secondary and upper secondary levels. The MTEF lumps all secondary schools together, including also vocational and boarding schools. For the purposes of these projections it has been assumed that the split of expenditure between different types of secondary schools remains unchanged over the period. A rise in enrollment rate is more than offset by the fall in population in this age group, so total expenditure per student and average personnel expenditure per staff member rises by 68 percent – a relatively small increase in real terms.

6.27 The MTEF projects an increase in extra-budgetary funding of only 20 percent over the period. On the assumption that its distribution between levels does not change, secondary vocational education is projected to show a 59 percent increase in expenditures. With no increase in enrollment rate expected, the number of students and staff members is projected to fall by about 18 percent – to the benefit of total expenditure per student and average personnel expenditure per staff member, which will increase by 95 percent.

6.28 Public colleges are also expected to experience a faster rate of increase in public than in total expenditure. With enrollment rate unchanged, the number of students is expected to increase by 6 percent, with the result that total expenditure per student and personnel expenditure per staff member will rise by 56 percent – about the same as the rate of inflation.

6.29 The picture in public universities is even worse, suggesting a near-crisis in financing at this level. Total expenditure is projected to increase by only 35 percent, in spite of a 124 percent
rise in public spending. A 6 percent increase in the number of students implies a rise in total expenditure per student and average personnel expenditure per staff member of only 28 percent – well below the inflation rate.

6.30 These projections can be used to illustrate the rough order of magnitude of the potential savings of various efficiency-boosting options specified as part of a ‘basic package’ in the previous section, as follows (Figure 6.1 shows the results for 2009):

- if public spending on pre-school pupils aged five or below were cut by 70 percent (assuming that 30 percent of pupils, from the poorest households or otherwise disadvantaged, would still be subsidized), and free food for those over the age of five were also confined to the least advantaged 30 percent, while the pupil/teacher ratio was raised to the average OECD level, fiscal savings of 211 million lei would be made by 2009;

- in general schools, if student/teacher and student/non-teacher ratios were reduced to OECD levels, through a combination of relocating secondary classes from schools that are below an efficient size (while allowing primary classes to remain where they are, with multi-grade teaching if necessary) and the abolition of strict norms for the number of teaching and non-teaching staff in autonomous schools, fiscal savings totaling 277 million lei would result;

- there would be some offsetting increases in expenditure, estimated at 40 million lei for hiring buses with drivers (assuming that a 20-seater bus could be hired for around 20,000 lei per year to make two journeys of up to 10 km per school-day and that 40,000 children would be riding to school) and around 101 million lei in other extra current expenditure on severance packages for non-teachers, re-training teachers, and making other adjustments to school premises and arrangements;

- renovation of school heating and insulation systems (preferably donor-funded) and a more efficient use of space in merged schools are assumed to be necessary to hold heating costs at current levels rather than to yield any savings;

- if vocational schools were closed and their students were absorbed into the general school nearest to them, an annual saving of some 64 million lei would result, reflecting the much lower unit costs to the budget of the general day school compared with the vocational boarding school, but a one-off severance package (the cost of which is not included in Figure 6.1) would be needed for vocational school staff;

- if the budget for state-funded stipends in higher education were cut by, say, 70 percent, and they were awarded to students from disadvantaged backgrounds rather than mainly on grounds of academic merit, public expenditure would fall by about 27 million lei;

- if, at the same time, all higher education students (except those from disadvantaged backgrounds) were required to pay fees, rather than just the contract students, both colleges and universities would benefit from substantial increases in fee income, but the government would incur some costs in setting up and guaranteeing a loan system.

35 The poverty rate in 2004 was estimated at 27.8 per cent (Republic of Moldova 2006a: Table 2).
36 Natural wastage would probably be enough to reduce student/teacher ratios to the desired level.
Figure 6.1: Fiscal Space in Education: Possible Saving & Extra Spending, 2009

![Diagram showing fiscal space in education]

Source: Author’s Calculations.

F. CONCLUSIONS

6.31 Increasing the efficiency of education sector spending can yield net potential savings of about 437 million lei, a substantial amount out of the total projected 2009 education budget. However, there are at least two grounds for caution (in addition to the very rough basis of the calculations) in treating this amount as pure fiscal space.

6.32 The first is the crisis in the general school teaching profession. Many observers have reported the concerns of staff in raion offices and schools about the future of the profession. They point out that many teachers are near the end of their working lives and relatively few new teachers are coming forward to replace them. They relate this directly to the low salary levels for teachers, discussed above. Special incentives for young recruits are only part of the answer to this problem, which requires a re-shaping of salary structures for the whole profession. Our fiscal space calculations retain the assumptions of our base projections as far as personnel expenditure per teacher is concerned - a 68 percent increase on average between 2004 and 2009. This would imply not only a slight increase in real terms over the period (since prices are expected to rise by 54 percent) but also a dramatic further falling behind other wage earners in the economy: the latest MTEF estimates that the average wage will rise by 159 percent over the period. As with the rest of the public sector, higher teachers’ wages would be an important element of attracting and retaining qualified teaching staff.

6.33 The second reason for caution in the fiscal space discussion is the very low proportion of the publicly funded budgets of educational institutions available for quality improvement, i.e. expenditure on teaching materials, books and magazines, maintenance, repairs and purchase of
equipment, professional retraining, IT works and repairs to buildings (for instance, 8 percent in general schools). Higher spending on quality-related inputs is needed.

6.34 The magnitude of net potential savings in the education sector suggests that there is a significant scope for improved efficiency in the sector. Before resources are ultimately allocated back into the education sector, care must be taken to ensure that limited public resources are being efficiently used. The preceding analysis suggests a challenging reform agenda and a number of opportunities for greater efficiency at various levels of education concerning staffing, resource use, and input mix.
7. PROMOTING THE FISCAL SUSTAINABILITY OF THE PENSION SYSTEM

A. INTRODUCTION

7.1 During the recession that followed independence in Moldova, the pension system inherited from the Soviet period came close to collapsing. To strengthen the fiscal sustainability of the system, a reform program was initiated in 1998. Pensions entitlements earned before 1998 were revaluated (and reduced), and a new formula was introduced for the pensions rights associated to the contributions paid after 1998. To reduce uncertainties in the revenue-expenditure gap, increase transparency, and improve equity, the reform program mandated that pension payments be made based on actual paid contributions rather than on stated wages, supported by an appropriate information technology (IT) infrastructure containing electronic records of individual contributions. Retirement age was also set to increase gradually.

7.2 While a number of short-term objectives have been met by the reform program (including pension payments provided on time, in-cash rather than in-kind, and without the need for budget transfers), the reform program remains incomplete. A hold was put on the retirement age increase in 2001, the pension formula has been revised several times, and the National Social Insurance House (NSIH) record system has not been completed. As a result, although the NSIH has enjoyed a favorable economic and demographic environment for 4 years now, it was in deficit at the end of 2005. The medium and long-term financial stability of the system requires that the reform program be completed. From a fiscal perspective, the fundamental challenge is that of ensuring that pension benefits are fully financed by available resources within the pension system. It requires eliminating unfunded liabilities and imbalances in the system, to reduce fiscal pressures and preserve the fiscal space required by the Government to carry out its development program.

7.3 This chapter focuses on fiscal issues related to social insurance programs and in particular, the pension system. It looks at the long-term financial viability of the pension system as well as the challenges in completing the reform program while taking into account the likely poverty and distributional consequences. In particular, it focuses on the following key issues: relatively low levels of pension benefits; the substantial redistribution from non-agricultural workers to agricultural workers and the strategy to unify the pension systems for all categories of retirees; and the financial stability of the pension system, given current and future demographic trends, large emigration flows, and projected macroeconomic and fiscal developments. It concludes by assessing the likelihood of generating substantial reserves and the institutional requirements for managing such reserves well.

37 This chapter thus focuses primarily on the social insurance program of the government, representing 87 percent of all the NSIH social transfers. However, while the distinction between social insurance and social assistance programs is clear in principle (i.e., social insurance programs aim to smooth individuals' income shocks due to temporary or permanent loss of earning capacity, and not directly linked to alleviating poverty), NSIH social insurance and social assistance programs are not financially independent. As such, this chapter presents also some NSIH aggregate financial indicators, though the in-depth analysis of current social assistance programs and the possible impact of their reform are presented in Chapter 8.
B. PENSION INCOME

7.4 In the 1990's, the social insurance system was in crisis. In 1998 and 1999, most of the pension benefits remained unpaid and, only 40% of the elderly entitled to pension received some benefit. In such conditions, pensions clearly could not be increased. In 2000, the average pension represented no more than 22% of the average wage and 38% of the poverty line. The recent pension increases thus correspond to a logical recuperation of meaningful pension income levels. With an average pension just above the poverty line, the levels obtained at the end of 2005 still do not appear particularly high.

7.5 Figure 7.1 compares the average pension and the minimum pensions to the average wage and the poverty line. There are several types of minimum pensions in Moldova, only the 2 principal ones are represented in Figure 7.1. One is paid to the old-age retirees from the agricultural sector and the other is paid to the old-age retirees from the non-agricultural sector. The other minimum pension is paid to the disabled and the survivors. They are lower than these two levels because the insured have contributed for shorter periods, or because the survivors are only entitled to a portion of the deceased insured pension (50% in the case of widows). In the general system (excluding privileged pensions) disabled pensions are on average 15% lower than old-age pensions, and survivor pensions are 39% lower.

