

INTERNATIONAL DEVELOPMENT ASSOCIATION
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REPUBLIC OF MOLDOVA

**Joint Staff Advisory Note on the Annual Evaluation Report on the
Economic Growth and Poverty Reduction Strategy Paper**

Prepared by the Staffs of the International Development Association (IDA)
and the International Monetary Fund (IMF)

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I. INTRODUCTION

1. **This Joint Staff Advisory Note (JSAN) provides the staffs' assessment of the authorities' first Annual Evaluation Report (AER), which covers the period from late 2004 to early 2006.** The Republic of Moldova's Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) was presented to the Boards of IDA and the IMF in November 2004, and was the first full Poverty Reduction Strategy Paper prepared by the Moldovan authorities. It was developed in broad-based consultation with stakeholders and civil society, and benefited from a participatory process that was organized under the supervision of a Participation Council comprised of representatives of all stakeholder groups. The EGPRSP was adopted by Government in May 2004, and approved by parliament in December 2004. It built on the three pillars of the previous Interim Poverty Reduction Strategy Papers: sustainable economic growth, human development, and social protection and inclusion.

2. **Broadly, the AER provides a candid assessment of the accomplishments and shortcomings of the past year, focusing on outcomes rather than inputs.** It points to evidence of continued poverty reduction, but also highlights areas where policy implementation has been slower than originally envisaged. At the same time, the AER could have indicated more clearly the policy priorities for the coming year, and outlined how the EGPRSP could be strengthened. The staffs note that progress has picked up in several areas since the elections in March—April 2005, and that as a result, the authorities have adopted a new program that they hope will be supported by the IMF's Poverty Reduction and Growth Facility. Similarly, the World Bank staff is considering a new Poverty Reduction Support Credit. This reform momentum has been enhanced by the European Union-Republic of Moldova Action Plan, approved in February, 2005. In those areas of endeavor where the two documents overlap, the EGPRSP and the EU-RM Action Plan are mutually consistent, and reforms have accelerated. The staffs commend the authorities for seeking to monitor the

EGPRSP and the EU-RM Action Plan in a mutually consistent way, and urge that further efforts in this regard be undertaken.

II. POVERTY DIAGNOSTIC

3. **The AER presents an updated description of the dynamics of poverty and inequality in Moldova.** Changing demographic and other aspects of poverty are adequately covered. Between 2000 and 2004, the poverty rate fell steadily from over 70 percent to about 26 percent of the population, and the AER correctly notes that much of the decline can be attributed to rapid economic growth. Over this same period, inequality decreased as well, with the Gini coefficient falling from 0.38 to 0.36. The staffs commend the government for recent improvements in its efforts to measure and monitor poverty. While the previous JSAN highlighted the lack of a single methodology for poverty measurement, the government has now settled on a single national measure of the poverty rate, which is produced by the Ministry of Economics and Trade in collaboration with the National Bureau of Statistics. Starting with the 2006 household budget surveys, several improvements in the measurement of poverty are planned—for example, excluding durable goods from consumption and making regional price adjustments—that will benefit future poverty monitoring efforts.

4. **The report raises the appropriate concern that the decline in poverty among households in rural areas—where the majority of the poor live—has stagnated.** Large cities, in contrast, have continued to see poverty rates fall. Further, the report is candid in noting that chronic poverty is a serious problem, with nearly 50 percent of households living in small cities remaining in poverty. While economic growth has been a significant contributor to poverty reduction in the past, the staffs note that quarterly data suggests that the national poverty rate has been relatively stable since the end of 2002, despite continued strong economic growth performance. Data for the first three quarters of 2005 indicate that poverty rates have actually experienced a slight upward trend. Thus while Moldova is still on track, based on intermediate targets, to achieve the Millennium Development Goal of reducing poverty by half by 2015, the slowdown in poverty reduction is a concern.

5. **The staffs recommend a deepening of the analytical work on the trend in poverty in rural areas and small towns,** in part because of indications that the report's findings are persisting into 2006. Increasingly, Moldova's anti-poverty efforts will need to concentrate on improving economic opportunities in agriculture and among small farmers. As the report recognizes, addressing the fragmented and poorly targeted social assistance programs will also be an important element of Moldova's anti-poverty program.

