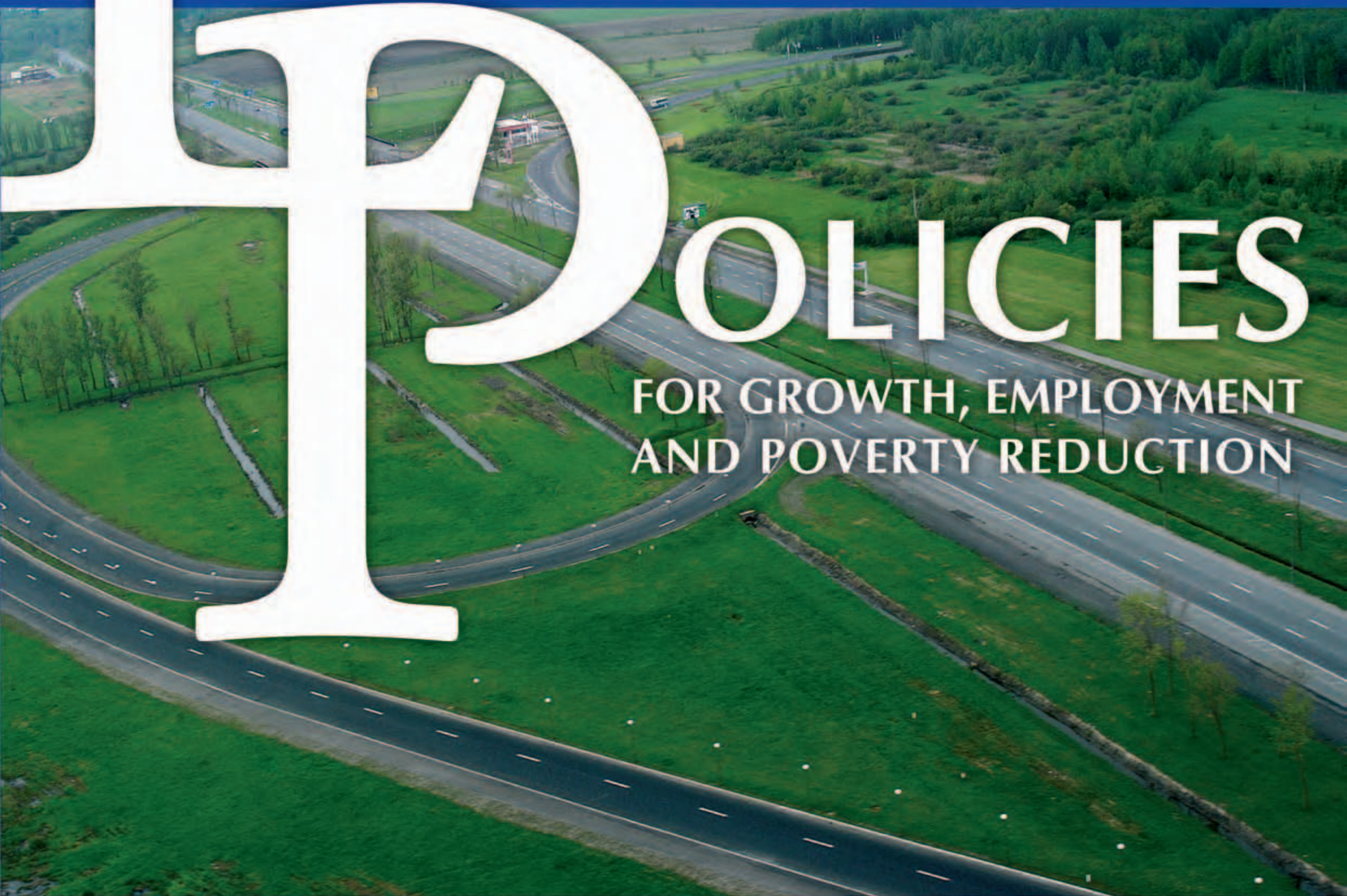
REPUBLIC OF MOLDOVA: ECONOMIC POLICIES

FOR GROWTH, EMPLOYMENT AND POVERTY REDUCTION



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FOR GROWTH, EMPLOYMENT AND POVERTY REDUCTION

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This report is an independent report produced by a team of international and national experts organized by the Bureau for Development Policy of UNDP, New York. The main objectives of the report are: 1) to broaden the dialogue in Moldova on economic policies and their impact on growth, employment and poverty reduction; and 2) to offer to the Government of Moldova some practical recommendations on how to use economic policies to promote such objectives.

The Bureau for Development Policy of UNDP has initiated a broad range of global, regional and country reports designed to help fashion more pro-poor economic policies. This set of activities has broadened the dialogue on pro-poor policies at the national, regional and international levels. While each report stands on its own, addressing the specific circumstances of each country, taken together they provide a consistent analysis and vision of the poverty reduction process.

This Report constitutes the final product of an 18-month long project intended to foster a national dialogue on growth and poverty reduction policy options. A first version of the Report was presented to the National Review Committee in the fall of 2004 and a revised draft of March 2005 was discussed at a set of roundtables before a final, extended National conference in June 2005.

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Prologue

Almost ten years down the road [from independence] it is clear that the road map [for Moldova's transition] was at best inadequate and that the so-called transition in most respects has been a failure. (Ronnas & Orlova 2000, 15)

In 1989, Moldova was a small province of a large authoritarian state; fifteen years later it was an independent country that had passed through several legitimately representative elections, with prospect to do so in the future. While like many former Soviet republics Moldova suffered from separatism (the Transdniestre region), no Moldovan soldier had died in conflict for a decade.