Figure 7.1: Pension Benefits Levels in comparison to the Average Wage and the Poverty Line

7.6 Social assistance programs, by contrast, aim to alleviate current poverty. They are direct or indirect transfers mostly funded by the State budget. In Moldova, this aid consists of monthly benefits, social services and subsidies (primarily in energy and housing) to specific vulnerable groups. Ideally, the recipients of these transfers should be only poor households, and a reform to improve the targeting is under study.

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7.7 The average pension in 2005 was more or less equal to the poverty line, but about 17.2% of the current pensions were still below such level, at the beginning of 2006. The increase of the pension will certainly improve many pensioners welfare situation but may not lift all the pensioners out of poverty. Poor pensioners tend to live in extended rural families and eliminating poverty among them would require higher transfers to push all their families' members out of poverty. Such action is clearly relevant to social assistance programs. Some attention could be given, however, to the minimum pension paid to the disabled and the survivors. Simulations show that most of the pensions could be in 2009 above the poverty line, but still 4.4% could remain under. About 78% of the recipients of these very little pensions are working-age permanent disabled persons. As this population is usually among the groups with high risk of poverty, revising the minimum benefits paid to the disabled and survivors seems advisable.

7.8 Since 2001, pension benefits have been increased through two types of interventions. Most of the increases have been done through general pension increases. In 2002 and 2004, however, the increases were obtained through the revaluation of the pensions rights associated to the years worked before 1998. This choice probably reflects concerns about the low level of pension income at retirement.

![Figure 7.2: Pension Income at Retirement by Pensioners Category](image)

Source: NSIH data.

7.9 Reassessing pension rights in order to increase pension, similar to exercises conducted in 2002 and 2004, is not efficient or transparent. It leads to cumbersome recalculations of pension benefits, and pension increases that vary across recipients. Given these inconveniences, policymakers' choice has probably been motivated by the following additional consideration, namely the change in pension formula. Thus, besides increasing the level of current pensions, the recalculation of the pre-1998 pension rights leads also to the increase of the levels of pension at retirement, so the measure also raises future retirees' pensions.

7.10 Despite these measures, pensions at retirement are still rather low in comparison to the current wages. Current retirees (about 30,000 persons retire per year) are also likely still dissatisfied with the level of pension income at retirement. First, the disparity of pension income among the new pensioners is large (see Figure 7.2). Second, replacement rates (the ratio between pension and the retiree's income at the end of his/her working period) are very low for some pensioners' categories.

7.11 The income drop is particularly high for the retirees of the manufacturing sector. Estimates show that, in 2006, pension income at retirement could replace just 22% of their last income. Estimates also indicate that this replacement rate could fall further to as low as 19.3% in 2008. The reason of the large income drop at retirement is that, in the calculation of the pension rights earned after 1998, workers' wages are not adjusted in the computation of the average wage.

This does not necessarily mean that recipients of these pensions live in poverty. Many elderly live in extended families, about 7% are still working, some obtain return from their savings (rents etc.), while others receive social assistance benefit. Only a detailed analysis of the results of the household survey of 2005 would indicate if pensioners are relatively poorer than the rest of the population.

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Table 7.1 illustrates this point. It compares, depending on different rates of wage growth, the average wage and the pension obtained by new retirees. The results indicate that in a context of modest wage growth of 2 percent per year, for example, the average wage on which the pension is calculated represents 69.8% of the last wage. Pension replaces 37.7% of the last income and given that pensions are partially indexed to the nominal wage growth, the average replacement rate during the overall retirement period is equal to 40%. This replacement rate is comparable to international standards. Replacement rates significantly decrease, however, in a context of strong wage growth because the wages earned at the beginning of the working career pulls down the overall average. With a nominal wage of 8 percent per year, the replacement rate at retirement drops to 17.4%.

Table 7.1: Average Wage and Replacement Rates

<table>
<thead>
<tr>
<th>Nominal wage growth</th>
<th>Average computed wage</th>
<th>Replacement rate at retirement</th>
<th>Average replacement rate over the retirement period</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.0</td>
<td>69.8</td>
<td>37.7</td>
<td>40.0</td>
</tr>
<tr>
<td>4.0</td>
<td>51.5</td>
<td>27.8</td>
<td>31.4</td>
</tr>
<tr>
<td>6.0</td>
<td>39.9</td>
<td>21.5</td>
<td>25.9</td>
</tr>
<tr>
<td>8.0</td>
<td>32.2</td>
<td>17.4</td>
<td>22.3</td>
</tr>
<tr>
<td>10.0</td>
<td>26.9</td>
<td>14.5</td>
<td>19.8</td>
</tr>
<tr>
<td>15.0</td>
<td>19.1</td>
<td>10.3</td>
<td>16.6</td>
</tr>
</tbody>
</table>

Note: Average wage and replacement rate at retirement computed for a contributory period of 40 years, average replacement rate computed over a retirement period of 25 years, assuming real wage growth equal to half of the nominal wage growth.

Sources: NSIH data

7.12 Because wages have increased rapidly since 1998 (by about 25% per year), the average wage computed for pension since 1998 has fallen sharply in relation to the current wage. It was of around 69% in 2002, it could be at 48% in 2008. Without changes in the computation of the average wage in the pension formula, replacement rates at retirement will keep falling at a result.

7.13 If economic growth is sustained, and wages keep rising, it is doubtful that such an outcome receives political and social support. Replacement rates can be rather low, but the gap between the system implicit financial return and the average return of other private savings opportunities cannot be too large. Policy makers should, therefore, analyze what upgrading strategy would be the best for Moldova. To be fiscally sound, the envisaged changes must affect only the new generations of pensioners, so the upgrade of the system increases pension expenditures, but gradually. The size of the upgrade depends, moreover, on the system's capacity to collect revenues. This issue and the overall fiscal impact of upgrading the system are analyzed in the next sections.

C. TOWARDS A UNIFIED CONTRIBUTORY SYSTEM

7.14 Being universal, almost all workers, wage employed, farmers and self-employed must be insured to NSIH. Assuming that the level and the structure of employment remained roughly between 2004 and 2005, the comparison of the number of contributors reported by NSIH with the figures published by the National Statistic Bureau (BNS) indicate that NSIH covers about 93.6% of the working population (Table 7.2). All these reported contributors, however, do not participate on the same basis. The amount of contribution largely varies depending on the type
and sector of employment: wage employed contribute in proportion to their wages; farmers and self-employed pay a flat amount per year and subsistence farmers likely contribute nothing.

7.15 As explained in previous reports, farmers contribute very little: on average, about 179 lei per year per person in 2005. Three quarter of self-employed workers also contribute very little: 180 lei per year per person in 2005. In comparison, the contribution due from a worker paid the minimum wage of 100 lei per month amounts to 348 lei per year (= .29 * 100 * 12; employee’s and employer’s shares). Farmers, self-employed and wage-employed are, however, entitled at retirement to the same minimum pension (20% lower in the case of the farmers). The low amount of contribution paid by self-employed workers and farmers in comparison to the wage-employed appears, therefore, largely unfair.

Table 7.2: Employment and Number of Contributors

<table>
<thead>
<tr>
<th>Employment Category</th>
<th>2004 BNS</th>
<th>2005 NSIH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage employed</td>
<td>860900</td>
<td>826408</td>
</tr>
<tr>
<td>Public administration</td>
<td>240693</td>
<td></td>
</tr>
<tr>
<td>Other wage employed Non Agriculture sector</td>
<td>374118</td>
<td>713954</td>
</tr>
<tr>
<td>Wage employed Non Agriculture sector</td>
<td>708430</td>
<td></td>
</tr>
<tr>
<td>Wage employed discount contribution rate</td>
<td></td>
<td>5354</td>
</tr>
<tr>
<td>Wage employed Software</td>
<td></td>
<td>170</td>
</tr>
<tr>
<td>Wage employed in Agriculture</td>
<td>246089</td>
<td>112454</td>
</tr>
<tr>
<td>Self-employed &amp; farmers</td>
<td>332264</td>
<td>405550</td>
</tr>
<tr>
<td>Self-employed</td>
<td>164940</td>
<td>101323</td>
</tr>
<tr>
<td>Self-employed flat rate</td>
<td></td>
<td>23845</td>
</tr>
<tr>
<td>Self-employed with permit</td>
<td></td>
<td>77465</td>
</tr>
<tr>
<td>Land owners (renting)</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Farmers</td>
<td>167324</td>
<td>304227</td>
</tr>
<tr>
<td>Subsistence farmers</td>
<td>119534</td>
<td></td>
</tr>
<tr>
<td>Total employment</td>
<td>1316042</td>
<td></td>
</tr>
</tbody>
</table>

Notes: 1/ BNS and NSIH have different definitions of employment categories.