III. PRIORITY AREAS FOR PUBLIC ACTION

A. Macroeconomic Framework and Growth

6. **The AER presents a detailed account of recent macroeconomic developments in Moldova,** noting that the poverty reduction of recent years owes much to this factor. In 2005, real GDP grew by 7.1 percent, outperforming the EGPRSP target of 5 percent, while inflation continued to decline to 10 percent. The government budget recorded a surplus of

1.7 percent of GDP (compared to the planned deficit of 0.9 percent of GDP), and financial sector and external debt indicators improved. Large-scale migration has also been one of the central elements of Moldova's economic landscape, with mixed implications for poverty reduction. On the one hand, it has helped to ameliorate poverty by generating growing remittances from Moldovans working abroad to support their families. On the other hand, migration has resulted in labor shortfalls in some sectors, contributing to higher wages and a gradual deterioration in competitiveness. The staffs believe that the role of migration and remittances in the Moldovan economy deserves more careful treatment and urge the authorities to give it more prominence in the next AER.

7. **The AER correctly emphasizes the worsening in the external current account.** Higher remittances have fueled imports of consumer goods, while rising oil and natural gas prices have caused the energy import bill to surge. At the same time, export growth has slowed, and the report rightly views this poor export performance as one of the major vulnerabilities of the economy. The AER attributes it to a suboptimal structure of domestic output and outdated capital stock, much of which was inherited from Soviet times. In the staffs' view, the report would also have benefited from a more thorough analysis of competitiveness. Even though the leu still appears to be somewhat undervalued against estimates of its equilibrium level, continued appreciation may quickly erode the remaining competitive advantage. Tight control over inflation and more nominal exchange rate flexibility may be needed to avoid further loss of competitiveness. It is therefore encouraging to note that the AER underscores the importance of price stability as one of the key prerequisites for overall macroeconomic stability and growth. More fundamentally, the problem of Moldova's competitiveness needs to be viewed in the context of the challenge of improving the overall business climate. The export sector will not be able to develop fully its potential in an environment that is not conducive to private investment and where working opportunities are scarce, pushing workers abroad.

8. **The report recognizes that the quality of growth poses a major concern for the outlook.** Household consumption, fueled by workers' remittances from abroad, has been the main engine of the robust growth in recent years and may not prove durable. The authorities acknowledge that in order to achieve medium and long-term sustainability, productivity needs to become the driving force of growth, which, in turn, calls for sound policies and structural reforms aimed at revitalizing the business climate and creating conditions that are conducive for private sector investment. The staffs welcome this recognition in the AER, and support the authorities' goal of increasing investments in infrastructure; in this regard, the report could have confronted more squarely the trade-off between higher public sector wages and increased infrastructure spending.

B. Fiscal and Budgetary Management

9. **The AER notes that fiscal policy continued to be tight in 2005.** While the authorities lowered the profit and personal income tax rates, they maintained a tight stance of fiscal policy, posting a surplus of 1.7 percent of GDP, mainly owing to strong revenue performance. General government revenues grew by almost 3 percentage points of GDP over

the level of 2004, mainly stemming from VAT overperformance. This result, in turn, reflected spending on imports of consumer goods, financed by strong remittance inflows. Given the need to limit the role of the state in the economy, the staffs support the government's policy of reducing the tax burden through lower direct tax rates, while broadening the VAT base. In order to improve the efficiency of tax collections and lower the administrative burden of the tax system, the authorities are preparing a comprehensive tax administration strategy that will specifically address a risk-based approach to audit and enforcement, improvements of the VAT refund process, and use of indirect methods of assessing tax liabilities.

Medium-term expenditure framework (MTEF)

10. **As noted in the AER, the MTEF does not fully reflect the priorities of the EGPRSP**, though steps have taken to improve this alignment, and to tighten the link between the MTEF and budget process. In line with the recommendations in the previous JSAN, the authorities have undertaken more realistic revenue projections, launched pilot MTEF exercises for local governments in three rayons (territorial administrative units), expanded the pilot for program budgeting, included expenditure analysis based on performance indicators in the annual budget execution report, and improved strategic planning by preparing a strategy for the agricultural sector (similar to existing strategies for education, health, and social protection). Looking ahead, particular attention should be paid to developing the capacity of line ministries to formulate sector policy strategies that would provide sufficient policy guidance for elaboration of proposals on sector expenditure ceilings under the MTEF. Stricter adherence to the existing calendar of the MTEF phase of the budget cycle is required to allow sufficient time for consultations on the adequacy of reflection of the national policy priorities in MTEF proposals, including the earlier involvement of the parliament into this process. This in turn necessitates the alignment in the timetable of the EGPRSP updates with the MTEF/annual budget calendar.