7.16 In Government decision No. 1219 from October 23, 2006, the government approved a draft strategy to reform the pension system in agricultural sector. Under the new framework, the workers from the agricultural sector who are wage employed should be applied the same contribution rate than the other wage employed. Farmers and self-employed should contribute a minimum consistent with the minimum pension benefit they will be entitled to at retirement. Such strategy should significantly increase NSIH revenues. The contributions due from self-employed workers and farmers (excluding the subsistence farmers) could amount to about 1.3% of GDP (about 560 lei million in 2006) and those due from wage-employed in the agricultural could represent about 0.5% of GDP (about 230 lei million in 2006). These changes in contributions payments, however, are gradually introduced because many of these contributors are poor or work in lagging enterprises.

7.17 In the case of farmers, in 2006, the flat amount of contribution was set at a level equivalent to 26% of the officially desired minimum level (480 of 1815 lei per year). There is no readily available information on farmers; average income in 2005, but if the income distribution among farmers was similar to the income distribution among the wage-employed in the
agriculture sector, this flat amount of contribution would still appear excessive for about 20 percent of farmers. In the case of self-employed workers, in 2005, the payment of the desired minimum level of contribution was required of about a quarter of the self-employed population. The rest of the self-employed continue to pay very little amounts (equal to 30% of the monthly fees they pay to the State).

7.18 The resulting imbalance between farmers and self-employed workers’ paid contributions and future pension entitlements roughly represents NSIH implicit subsidies of 247 million lei in the case of the farmers and 138 million lei in the case of the self-employed, a total of about 0.8% of GDP using data for 2006.

7.19 The government has not articulated a strategy for the integration of all the self-employed workers and farmers into the new contribution framework. In the case of farmers, this process will probably take several years. Simulations show that still in 2015, a flat contribution above 53% of the desired minimum level will still be unaffordable for some 20% of farmers.

7.20 Supporting the participation of poor workers in social insurance is an effective and efficient pro-poor policy, as long as the policy is transparent and does not disproportionately benefit workers who do not require public support. In the absence of support, poor and near poor workers cannot contribute to a pension system on a regular basis. As a result, very few are able to contribute by themselves the number of years necessary to finance a minimum pension. If instead, during their spell of poverty, these workers receive some financial support to enter or pursue their participation into the pension system, they have more chances to accumulate pension rights. In the long-term, such policy enhances the overall population welfare and reduces the number of future elderly with no or insufficient old-age income support.

7.21 Since poverty rates are extremely high among farmers (53.6% in the first semester of 2005 compared to 28.5% for the total population), setting a subsidized unique flat rate for farmers seems at this stage reasonable and efficient. However, subsidizing more than three quarter of the self-employed seems inefficient, since the population of self-employed workers have the lowest poverty rate (17.6% in 2005). Leakages are likely important in that group. The payment of the desired minimum contribution should be enforced rapidly in that sector.

7.22 With respect to workers from the agricultural sector who are wage employed, enterprises were asked in 2004 to pay a contribution rate of 20% (against 27% in the other sectors). The introduction of a contribution rate on wages in 2004 has significantly increased the labor costs of many enterprises in the sector. It might have led to some retrenchments, and certainly numerous case of financial squeezing. As the 2004 Social report observes, most of the new arrears in contributions in 2004 are due from agricultural sector enterprises that could not comply with the new regulations. Instead of suspending the progressive convergence of the contribution rate, the

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40 For these farmers the flat amount of contribution would represent more than 10% of their income.
41 Based on NSIH 2005 number of contributors, 83858 among 101 323self-employed paid a flat contribution amount.
42 This is the difference between desired minimum and paid contributions. More precise estimate would compute the system’s subsidies based on the present value of the expected amount of the contributions paid, and the number and the level of the future payments of the minimum benefit.
43 For these farmers the flat amount of contribution would represent more than 15% of their income.
44 The cost of screening the applicants would outweigh the benefits from reducing the leakage.
45 The leakage is the amount of implicit subsidies that are not directed to the poor but to better-off.
government responded with the introduction of an explicit subsidy equal to 4 percentage points of the contribution rate. In 2006, this subsidy could amount to about 32 million lei. Providing such a blanket subsidy to all the agricultural enterprises was probably unnecessary, and therefore not fiscally and socially efficient. The particular strong wage growth in the agricultural sector in 2004 and 2005 (23.8 and 19.7%) reflects important productivity gain and suggests that not all the agricultural enterprises currently face financial difficulties to comply with the new regulation.

7.23 To summarize, the government strategy to unify the contributory system should increase the system revenues in the medium-term. The new regulations should be introduced gradually in the case of farmers, because many are poor, but could be implemented more quickly in the case of self-employed workers and wage employed workers of the agricultural sector.

D. Setting up the Pension Fund's Regulations and Supervisory Institutions

7.24 The pension fund is not financially independent of other NSIH programs. While expenditures by types of programs are easily distinguished, revenues and current administrative costs are distributed across programs. The budget law mentions some redistribution, but it is theoretical and does not have practical implications. As a result, the deficit, the surplus as well as the reserves are produced at the NSIH aggregate level. Table 7.3 presents the NSIH overall financial balance and an approximation of the financial balance of the pension system that does not include the administrative costs and the amount of reserves and outstanding debt in contributions that could be attributed to the fund.

7.25 These figures show that after three consecutive years of surplus, NSIH ran into deficit in 2005 because of the pension fund. This deficit is the result of two government actions: policy makers implemented a huge pension increase in November 2004, while decreasing revenues by reducing the contribution rate by 1 percentage point, and thus the revenues from contribution by about 0.2% of GDP.

7.26 More generally, these results indicate that the recent policy of pension increases had reached its financial limit. Although wages and employment in the wage employed sector have steadily increased over the period, contributions in relation to expenditures have increased at a much slower pace. In 2004 and 2005, wages in the administration have increase by about +14% per year and, wages in the industry have increased by 18.6%. Figures on employment in 2005 are not available, but employment (agriculture sector excluded) has increased in 2004 by 1.3%. Consequently, revenues from contribution have increased by 0.5 percentage points of GDP (0.7 if contribution rate had not been cut). Pension expenditures, however, in the same period have grown by 1.7 percentage points. This is clearly not sustainable.

7.27 The short-term financial position of the NSIH is, however, not alarming. The institution reports reserves of about 1.6% of GDP and the pension system relies very little on State budget transfers. Of the 566 million lei of social benefits financed by the State budget in 2005, only 50 million accrued to pensions. These payments finance higher pensions to civil servants and privileged pensioners (about 11 500 beneficiaries or 2% of the total pension expenditures).
Table 7.3: Pension Fund Financial Results 2002-2005

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National Social Insurance House (% of GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>8.93</td>
<td>8.57</td>
<td>9.21</td>
<td>9.73</td>
<td>10.19</td>
<td>10.54</td>
</tr>
<tr>
<td>Of which budget transfers</td>
<td>1.65</td>
<td>1.40</td>
<td>1.42</td>
<td>1.89</td>
<td>1.56</td>
<td>1.52</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>8.42</td>
<td>7.87</td>
<td>8.66</td>
<td>9.86</td>
<td>10.19</td>
<td>10.46</td>
</tr>
<tr>
<td>Financial Balance</td>
<td>0.5</td>
<td>0.7</td>
<td>0.6</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Accumulated reserves (e.o.p.)</td>
<td>2.13</td>
<td>2.39</td>
<td>1.59</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Pension Fund (excluding administration costs) (% of GDP)**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Total payments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Pension and related benefits</td>
<td>5.53</td>
<td>6.12</td>
<td>7.30</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pensions</td>
<td>5.46</td>
<td>6.05</td>
<td>7.22</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social insurance</td>
<td>5.36</td>
<td>5.95</td>
<td>7.08</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State budget</td>
<td>0.10</td>
<td>0.11</td>
<td>0.13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other pensions and related benefits</td>
<td>0.07</td>
<td>0.07</td>
<td>0.08</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Other Benefits</td>
<td>1.17</td>
<td>1.19</td>
<td>1.07</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social insurance</td>
<td>0.01</td>
<td>0.08</td>
<td>0.04</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State budget</td>
<td>1.16</td>
<td>1.11</td>
<td>1.03</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2. Total Revenues</strong></td>
<td>7.56</td>
<td>8.04</td>
<td>8.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Revenues from contributions 2/</td>
<td>6.31</td>
<td>6.80</td>
<td>6.82</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Pensions financed by State Budget</td>
<td>0.10</td>
<td>0.12</td>
<td>0.14</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Benefits financed by State Budget</td>
<td>1.16</td>
<td>1.11</td>
<td>1.03</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3. Revenues – expenditures</strong></td>
<td>0.86</td>
<td>0.73</td>
<td>-0.37</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related to pensions ^2 (C+D-A)</td>
<td>0.89</td>
<td>0.80</td>
<td>-0.33</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: NSIH.

Notes: 1/ NSIH social insurance and social assistance programs are not financially independent. Revenues, surplus, deficit, reserves and outstanding debts are accumulated at the House level. 2/ Estimates based on the budget law indications about the share contribution rate destined to pension programs. 3/ Government mid-term framework.

7.28 The Government’s mid-term fiscal framework forecasts that the financial position of the NSIH over the period 2006-2008 will improve. The current demographic trends are favorable. Despite the interruption in the increase of retirement age in 2001, the total number of pensioners has decreased in the past years. In the medium-term as larger cohorts from the postwar baby boom reach retirement age, this demographic trend is expected to reverse, and the share of elderly in relation to the working-age population should steadily increase. If, as planned, the government resumes in 2008 the increase of the retirement age (until it reaches 65 for men and 60 for women in 2015), the upturn could be delayed until 2015 (see Figure 7.3 based on NSIH pension model).
7.29 This favorable trend is reinforced by the relatively older age of the current pensioners. According to the NSIH database, old-age and disabled pensioners were on average 75 years old. This surprising result is partly due to the low number of relatively young old-age pensioners less than 60 in the case of the women, and less than 65 in the case of the men. They represent about 45% of the population 55 years and older but only 19% of the older pensioners. Many workers have probably delayed retirement because of the large income drop it implies. From a fiscal point of view, this observation means that little savings can be expected from reviving the programmed increase in retirement age. Such increase is, however, important because it guarantees that in the future when pension levels at retirement improve, workers will continue to retire only after they reach the age of 65 and 60.

7.30 Based on these expected demographic trends, and given the expected results of the government strategy to increase revenues from contributions, Table 7.4 presents simulations of the pension system financial balance in the next 25 years. The system is constantly in surplus.

7.31 Obviously, these medium-term results rest on many assumptions and unknowns about the economic environment, the contributory capacity of the new workers generations and the profile of the future cohorts of pensioners.66

<table>
<thead>
<tr>
<th>Table 7.4: Medium-term Pension System Financial Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of pensioners</td>
</tr>
<tr>
<td>Average pension at retirement (% wage)</td>
</tr>
<tr>
<td>Pension expenditures (in % of GDP)</td>
</tr>
<tr>
<td>Revenues from contributions (% of GDP)</td>
</tr>
<tr>
<td>State budget financing (% of GDP)</td>
</tr>
<tr>
<td>Surplus(+) or deficit(−) (% of GDP)</td>
</tr>
</tbody>
</table>

Sources: NSIH data and pension model and author estimations.
Notes: 1/ Estimates based on the budget law indications about the share contribution rate destined to pension programs.
2/ Administration costs and other related benefits (funeral, etc.) excluded.

7.32 The consequences of the current large emigration flows are not expected to be significant in the short-term. The major impact will probably be in the long-term. Individuals currently leaving the country to work abroad are not likely to be contributing to the pension system at the moment. According to a MONEE study, half of the persons who live the country are less than 30, and many are from rural areas. Wage employment rate among these groups is rather low. In the long-term few returning migrants will be entitled to pensions because the system requires at least 20 years of contribution. In the long-term, the decline in the number of births could accelerate the aging of the population after 2020. This will translate into severe resource limitations for the pension system. Accordingly, the share of the revenues from contributions in the baseline scenario stabilizes around 9% of GDP in the long-term.

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66 Simulations using the NSIH database on contributors would produce more precise estimates of future retirees' pensions at retirement.
7.33 The assumption that the current trends in wages and employment will continue may appear optimistic. However, variants show that for the system to be in deficit in 2010, wage employment in the administration and the non-agricultural sector would have to decrease by 0.7% per year (instead of +0.6% in the baseline) starting 2006, and nominal wages growth rate would have to be lower than 10.8% per year (instead of +18% in the baseline). The possibility of such a scenario seems unlikely since from 2000 until 2004 wages (agriculture sector included) have been increasing in average by 26% per year and employment (agriculture excluded) has been growing by 1.1% per year.

7.34 On the expenditure side, the assumption of strong wage growth leads to a relative fall in pensions in relation to wages. As explained in detail in section 1, under the current pension law, a retiree’s recorded wages or contributions are simply averaged in the computation of pension at retirement. In a context of strong recent wage growth, pension levels appear to be quite low in relation to worker’s last earnings. Because this situation is most likely unsustainable in the medium and long-term, Table 7.5 presents the results of a variant, in which the system is upgraded and average pensions at retirement steadily increase. The results indicate that the system could keep producing surplus until about 2030.

<table>
<thead>
<tr>
<th>Table 7.5: Medium-term Pension System Financial Balance Gradual increase of pensions at retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of pensioners</td>
</tr>
<tr>
<td>618277</td>
</tr>
<tr>
<td>Average pension at retirement (% wage)</td>
</tr>
<tr>
<td>Pension expenditures (% GDP)</td>
</tr>
<tr>
<td>Revenues from contributions (%) (% GDP)</td>
</tr>
<tr>
<td>State budget financing (% GDP)</td>
</tr>
<tr>
<td>Surplus(+) or deficit(-) (% GDP)</td>
</tr>
</tbody>
</table>

Sources: NSIH data and pension model and author estimations.

7.35 At a pace of an equivalent of 1 to 1.5 percentage points of GDP per year, NSIH should accumulate a substantial level of reserves. Instead of producing surplus, policy makers could opt to reduce the contribution rate. Given the strong wage growth, this choice does not appear, however, pressing. Because of the enormous investment needs in Moldova, these resources could make, by contrast, a valuable contribution to economic growth if adequately invested.

7.36 Like that of East European countries with mature pension systems, the contribution rate in Moldova is high. This rate could be progressively lowered to 23% around 2010, but because of the probable rapid aging of the population due to emigration it should have to be increased again a decade later. Because of the strong wage growth, cutting the contribution rate does not seem urgent. International experience indicates that lowering contribution rates translates principally into higher wage increases. In some cases, it favors the employment of unskilled workers, but does not appear to increase total employment significantly.

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47 Pensions at retirement are computed on adjusted past wages combining 50% inflation and 50% wage growth. This method is applied to all the new retirees, civil servants included.
7.37 There is no obvious need for policy makers to stimulate higher wage increase over and above the wage increases fueled by large capital inflows and domestic economic growth. By contrast, there is a large need for higher fiscal savings in Moldova and growing pension reserves might be a convenient source of long-term financing. In such an environment, the pension fund is forced to buy only non-tradable government bonds (like in the US) or it is authorized to manage the portfolio given pre-established government mandates and restrictions.

7.38 The major risk associated with the building of pension fund reserves is mismanagement. Moral hazard and agency problems typically lead to situations where funds are not always invested in the best interest of the insured. In the case of a pension fund the beneficiaries, that is the future pensioners and the future generations of taxpayers, cannot closely participate in the management of the trust fund. The government does have influence over the funds investment strategy but it has also more than one objective and time horizons. The government goals (such as the restructuring of a bankrupted enterprise in an abandoned region, social housing etc.) might not be in conflict with preserving the long-term solvability of the pension system if “they are designed to correct market failures, address specific social or historical needs or capture some externalities”. The fact that these social and economic goals can also easily serve political purposes (e.g., free riding of some politicians or government agencies) creates additional complications. The problems of corruption, shirking, and overall monitoring of the trustees performance are also not negligible.

7.39 There are no obvious solutions to these problems. It is advisable to compose a Board of Trustees that reflects the diverse groups and balance the different conflicts of interest. The most successful experiences seem to be associated with pension fund tripartite boards with representatives from government employees and employers. Setting monitoring rules based on “behavioral” controls—adequate procedure of disclosure, presentations of investment strategies, use of auditing etc.—are also recommended. Finally, transparent rules for decisions on public investment and expenditures are also certainly helpful.

7.40 Clear regulations and supervision rules on what NSIH can and cannot do with its reserves need therefore to be rapidly developed. The design of institutional bodies to monitor NSIH decisions and hold it accountable needs also to be created.

E. CONCLUSIONS

7.41 The pension system in Moldova came close to collapsing in the late 1990s and as a result, a major reform program was initiated to strengthen the system’s long-term fiscal sustainability while promoting transparency and greater equity. The reform program remains incomplete and the system faces a number of critical challenges: First, pension incomes at retirement are very low in comparison to current wages. Second, the participation in the pension system of a many contributors, including farmers and self-employed workers, is largely subsidized.

7.42 In the first case, the strategy to upgrade the system has not yet been presented. Policymakers should analyze what upgrading strategy would be the best for Moldova. To be fiscally sound, the envisaged changes must affect only the new generations of pensioners, so the upgrade of the system increases pension expenditures, but gradually. The size of the upgrade depends, moreover, on the system’s capacity to collect revenues. In the second case, the government has developed a draft strategy to reform the pension system in agricultural sector and is moving towards the unification of the contributory system. Because poverty rates are extremely high among farmers, a gradual phasing in of new regulations should be considered. Self-employed workers, more than three quarters of whom are subsidized, have the lowest poverty
rate. Because leakages are likely in this group, a more rapid enforcement of new regulations, including the payment of the desired minimum contribution, is desirable.

7.43 With respect to the system’s long-term financial sustainability, prospects are generally favorable but a number of important risks remain. Over the last four years, the National Social Insurance House (NSIH) has enjoyed a positive economic and demographic environment. Although the NSIH experienced a deficit at the end of 2005, the pension system is currently on sounder financial footing with accumulated reserves of about 1.6 percent of GDP. Simulations also suggest that low pension benefits and favorable demographics trends should effectively allow NSIH to keep producing surplus and accumulating reserves in the medium-term. However, as the dependency ratio deteriorates, the long-term financial viability of the system will depend on how the reserves are managed and secured for the next generation. Setting up the regulations for this purpose is critical, given that moral hazard and institutional problems typically lead to situations where funds are mismanaged. The most successful experiences are associated with pension fund tripartite boards, representing diverse groups and interests.
8. SOCIAL ASSISTANCE BENEFITS IN MOLDOVA

A. INTRODUCTION

8.1 Before independence, Moldova’s comprehensive and centralised social welfare system was principally designed to assist those unable to work (ill or disabled) and children in need. The structure of the social welfare system was characterised by an emphasis on categorical benefits and little attention to household welfare as work was guaranteed to all and poverty was a relatively small phenomenon. In this context there was little need to distinguish between social insurance and social assistance given that the state owned all means of production and was expected to cater for all individuals.