11. **The reduction of the public debt burden should facilitate the orientation of additional public spending toward social and public investment priorities.** The 2004 JSAN encouraged the authorities to redouble their efforts to meet current debt service obligations. The AER points to the considerable reduction in external debt achieved since 2000. Equally important have been the steps taken by the authorities to resolve the problem of arrears on debt service to Paris Club creditors, including the establishment of the escrow account with funds earmarked for a partial clearance of arrears in the context of a requested debt restructuring from Paris Club creditors. The staffs note that future AERs could usefully incorporate an assessment of Moldova's external debt sustainability.

Public finance management

12. **The AER notes that the authorities place heavy emphasis on strengthening public finance management**, not least because they understand that these reforms will provide confidence to both Moldovan taxpayers and international development partners that resources are being managed well. The AER describes the progress made in implementing a

large, World Bank-financed Public Financial Management Project that introduces best international budget practices, including a new financial information management system and bringing the budget classification and chart of accounts in line with the IMF's 2001 Government Finance Statistics Manual. The report mentions the progress in developing performance reports on the use of public budget resources, and the staffs' note progress being made to strengthen the treasury single account, which is allowing the government to close accounts now held in the commercial banks. The staffs also welcome the development of a modern internal control and audit function and creating institutional capacity for training of civil servants in public financial management. Clarification of the mandate of the national Court of Accounts, and the launching of its strategic development plan, are also among the priority activities for the years to come.

Public administration reform (PAR)

13. **The report notes that the central public administration reform is one of the government's key priorities in the period ahead.** The AER thus provides an adequate account of the progress reached in initiating and planning the reform of the central public administration. In particular, the three most important areas of reform are covered: institutional streamlining, policy making process, and civil service reform. Government commitment to the PAR so far has been commendable. While the mobilization of financial resources for capacity building (donor partners have agreed to set up a \$7 million trust fund to support the reform) will contribute to the success of the reform, the Government's reliance on international consultants will eventually need to be supplemented by the establishment of internal government structures to support reform implementation. The staffs note that the absence of a civil service agency and a central structure for policy coordination create an absorption risk. An important opportunity to build internal central government capacity to sustainably manage the change may be missed if the government fails to establish a proper institutional framework. It will be also important to ensure that public wage policies are decided as an integral part of the public administration reform. In this context, the staffs have noted that wage growth in the public sector has significantly outpaced inflation during the past several years. They have urged the authorities to take a measured approach with respect to future public sector wage increases in order to avoid undermining the cost-efficiency of domestic production, while better linking the PAR to the broader MTEF exercise.

14. **One of the goals of the public administration reform is to strengthen accountability and improve governance in the public sector.** This is an important element in the overall campaign against corruption, which was identified in the EGPRSP as an impediment to sustainable growth. The staffs would welcome a more explicit discussion of progress in improving governance, including in the area of judicial reform and implementation of an anti-corruption strategy.

C. Social Policies

15. **The report notes that, while the allocation of resources to cover EGPRSP priorities in the social sectors has been reasonable, the increase in the level of spending**

has not been accompanied by sufficient progress in improving the efficiency of this spending. Public spending in Moldova has been on an upward trend, increasing from roughly 32 percent to over 36 percent of GDP during 2002-05, with the social sectors continuing to account for the bulk (63 percent) of public expenditures.

Social insurance

16. **The report highlights concerns over the financial instability of the pension system, placing emphasis on both demographics and migration.** The staffs note that, although these elements play an important role in the financial stability of the pension system, greater attention needs to be paid to the influence of: (a) low retirement ages (frozen and being reduced) and the continued existence of privileges; (b) the mismatch between farmers' pensions and contributions; (c) poor revenue collection; and (d) payment of pensions based on incomes declared at the time of retirement rather than record-based contributions (resulting in high pension overpayments). The staffs note that among the EGPRSP priority actions, there have been considerable delays in the creation of individual pension contribution records and limited use of medium-term forecasting tools, despite the existence of adequate pension models. At the same time, the staffs commend the government for progress in developing an agricultural pension reform strategy.

17. **The report acknowledges that the social assistance system is fragmented and poorly targeted.** Among the EGPRSP priority actions, the government has successfully separated social assistance from the social insurance budget. Other EGPRSP priority actions need to be accelerated, with special emphasis on targeting and the creation of a unified registry of beneficiaries. Moving towards a means-tested system implies the progressive elimination of at least some categories of beneficiaries and some types of benefits.