8.2 The collapse of the command economy necessitated reform of Moldova’s social welfare system. One of the first reforms was to nominally split the social protection system into two separate branches including social insurance and social assistance. The economic crises of the 1990s saw a significant reduction in the income maintenance capacity of social assistance benefits due to hyperinflation, the suppression of some benefits or some categories of beneficiaries and the growth of arrears in payments. By the end of the 1990s, the social assistance system had a very marginal role in protecting households from poverty. With resumption of economic growth and Government resources, spending on social assistance began to increase. The also Government began to re-establish some elements a “Soviet-type” system of social assistance with the reintroduction of a number of measures designed to increase categorical benefits particularly for the disabled and the war veterans and which resulted in a general increase in social assistance transfers.

8.3 The backdrop of such reforms was an exasperation of the already evident mismatch between the scope of social assistance outlined in government stated intentions and government actions. On the one hand, the Government of Moldova claims that social assistance is a system designed to assist the poor and the vulnerable which is in line with the scope of social assistance in most countries worldwide and in the region. On the other hand, as it will be argued in this chapter, the social assistance system is de facto a categorical system where the poor are not a privileged target category. Relying on categorical benefits is not a problem per se if there is a clear distinction between those benefits to be granted to special categories of citizens in need such as the disabled and those benefits to be granted to poor families based on means tests. Most countries in the world rely heavily on categorical cash benefits48, but Moldova stands out as one of the few countries that rely exclusively on categories while claiming that the system is designed for the poor. It is the total mismatch between stated intentions and real actions that makes of Moldova an exceptional case.

8.4 This chapter makes a summary evaluation of social assistance benefits in Moldova, assesses the financial viability and sustainability of the system, provides some possible future scenarios and proposes possible reforms compatible with the Government reform agenda.

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48 In a study of 47 countries, Coady, Grosh and Hoddinott (2002) find that out of 87 types of cash benefits provided, 68% are categorical, about 26% are means tested or proxy means tested and the rest are community based assessed. However, the study considered all cash benefits under the social protection systems and not just social assistance benefits which are generally means tested.
B. SOCIAL ASSISTANCE EXPENDITURES

8.5 There are several classifications of social assistance benefits in Moldova used by different organizations including the MOF, the Statistical Bureau, the MHSP and the NSIH. As we collected data from all these organizations, we first reconciled these different classifications into one homogeneous list of benefits which include the following nine items:

1. Utilities compensations
2. Child indemnities
3. War veterans allowances
4. Social allowances
5. Death grants
6. Chernobyl compensations
7. Care takers allowances for disabled
8. Transport compensations for disabled
9. Material assistance

8.6 The state budget pays for most of the benefits with the exceptions of transport compensations for the disabled which is paid out of budgets of Administrative Territorial Units (ATU or local budgets) and material assistance which is mostly financed from the Republican Fund and local funds. In reality, transport compensations for disabled are financed by the local authorities that are partly financed by the central state budget and material assistance is financed by the Social Support Fund (SSF) of the population which also receives some contributions from the state budget. The administration of social assistance benefits is mostly handled by the NSIH (centrally and locally) with the exceptions of the transport compensations for disabled managed by the MHSP and administered locally by the local public administrations and material assistance which is controlled centrally by the SSF and administered locally by the local public administrations.

8.7 Social assistance benefits are all categorical with only two exceptions, child benefits for children in age 3-16 and material assistance. However, both these benefits are not means tested benefits as such but they are categorical benefits accompanied by means tested filters. Also, most benefits cover both the insured and the non insured persons and the distinction between social insurance and social assistance is unclear in terms of which benefit falls under what system and in terms of budget subdivisions. These are two features of the system evidently in contrast with the basic principles of social protection.

8.8 In 2005, total expenditure on social assistance benefits was approximately 538 millions lei equivalent to 1.7% of GDP and 4.8% of public expenditure. As a rule of thumb, expenditure on social assistance in percentage of GDP is typically between one and two percent and Moldova fits into this range. The largest benefit is compensations for utilities payments representing about 37% of total expenditure and this is followed by child benefits (21%), war veterans allowances (13%), social allowances (8%) material assistance (8%), transport compensations for disabled (5%), Chernobyl compensations (3%), death grants (3%) and care-takers allowances for disabled.

49 A list of key codes to reconcile the various classifications is provided in Volume II of this report.

50 Note that these are the figures taken from the state budget and provided by the NSIH. The NSIH also produce expenditure reports based on administrative records contained in the NSIH database which are somewhat different from the state budget data. As these last figures are provided by category of beneficiaries, these are the figures used for the macro assessment of individual benefits discussed further in the chapter.
Expenditure has increased for all benefits and in real terms between 2000 and 2005 and the largest benefits are among those that increased the fastest. Expenditure on child benefits have increased by 335%, utilities compensations by 136% and social allowances by 73% during the period while war veterans allowances increased by about 33% since their introduction in 2001.

8.9 Efficiency of Social Assistance Spending. Administrative costs for social assistance are not very high by world standards but they are high relatively to the administration of pensions. In 2005, expenditures for administration of NSIIP constituted 51.8 million lei in administrative costs of which about half was for salaries, 20% for goods and services, almost 13% for social contributions and 9.4% for maintenance with the rest being distributed equally among other items including medical insurance, travels, interests, capital investments and purchase of fixed assets. If we split these costs between social insurance and social assistance according to the number of beneficiaries, the administration of social assistance benefits consumed about 46.5% of this budget which is equivalent to about 5% of the total expenditure on social assistance benefits managed by the NSIIP. The annual administrative cost per beneficiary for social assistance can be estimated at 46 lei for 2005. These are not great amounts and far smaller than comparable figures for OECD countries but it should be noted that social assistance consumes much more than the administration of pensions relatively to the respective budgets. The number of beneficiaries in these two branches is similar but pensions are much higher than social assistance benefits on average.

8.10 Disabled, war veterans and families with children are the largest groups of beneficiaries. All benefits have multiple categories of beneficiaries and several benefits include the same categories of beneficiaries such as the disabled, children or war veterans which appear under several benefits. If we group all benefits by type of beneficiaries we see that the disabled are the most numerous and receive by far the largest share of total expenditure. This group is followed by children, pensioners and elderly and war veterans. Although many of the benefits for the disabled are not specifically targeted for children or war veterans these two categories account for a good share of the benefits paid to the disabled which makes children and war veterans the largest categories of beneficiaries together with other adult disabled. The poor as a category appear only once across all social benefits, under material assistance, and the share of beneficiaries is very small.

8.11 Social assistance benefits are a relatively small source of income for all households and only a marginally more important source for poor households. According to the Household Budget Surveys (HBSs) the main source of earnings for households is wages followed by social insurance (pensions) and by personal transfers from friends and relatives, including remittances. Agricultural income comes in fourth place and this is followed by finance which includes various types of financial income. Social assistance benefits come only in seventh place in terms of size. In 2001, they contributed for only 1.3% of total income for all households on average and 2.4% for poor households and these shares increased by 2004 to 2.1% and 5.1% respectively. Therefore, even in 2004, these benefits were not a very relevant source of income for poor households. Micro data also confirm that the largest social benefits received by households are utilities compensations, child benefits, war veterans' allowances and social allowances in this order. In 2004, these four types of benefits accounted together for over 90% of all social assistance benefits received by households.

8.12 Coverage has expanded for all benefits between 2001 and 2004. The coverage of utilities compensations has significantly increased by more than three folds for households and by almost five times for individuals. By 2004, 15.3% of households and 6.4% of individuals received at least one compensation for utilities payment. Among utilities compensations, the largest coverage
of the population is by gas and electricity compensations. Child benefits (or benefits for families with children) coverage also increased for both households and individuals reaching 4.3% and 1.7% of the population respectively in 2004. Benefits for children in age 3-16 are those with the largest coverage among child benefits. War veterans, social allowances and all other benefits bundled together also increased in coverage several folds. In 2004, social allowances covered about 3.2% of households and war veterans’ allowances about 2.9%.

8.13 The increase in coverage has been accompanied by a mixed performance in terms of average benefit in real terms which, on average and for all benefits, has declined between 2001 and 2004. Average benefits paid varied significantly in real terms between 2001 and 2004 and across type of benefits. Utilities compensations decreased from an average of 107 lei per month in 2001 to 50 lei in 2004 and war veterans’ allowances from 313 lei to 139 lei. Instead child benefits increased in real terms from 68 lei per month to 98 lei and so did social allowances from 54 lei to 86 lei.

8.14 Some people and some households benefit from multiple transfers and this phenomenon has increased in recent years. Social benefits are not mutually exclusive by design. Most benefits are categorical and some persons can fall in several categories. For instance, the disabled and the war veterans are included as categories of beneficiaries in almost all types of benefits. In 2001, only 11% of households’ beneficiaries and 8.5% of individuals were receiving more than one benefit but this share increased to 28.6% for households and to 24.9% for individuals by 2004.

8.15 The information available from the HBSs does not allow for a proper evaluation of targeting. A rough evaluation of targeting was only possible for child benefits where it is evident that these benefits suffer from both leakage and under-coverage. For example, we estimated a leakage rate for benefits for children below the age of three of 41% in 2004 and a corresponding under-coverage rate of 68%. The respective rates for children in age 3-16 were 39% and 90% respectively. Adjustments to the HBSs questionnaires would be needed to make a more accurate evaluation of targeting but if these figures are confirmed these are very high leakage and under-coverage rates by international standards.

8.16 Equity of Social Assistance. If social benefits were to be distributed completely randomly we should expect to see a similar share of benefits reaching each quintile, which is about 20% of total expenditure for social assistance per quintile. In this case the system would be welfare improving and distributional neutral. If, instead, benefits were distributed according to household income, with lower income households receiving the greater transfers, we should expect to see lower quintiles receiving a relatively higher share of benefits. Such a distribution of resources would be a progressive type of distribution. If, on the other hand, richer quintiles receive the greatest share of social benefits, then the system would be regressive, it would distribute public resources in favour of the rich.
8.17 The social benefits system in Moldova is clearly regressive although improving. There is extreme inequality in the distribution of social benefits. In 2001, the lowest quintile received only 5.7% of all benefits, well short of the 20% that it should have received under a distributional neutral and random system. The second quintile received a share of only 7.8% while the fourth and fifth quintiles received 44.6% and 28.8% of total resources respectively. All social assistance benefits with no exception were regressive although some benefits were more regressive than others. Between 2001 and 2004 the situation has improved. By 2004, the first and second quintiles were receiving 8.1% and 15.1% of total benefits against the fourth and fifth quintiles which were receiving 27.3% and 23.9% respectively. Middle income households (the third quintile) are those that improved the most during the period. Also, the situation has improved between 2001 and 2004 for all the main four types of benefits with the exception of social allowances. The system in 2004 was still largely regressive but the distribution of benefits has significantly improved during the period.
8.18 These findings are generally supported by parametric estimates on the household probability of receiving benefits, with some caveats. Utilities compensations are biased towards rural and larger households and towards households with older age members. The probability of receiving child benefits is affected positively by household size and negatively by the age of the head of the household. These effects are both expected given that child benefits are provided for children and given that children tend to be concentrated in younger households. However, controlling for these variables shows that child benefits are in fact progressive with poorer households being more likely to benefit than richer households. War veterans allowances are biased towards households where the head of the household is older which is expected given the nature of the benefit. However, despite controlling for this fact, the benefit is highly regressive with upper quintiles being more likely to receive this benefit. For social allowances, household size seems to matter the most in the allocation of this benefit. Larger households are more likely to get this benefit. Also this benefit is still regressive after controlling for household characteristics although the significance of this regressivity is less marked than for war veterans. In conclusion, parametric and non parametric estimates concord in establishing that all benefits are regressive with the only exception of child benefits which regressivity turns into progressivity once we control for household characteristics.

8.19 The poverty incidence of social assistance benefits is small on average but significant for the very poor. As we already know from various studies made on poverty in Moldova, all the Foster-Greer-Thorbecke (FGT) poverty measures have significantly declined between 2001 and 2004. In 2001, the impact of social benefits on poverty was very marginal, estimated at 0.6% of the headcount ratio and increasing to 2% for the poverty gap ratio and 3.7% for the severity of poverty ratio. Looking at the very poor, these impacts are larger between 1.1% for the poverty ratio and 5.6% for the severity of poverty index. The impact is small but increases significantly

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51 Results of the parametric estimates are available in Volume II of this report.
amongst the poorest. Moreover, the elasticity of poverty incidence to social benefits increases over time. By 2004, social benefits managed to reduce the headcount ratio for the poor by 4%, the poverty gap by 9.3% and the severity of poverty index by 15.2%. For the very poor these changes are much greater, 6.8% for the headcount ratio, 13.8% for the poverty gap and 23% for the severity of poverty. Therefore, social benefits for the extremely poor (the poorest among the very poor) have a positive and significant effect on welfare.

Table 8.1: FGT Poverty Measures With and Without Social Assistance Benefits

<table>
<thead>
<tr>
<th></th>
<th>Poor</th>
<th>Very poor</th>
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<tbody>
<tr>
<td></td>
<td>with</td>
<td>without</td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Headcount ratio</td>
<td>68.5</td>
<td>68.9</td>
</tr>
<tr>
<td>Poverty gap ratio</td>
<td>29.1</td>
<td>29.7</td>
</tr>
<tr>
<td>Severity of poverty</td>
<td>15.6</td>
<td>16.2</td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Headcount ratio</td>
<td>53.9</td>
<td>54.9</td>
</tr>
<tr>
<td>Poverty gap ratio</td>
<td>20.0</td>
<td>21.1</td>
</tr>
<tr>
<td>Severity of poverty</td>
<td>9.7</td>
<td>10.5</td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Headcount ratio</td>
<td>43.0</td>
<td>44.5</td>
</tr>
<tr>
<td>Poverty gap ratio</td>
<td>13.1</td>
<td>14.3</td>
</tr>
<tr>
<td>Severity of poverty</td>
<td>5.5</td>
<td>6.4</td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Headcount ratio</td>
<td>40.9</td>
<td>42.6</td>
</tr>
<tr>
<td>Poverty gap ratio</td>
<td>12.6</td>
<td>13.9</td>
</tr>
<tr>
<td>Severity of poverty</td>
<td>5.4</td>
<td>6.4</td>
</tr>
</tbody>
</table>


8.20 We have also regressed the poor and the very poor (as dummies) against the main four types of benefits (also as dummies). This particular procedure, allow us to see what benefits are more likely to accrue to the poor and to the very poor controlling for other benefits, or in other words, controlling for the multiple benefits effect already described. Among social benefits, utilities compensations and war veterans' allowances tend to be pro-rich while child benefits and social allowances tend to be pro-poor. In 2001 and as compared to the non poor, the poor were less likely to receive utilities compensations and war veterans allowances and more likely to receive child benefits and social allowances. The same was true for the very poor. Throughout the years, the negative likelihood of receiving utilities compensations and war veterans' allowances for the poor disappears while it is maintained the positive likelihood for child benefits. For the very poor, the negative bias disappears for war veterans and is weakened but still significant for utilities compensations while the positive biases for child benefits and social allowances are maintained.

8.21 In substance, the overall impact of social benefits on poverty is rather small but not negligible for the very poor. We observed in previous sections that the share of income constituted by social assistance benefits is small for all quintiles but also that it was larger for lower quintiles. Results on the poverty incidence suggest that the relatively small changes in income determined by social benefits are sufficient to close a certain share of the poverty gap for

53 Note that we are not testing single benefits regressivity and progressivity here as we are controlling for all benefits together.
the very poor. The equity analysis and the poverty regressions presented concord in establishing that child benefits and social allowances are the two benefits that are more likely to contribute to this phenomenon.

C. OPTIONS FOR REFORM

8.22 As discussed in previous sections, expenditure on social assistance benefits (including total expenditure as a percentage of GDP and government expenditure, expenditure per beneficiary and administrative cost) is not very large by any standards and cannot be expected to address the poverty problem alone. In 2001, the estimated cost to fill the poverty gap was about 3,264 m. lei per year (272 m. lei per month) for the poor and 1,756 m. lei per year (146 m. lei per month) for the very poor. These amounts decreased between 2001 and 2004 as the poverty ratios declined and in 2004 the gap for the poor was down to 1,780 m. for the poor and 785 m. for the very poor. In 2004, these shares were equivalent to 3.3 and 1.5 times social assistance expenditure, to 5.6% and 2.5% of GDP and to 15.8% and 7% of government expenditure respectively which are far greater amounts than the existing social assistance budget.

8.23 There is, however, a great mismatch between what the system is supposed to do — support the poor and the vulnerable — and what the system actually does — support selected categories of beneficiaries irrespective of income. Therefore, we have little ground to argue that social assistance expenditure should be simply increased but plenty of elements to argue that the administration and delivery of social assistance benefits has to be improved before any increase in budget expenditure can be considered. The question is how this should be done and what the expected outcomes of such changes are.