Education

18. **The report gives an accurate description of the progress made in education and highlights a number of difficulties confronting the sector.** The staffs commend the effort to report on a wide number of useful quantitative monitoring indicators. A number of qualitative indicators, however, could also be usefully added. In measuring the increased quality of education in rural communities—a priority action in the EGPRSP—it would be useful to measure the increase in average learning achievement of students in rural schools, as well as the reduction in the gap in average achievement between rural and urban schools.

19. **While spending on education has been growing, the report indicates available resources have been insufficient to maintain the quality of education in Moldova.** The staffs are concerned that the report, by emphasizing that expenditures on education are still “very low” when compared with spending levels that existed in the mid-1990s (10 percent of GDP), gives insufficient attention to the need to improve the efficiency of Moldova's educational system. Plans for optimization of the school network are mentioned in the AER, but the staffs recommend that the report convey an increased sense of urgency of the need to attain efficient class sizes, and student/ teacher and student/non-teacher ratios (bringing them

closer to OECD standards). Further, while subsidies to school meals can play an important anti-poverty role, the staffs note that improving the targeting of meal subsidies—to poor students, rather than all students in a certain category (such as pre-schools, vocational schools, etc.)—or basing them on academic merit (higher education) would be a more efficient use of resources. With the falling numbers of school-age children, Moldova will need to take advantage of the opportunities arising from this demographic change to improve the efficiency of the education system. As noted in the “Education for All” strategy, increasing school autonomy should be an important part of this future reform effort.

Health

20. **The report provides an objective analysis of health outcomes, with the emphasis on indicators for reaching the Millennium Development Goals.** The report notes that the indicators on maternal and infant mortality are below targeted levels, and—although the HIV infection rate is mentioned in the report as a concern—the results of Moldovan HIV prevention programs have been promising. With the government providing insurance to non-working groups of the population, the introduction of a compulsory health insurance system in 2004 was expected to increase access to health services. The increased utilization of health care services and the introduction of a limited list of compensated pharmaceuticals suggests that there has been movement toward this objective. The report, however, provides insufficient evidence to gauge the extent to which the introduction of health insurance has increased access to health services among vulnerable groups. Going forward, the staffs recommend that the government concentrate on increasing the efficiency of the healthcare sector in order to maintain the benefit package of universal health insurance (perhaps by revisiting the eligibility criteria for free health insurance), as well as allowing for increased investment in the quality of healthcare delivery.

D. Infrastructure and Agriculture

21. **The report clearly recognizes that public investment in infrastructure has been limited since independence, and that there is a great need to increase it.** In particular, actual spending and planned budget allocations for road repairs remain inadequate. Other than the stated intentions of seeking external financing and involving the private sector, the staffs note that the report suggests no intentions on the part of the government to reallocate more budget resources toward public infrastructure investment, particularly roads, to meet the priorities set by the EGPRSP.

Transportation infrastructure

22. **Given the lack of resources, the EGPRSP priority actions in the transport sector are unlikely to be fully met.** In the road sector, three of the six priority actions have been partially implemented: (i) identification/design of regional road projects (though financing has not been secured); (ii) implementation of modern systems for evaluation of road conditions (based on technical assistance financed by SIDA); and (iii) negotiations/discussions with IFIs on rehabilitation of national road network. The AER discusses securing

sustainable road financing through potential private sector involvement, including foreign investors and public-private partnerships, suggesting that reconstruction and management of roads be concessioned to such investors against toll roads or vignette system (“road taxes levied on drivers”). In the view of the staffs, Moldova may not be ready for such arrangements, which in other countries have implied considerable levels of contingent liability to the government and thus do not cleanly address the problem of limited budget resources to support roads (in addition to requiring creation of a complex regulatory system on concessions). Progress on the priorities in railway transportation has been also partial. The rehabilitation of the railway network has begun, and the state railway company, the CFM, has paid its debt to state budget. In terms of future strategy, however, the staffs note that, except for the proposal to develop a Railways Reform Strategy in line with EU requirements, it appears that the implementation of the existing CFM Restructuring Plan has stalled. The staffs urge that implementation of this plan be resumed.