Table 8.2: Poverty Gap

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty gap (m. lei)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor</td>
<td>3264</td>
<td>2348</td>
<td>1721</td>
<td>1780</td>
</tr>
<tr>
<td>Very poor</td>
<td>1756</td>
<td>1151</td>
<td>691</td>
<td>785</td>
</tr>
<tr>
<td>% of GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor</td>
<td>17.1</td>
<td>10.4</td>
<td>6.2</td>
<td>5.6</td>
</tr>
<tr>
<td>Very poor</td>
<td>9.2</td>
<td>5.1</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>% of Government Expenditure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor</td>
<td>54.3</td>
<td>30.4</td>
<td>18.8</td>
<td>15.8</td>
</tr>
<tr>
<td>Very poor</td>
<td>29.2</td>
<td>14.9</td>
<td>7.6</td>
<td>7.0</td>
</tr>
<tr>
<td>Average poverty gap per capita (lei)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor</td>
<td>899</td>
<td>649</td>
<td>476</td>
<td>494</td>
</tr>
<tr>
<td>Very poor</td>
<td>484</td>
<td>318</td>
<td>191</td>
<td>218</td>
</tr>
<tr>
<td>Average poverty gap per poor (lei)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor</td>
<td>1313</td>
<td>1204</td>
<td>1108</td>
<td>1207</td>
</tr>
<tr>
<td>Very poor</td>
<td>689</td>
<td>799</td>
<td>721</td>
<td>837</td>
</tr>
</tbody>
</table>


8.24 A couple of simulations may help to better understand the possible implications of reforms. We can see what would happen if the system is kept as it is with the forecasted changes in macroeconomic variables (scenario 1) and what we should expect instead from a redistribution exercise (scenario 2). Forecasts are based on a common set of basic indicators taken from the

54 The poverty gap is the cumulated distance that separates each poor from the poverty line. This gap is therefore an estimate of the resources required to bring each poor up to the poverty line (simulating the elimination of poverty altogether).

8.25 In Scenario 1, no reforms will be implemented and the social assistance system will continue as it was in 2005. Expenditure projections are made by simply interpolating past expenditure by type of benefit and based on the basic forecasting indicators. Under this scenario all benefits will tend to decline as a percentage of GDP and as a percentage of Government expenditure with the result that total expenditure will significantly decline from 5% to 3.7% of government expenditure between 2003 and 2009. In such scenario the problems described with the system in terms of targeting, equity, efficiency and poverty incidence will persist and the reduced relative expenditure is likely to reduce even further the impact on the very poor.

**Figure 8.3: Expenditure Forecast (Scenario 1)**


8.26 In Scenario 2, real expenditure is kept constant in real terms at the 2004 level and the government manages to improve targeting and redistribute all social benefits given to the top quintile to the bottom quintile. The redistribution is achieved by spreading the total amount previously given to the top quintile over all persons belonging to the bottom quintile in equal shares (people in the first quintile were all very poor in 2004). In this case, there is no effect on the poverty headcount index, neither for the poor nor for the very poor. This measure would not move any poor out of poverty or any very poor out of deep poverty. This is due to the fact that in 2004 the total amount available to redistribute from the top quintile was only about 5 m. lei per month (0.19% of GDP in annual terms) which was an average of about 7 lei per capita. Transferring these amounts to each person in the bottom quintile does not bring anyone above the poverty line or above the extreme poverty line because all people in the first quintile are below the extreme poverty line by more than 7 lei. We have instead a marginal effect on the poverty gap and on severity of poverty indexes because these two indexes consider the distance between each poor from the poverty line. This distance is reduced for those of the first quintile and these indexes are also reduced.

8.27 It is evident that the existing budget for social assistance has a limited potential for lifting all the poor out of poverty. In the best possible scenario with perfect targeting, full vertical efficiency and all benefits means tested only, the 2004 social assistance budget could have filled
the gap for about two thirds of the very poor only. However, this would have implied a reallocation of benefits from the non extreme poor to the extreme poor which would have moved some of the existing poor into deep poverty reducing significantly the impact on extreme poverty. Moreover, perfect targeting would imply a perfect knowledge of household income which is where the Government of Moldova is very weak. Therefore, solutions to improving the social assistance system are more complex, have to be found in a combination of multiple actions and are necessarily long term.

D. POLICY RECOMMENDATIONS

8.28 We look first at what the government intends to do, we then see whether it can be done and on the basis of this assessment, we propose alternative or complementary solutions. The focus is on the financial efficiency and poverty alleviation capacity of the system.

8.29 The Government of Moldova (GOM) has repeatedly stated the necessity to reform the social assistance system in various social reports over the years. Many of the shortcomings that we have highlighted in this chapter have been already identified by ministerial staff and reported on different occasions in formal and informal meetings and reports. The Government has clearly understood that social benefits are not achieving the main objective they are designed for: support the poor and the vulnerable.

8.30 In order to reform the social assistance system, the GOM went through a number of key steps. In December 2003, an inter-ministerial commission charged with implementing the new social protection strategy was established and in December 2004 the Government approved the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) which outlined a number of objectives and the long-term strategy for social assistance reforms. The 2004 Social report published in 2005 explained more in detail the main features of the reform and this plan was further developed and finally approved with Government resolution No. 151-153/1221 “On Streamlining the Social Assistance System”, dated November 11th, 2005. Box 4 shows the main guidelines of the government reform strategy.

8.31 The adoption of the new system should require the implementation of four main steps: A first step where the appropriate filters and scoring mechanism are selected and put into law; a second step with the implementation of a pilot project aimed at testing the efficiency of the filters in selected areas; a third step for introducing the new system at the national level; and a fourth step when these filters will be assessed and revised on a regular basis. Step one and two are already in their implementation phase while step three is expected to be implemented in 2007.

8.32 On the surface, the government reform strategy is sound and would be able to address many of the shortcomings of the social assistance system that we have identified in this chapter. However, some of the elements that will cover the gap between intentions and actions have yet to be defined in some important areas.
Box 6: The Government Reform Strategy

A. Long term pillars (EGPRSP)
1. Monitoring individual programs in order to improve eligibility criteria and rationalise types, forms and duration of benefits;
2. Provision of social benefits to the poor which will require the development and approval of poverty criteria and a household welfare evaluation mechanism;
3. Creation of a separate social assistance budget;
4. Development of a unified database management system for social assistance beneficiaries;
5. Revision of the legal framework;
6. Improvements in the institutional coordination mechanisms.

B. Medium term actions (EGPRSP)
1. Monitoring of the social assistance programs carried out in the framework of the EGPRSP implementation;
2. Gradual introduction of a means tested system;
3. Legislation, poverty assessment and household welfare assessment mechanisms designed with external assistance;
4. Separation of the social assistance budget from the state social insurance budget;
5. Institution of a single database for social assistance.

C. Specific recommendations (Govt. resolution No. 151-153/1221)
1. Household welfare should be assessed with a mixed system made of means-tested mechanisms accompanied by proxy-means filters.
2. Well-being should be assessed based on income and non-income criteria looking at living standards in their complexity.
3. Urban and rural areas should be assessed using different criteria.
4. The Subsistence Minimum established by law annually should be used as a benchmark for establishing benefits' size.
5. Household income should be made of all sources whether in cash or in kind including social services provisions.
6. Benefits earned for special state merits should be separated from benefits earned on the basis of low income. This should be achieved by reducing the number of benefits and categories of beneficiaries and by reducing the possibility of earning multiple benefits.
7. Household income assessment should be initially made annually and later, if possible, every six months.
8. Two pillars of the new system are the income assessment and the improvement of the accessibility to social assistance. This means that the role of local authorities in the implementation of the new system is essential. The new figure of social assistant introduced by law in 2003 should be strengthened.
9. The role and functions of the social assistant should be clarified and a new questionnaire for social assistance should be developed. The database for social assistance beneficiaries should be unified and for this purpose it is necessary to implement two steps: 1) Separation of responsibilities between social assistance and family protection departments, who will be charged with the material assessment of the families, and the NSIH who will be charged with keeping a separate and unified database of social assistance beneficiaries; 2) The social assistance and family protection units will take full responsibility for the provision, payment and tracking of social service provision.
10. The changes proposed will require changes in the finance mechanisms and allocations of resources. These changes should be implemented in the framework of the Medium Term Expenditure Framework (MTEF).
11. The new system will be tested with a pilot project.

A. Revision of the legal framework and transition to a means tested system

8.33 There is not much in the government reform agenda on the legislative changes that need to be introduced to reform the system. Yet, this is essential and preliminary to most of the reforms suggested. Some actions such as defining the methods for means-testing can be implemented with government resolutions but some others such as changes in the benefits structure will require new legislation. Moreover, the introduction of new legislation will require a clear vision of how the social assistance benefits system should look like after the reforms.

8.34 The reform strategy is also silent on the categories and benefits that need to be suppressed in order to move from a categorical to a means tested system. As it stands, it would seem that means tested filters will accompany each category of benefit but that all categories and all benefits will remain even if the strategy calls for a unification of benefits. It is also clear from the various exchanges we had on this topic with government officials that, so far, there has been little discussion on which benefits and categories should be discontinued and when. This is a problem also because the question of multiple benefits beneficiaries cannot be addressed without the streamlining of existing benefits.
8.35 The lack of clarity about legal changes and about the shift from a categorical to a means-tested system may hide a more substantial political obstacle. It is understandable that announcing the elimination of categorical benefits is not a politically sound move and that people will need a great deal of information about the shift from one system to another to accept such changes. And even then many people who are not poor and are currently benefiting from social transfers will resist such changes. For this reason, it is not guaranteed that parliament will endorse the reforms. The current government has been elected and supported by former communists and most of the changes made in the social assistance sphere in the course of the first mandate have been in the direction of stepping back towards a Soviet-type system of categorical benefits focused on war veterans and the disabled. This is what clearly emerged from this study. It is hard to see how parliament will be easily convinced about the necessity to shift from a categorical to a means-tested benefits. In other words, while ministerial staff and even some ministries may be convinced of the necessity of the reforms, these same reforms may be dumped by parliament when submitted as laws. Rather than sidelining the problem, the solution would be to draft a calendar for change which clearly indicates which benefits and categories should be discontinued and when and bring this agenda in the public domain as soon as possible.

B. Administrative division between social insurance and social assistance

8.36 The reform strategy includes the separation of the social insurance and social assistance budgets and the separation of the two database systems. As already described, at present the NSM manages social insurance and social assistance jointly. This reform is long overdue and would make social assistance consistent with its scope. However, while the NSM is an established and experienced body there is no equivalent for social assistance precisely because social assistance is largely managed by the NSM. The institutional capacity needs to be established and developed.

8.37 Creating a new social assistance agency is costly and the Government itself has suggested keeping the administration of social assistance under the responsibility of the NSIH. In this case, the NSIH becomes a social protection rather than a social insurance institution and needs to operate a clear distinction between social insurance and social assistance in-house by creating separate departments with separate budgets and data management systems. This is perhaps the most feasible and least costly solution at present. It would also facilitate the needed division between the insured and non-insured for children and disabled benefits. Keeping the insured and the non insured under the same agency certainly simplifies the monitoring and coordination of these benefits.

8.38 It is also suggested that benefits earned for special state merits should be separated from means tested benefits. We argued that this was a problem and the government agrees but there are no suggestions on alternative management solutions. If war veterans’ benefits are separated from social assistance they can either stand on their own and be administered separately or they have to go under social insurance. Given that there is no ground to justify the presence of war veterans’ benefits under social insurance, the most sensible option is to keep the management of these benefits separate from both social assistance and social insurance. The same argument applies to benefits designed for extraordinary calamities which will have to stand on their own under a separate ‘humanitarian’ chapter. Such changes are mostly simple nominal reallocations and do not really require additional finance or extra administrative costs provided that the NSIH continues to administer all benefits. If this is the case, then the scope of the agency should be redefined as social protection rather than social insurance agency and the budget and administrative subdivisions should be clarified. Any alternative which will require the establishment of new administrative bodies is likely to be more expensive.
C. Develop a means-tested system of welfare evaluation

8.39 This is one area where the government agenda is more specific. The November 2005 resolution explains in detail and compares various technical options for evaluating welfare and it is suggested to use a combination of means and proxy-means testing together with the required documentation. There is a government regulation (No. 1084, 4th October 2004) which explains how to assess household and individual income. This will need to be updated but some of the main guidelines are in place. There is also an ongoing pilot project which is testing with means-tests filters applied on utilities compensation. The results of this test are expected to guide the government with further reforms. This is perhaps the area of social assistance reforms where the government is more advanced with. If implemented, the proposed reform is expected to improve significantly equity and vertical efficiency.

D. Enhancement of the role of local administrations

8.40 Shifting from a categorical to a means tested system requires the strengthening of local capacity in the functions of income assessment and delivery of benefits. This strengthening is in the reform agenda and includes the increase of responsibility of the new figure of social assistant introduced in 2003 and the separation of the social assistance and family protection units at the local level. The family protection units are expected to carry out the household welfare assessment while the social assistance units are expected to administer the benefits. These reforms are certainly needed and will require an initial investment in training and in the administrative reorganization at the local level. What is still missing is the detailed schedule and costing of these activities.

E. Improve monitoring and evaluation of social assistance benefits

8.41 In order to be able to properly monitor social assistance benefits some additional actions need to be outlined after the determination of the new set of benefits that should substitute the current structure. First, the NSIH, Statistical Bureau and MHSP should agree on a single terminology of benefits which is also compliant with existing legislation and the state budget. Second, the HBSs questionnaire needs to be adjusted so that questions are able to identify each possible category of beneficiary and each possible type of benefits. Third, a joint monitoring and evaluation unit between the statistical bureau, the MHSP and the NSIH should be established and trained to use the HBSs and macro data for such evaluation. As a result of these measures a monitoring and evaluation report should be published on a regular basis.

F. Other issues

8.42 The sequence of reforms is also important and the legislative changes that will be necessary to reduce the number of benefits and to shift toward an income based system should be prior to the administrative changes which require a lengthy phase of adjustments of the organizations involved. Again, the political obstacles described should not be undervalued in the process of reforms and the existing political knots (if any) should be untied before the administrative reforms are undertaken.

8.43 The government also faces a complex financial dilemma. On the one hand, even if the government will manage to keep social benefits expenditure at the same level of 2004 as a percentage of government expenditure (and achieve in this way a real growth of expenditure of over 64%) and even if the government is extremely good in improving targeting and distribution, the social benefit budget will still be small. It was shown how a simple redistribution of social

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benefits from the top to the bottom quintile will not affect the poverty headcount. We should not expect social benefits, under any possible scenario, to be a major force for poverty reduction in the medium term unless the government budget increases expenditure very significantly. On the other hand, expenditure should not be increased until the government manages to improve targeting and distribution. Increasing expenditure with the existing distributive system will increase relative poverty, not decrease it.

8.44 These considerations suggest that solutions are complex and long-term. Redistribution cannot occur with drastic measures but needs to be a fine tuning exercise. Simply canceling benefits to the rich is not feasible in the short-term and it is irrelevant to give micro amounts to the poor. We suggest instead a two-tier long-term approach:

- The focus should be first and foremost on the very poor and the amounts should be adequate to close the gap with the extreme poverty line. This is because this group is the most disadvantaged by definition and because we showed that the poverty rates of this group are relatively more sensitive to changes in social assistance benefits. Activities aimed at improving the distribution of benefits should be focused on increasing the transfers to the very poor by adjusting first the benefits with the worst performance. Utilities compensations and material assistance should be the benefits to reform first followed by social allowances and child benefits in this order. The objective here is to lift the very poor out of deep poverty. The cost of this activity has been estimated in Table 8.1 and this cost could be covered in part via redistribution and in part via the estimated growth in real expenditure.

- The next focus group should the poor who are not extreme poor. For this group, the focus should be on the transition toward the formal social insurance system. In a sentence, active labor market policies instead of social assistance. This is costly but could be financed partly out of the real increase in social assistance expenditure keeping this expenditure constant as a percentage of Government expenditure and partly out of the budget for ALMPs. These policies should be specially tailored for the poor with means-tests and linked to social assistance benefits for example by offering to social assistance beneficiaries the alternative of a public work. Public works, social funds, work for food schemes and micro-credits for start-up businesses would be some of the possible schemes to utilize. This policy should achieve a double objective: stop the current outflow of people from social insurance and free financial resources to be reallocated to the very poor. An estimate of costs and benefits of this proposal should be made once the specificities of the ALMPs have been defined.

8.45 In the meantime, there are other short and medium term actions that may prove to be effective from a financial perspective. One is a thorough evaluation of the disability assessment procedures. The disabled are the largest category of beneficiaries and the single category with the largest number of benefits. Being diagnosed with a disability gives automatic access to a range of benefits and the diagnosis is often an arbitrary decision based on medical evidence. It is no mystery that disability commissions worldwide are prone to corruption, collusion or mismanagement. This does not have to be the case in Moldova but reviewing procedures and test existing disabled on a random basis is a useful tool to make sure that the system is healthy and there is no waste of resources.

8.46 A second grey area is material assistance. This is the largest benefit in terms of beneficiaries and the third in terms of expenditure. It is mostly extra-budgetary and for this reason
reforms of this benefit will not lead to automatic state budget savings. However, revenues are growing, they are property of the state and it is expected that these funds should be well spent. At present, the central management of the benefit which is the social support fund of the population is very weak and very little transparent while there is a wealth of data at the local level which have never been mined. In this case, a thorough analysis will have to start with the data collection and with an assessment of national financial procedures and local administrative practices. This exercise may lead to findings that can help to improve the financial administration of the fund. Also, given the experience accumulated by the local staff in visiting households and compiling the income based questionnaire, this benefit is the ideal candidate for experimenting with a full means tested system.

E. CONCLUSION

8.47 In sum, the government reform agenda provides a good platform for reforms but should be complemented with a number of short and medium-term actions to achieve the proposed long-term objectives as follows:

Short-term actions
- Define the future structure of social assistance benefits (number of benefits, categories, etc);
- Define a more specific calendar for the discontinuation of existing categorical benefits and the transition to a means-tested system;
- Draft the legal changes required and open this draft to public debate;
- Evaluation of the disability assessment procedures;
- Review of the Republican Social Support Fund and Local Funds.

Medium-term actions
- Submit legislative reforms to parliament;
- Reorganise the NSIH into a Social Protection agency with administrative and budget subdivisions for social insurance and social assistance according to the new social assistance structure;
- Implement the reforms of individual benefits;
- Develop a system of monitoring and evaluation of social assistance benefits with changes in the HBSs and the establishment of a monitoring and evaluation group;
- Design active labor market programs for the poor linked to social assistance benefits and prepare a cost benefit analysis of such proposal.

Long-term objectives
- Progressive redistribution of the existing benefits in favour of the very poor;
- Progressive transition of social assistance beneficiaries to social insurance schemes.