Agriculture

23. Poor performance in the agricultural sector has been the main reason why declining poverty trends in the rural sector have recently been reversed, with the result that overall poverty reduction has stagnated. The EGPRSP emphasized the promotion of liberal market policies, including support to family farming as the future of Moldovan agriculture by increasing farmers’ skills and opportunities, improving sanitary and phytosanitary (SPS) standards, increasing FDI in agriculture by improving the business environment, and using public resources judiciously without discriminating against certain farm types or creating distortions. The staffs note that continued support for large agricultural enterprises only delays the needed restructuring of the sector. The staffs urged that greater attention be paid to undeveloped and distorted markets that reduce the profitability of agriculture and the incentive to invest. For example, on the output side, exports of certain commodities (cereals, oilseeds) have been restricted, thereby reducing producer prices and farmers’ incomes. The staffs particularly welcome the authorities’ commitment to eliminate artificial, non-tariff export barriers—such as the need to ship by rail not by truck, or the requirement to transact grain exports on the Moldova Commodity Exchange. The lack of a modern agricultural SPS system also reduces access of Moldovan farmers to new (particularly EU) export markets. Poor market infrastructure and lack of marketing know-how on the part of farmers also reduce opportunities. On the input side, restrictions on seed imports increase production costs in the sector and inhibit the introduction of newer and better quality plant varieties. The report correctly notes that public expenditure on agriculture is low. The staffs recommend that, given this constraint, more effective use of public resources is needed. Rather than spending scarce resources on subsidies for items like machinery, fuel, planting of certain “strategic” crops—subsidies that are often not available to small farmers—the staffs urge that greater emphasis be placed on spending that enhances long-term growth prospects in the sector.

IV. PARTICIPATION, COORDINATION, AND MONITORING

24. **The AER describes the participation process well**, noting that the Participation Council approved a Communication Strategy in early 2005, which involves regularly publishing an informative bulletin for inclusion in Moldovan newspapers, radio and television outreach, and a trilingual website (www.scers.md). The report recognizes that the communication strategy needs to be strengthened, and thus a new, more focused approach has been adopted for 2006-09. The staffs urge the authorities to implement this strategy.

25. **The staffs commend the authorities for striving to conserve limited administrative resources by monitoring the EGPRSP and the EU-RM Action Plan in a consistent, unified manner.** Nevertheless, a perception remains that the authorities need to report to the donor community using one format, and to the EU employing another. The staffs urge the authorities to identify one consistent format for both exercises, and pledge to remain flexible in assessing the government's own reports on its activities. Such flexibility is consistent with the donor community's own broader efforts to coordinate and harmonize their support to the EGPRSP. The mobilization of a common trust fund in support of PAR represents one such effort. The PRSC being considered by the World Bank is also being coordinated more closely with the budget support of donor partners.

V. CONCLUSIONS

26. **The staffs commend the authorities for undertaking a candid and thoughtful AER exercise.** This report highlights shortcomings as well as achievements, and thus is particularly useful as a means of assessing productive directions for future work. The monitoring and evaluation methodology employed was outcome-oriented, and not just an inventory of inputs. Poverty monitoring has been institutionalized, and it is hoped that this approach will be extended in 2006 and beyond. The staffs commend the authorities for their efforts to address the recommendations made in the previous JSAN. In particular, while ownership of the reform agenda was questioned in the previous JSAN, the staffs now have greater confidence in the authorities' commitment—perhaps explained in part by the welcome influence of the EU-RM Action Plan. Further, more effort has been made to produce realistic macroeconomic forecasts, and to improve poverty analysis and monitoring. At the same time, more could be done to strengthen the participatory process, and to identify financing sources for priority projects with poverty-reducing implications.

27. **As the authorities sharpen their strategic focus and strengthen implementation of the poverty reduction strategy, they would be advised to address the following challenges highlighted earlier in this assessment:**

- Maintain an appropriate macroeconomic framework that takes into account the country's external vulnerabilities (such as changes in energy import prices).
- Ensure better strategic linkages between the annual budgets, the MTEF and the EGPRSP; align the AER with the annual budget cycle.

- Strengthen the efficiency of public spending through, in particular, adopting a measured approach with respect to future public sector wage increases consistent with a coherent public administration reform strategy, restructuring public finances towards supporting growth-promoting infrastructure needs, and finding budgetary savings through, for instance, optimizing school staffing levels.
- Strengthen domestic incentives for people to work and invest in Moldova through eliminating distortions in agricultural markets, creating a better environment for increased profitability and private investment in the economy, and strengthening the targeting efficiency of social assistance.

28. The staffs look forward to an update of the EGPRSP policy action matrix in light of this exercise in near future. The staffs hope that this matrix and future AERs will (i) identify measurable targets and (ii) evaluate performance transparently against these benchmarks. In this way, the AER can contribute to prioritization of reform efforts, particularly if this is done hand-in-hand with the effort to evaluate performance against the broadly similar EU-RM Action Plan.