The period of notable political achievements had its profoundly dark aspect. In March 1995, *The Economist* magazine described Moldova as a 'model of sound reforming…a perfect laboratory of reform'. If this judgement were correct, it would be a terrible indictment of the transition process. In 1989 the head count poverty rate in Moldova was less than five percent, and in 1993 had risen to two-thirds of the population by one measure, close to half by another, as per capita income fell by half. In 1989 Moldovans had access to medical care comparable to that in Western Europe, and public education of high quality and open to all. A few years later, much of the population found social services beyond their means, accessible only with long delays, or of low quality.

A major tragedy of the collapse in Moldova was its differential impact on men and women. The both suffered an actual fall in life expectancy, though more for men than women (UNDP 1998b, p. 214). In the labour market the differential impact was the reverse, more women lost jobs than men, reversing their employment gains during the Soviet period. In the words of a UNDP report,

…[W]omen face[d] increased hardship in many countries. Confronted with decreasing numbers of child care facilities, women have often been forced to abandon work. (UNDP 1998b, p. 7).

In the words of a UN official in Moldova at the time, representatives of external agencies, insulated from the effects of the collapse, 'like the first class passengers of the Titanic in their lifeboats could only look on as their fellow voyagers sank into the abyss'. No transition country in Europe or Central Asia suffered a weaker recovery from the depths of collapse than Moldova. This report is not merely about another country that suffers from severe poverty, but an investigation of a society taken to the brink of disintegration.

Executive Summary

1. INTRODUCTION

1.1. Background to the Report

This report addresses macroeconomic aspects of employment and poverty reduction. Sectoral and micro issues are treated in as far as they directly relate to the macroeconomic framework for growth and poverty reduction. Even in these cases, specific policies are not treated, since they typically involve quite technical expertise. Thus, the vast majority of the suggestions refer to macro policy, and are found in chapters 2 and 3. The other chapters are to provide the analytical and empirical basis for these pro-poor macro policy proposals. It is the raison d'etre of this report that without a macroeconomic framework that accommodates robust and equitable growth, micro policies, no matter how appropriate, will have little impact.

The policy recommendations seek to foster pro-poor growth, by which is meant a growth path in which the income of poor, however the poor are measured, increases more than the income of the non-poor. That is, the annual increment in growth would be more equally distributed than the initial income. Effective and feasible policies must be based on rigorous theoretical analysis and an understanding of the characteristics of a country. There are no correct policies in the abstract. Therefore, this summary includes a brief explanation of the analytical and empirical basis of the policy suggestions, which is presented in greater detail in the full report.

1.2. The Framework for the Report

This report supports and complements the long term strategy of the Moldovan government as presented in the Economic Growth and Poverty Reduction Strategy document (EGPRS), completed towards the end of 2004. The objectives of the EGPRSP and the policies to achieve them have been further developed and clarified in several subsequent documents: the European Union Action Plan, the Medium Term Expenditure Framework, and the Action Plan of April 2005 presented to parliament after the election of March 2005. Successful achievement of the goals of the EGPRS requires three necessary developments in the economy: narrowing the trade gap, raising aggregate investment, and reducing inequality. The framework in which those three developments can be realised can be summarised as follows:

a. At the beginning of the twenty-first century, Moldova was a predominantly agricultural economy, but an agriculture-led growth strategy is not the route to sustainable poverty reduction.

b. A viable and sustainable long term growth strategy must be based on the emergence of *an* internationally competitive manufacturing sector.

c. Rising productivity in agriculture and manufacturing will require a purposeful public investment programme that 'crowds in' private investment, both domestic and foreign.

d. Expansion, and in some cases, reorganisation of existing poverty reduction programmes, including the social protection system, is essential, based on the principle of targeted universal provision supported by specific programmes that are income-tested; that is, universal programmes for targeted groups such as pensions for the elderly, with programmes based on falling below a designated poverty line playing a secondary role.

If in the medium term, the agricultural sector can help narrow the trade gap, a major step towards sustainable growth would be taken. Simultaneously, the rate of investment should rise. Trusting to a 'favourable business climate' is unlikely to stimulate investment to the level necessary for sustained poverty reducing growth. This problem is feasibly solved by using public investment to 'crowd-in' private investment, as well as creating projects that directly reduce poverty. Along with narrowing the trade gap and increasing investment, poverty reduction requires that, at a minimum, income and wealth inequality not increase.

2. MOLDOVA IN TRANSITION

2.1 Gender Analysis and the Transition

At the beginning of the 1990s, Moldova entered a process of transition from central planning to market regulation. To understand this transition, gender cannot be ignored. Gender inequality plays an important role in growth, employment and poverty reduction. The fundamental policy changes associated with the transition process are likely to affect men and women differently because of their different positions, roles, and responsibilities in society. The development of effective economic policies requires mainstreaming of gender into the design of policies, including the budgeting process.

The statistics necessary to incorporate adequately gender into the analysis of the transition and pro-poor growth do not for the most part exist. This is a serious oversight that should be addressed immediately by the Moldovan government; all the more immediately because there would certainly be funds from donors to cover the cost of collecting and analysing the information. Given the lack of statistics necessary for a rigorous gender analysis, this report is reduced to the inadequate approach of using the available information and attempting to draw reasonable inferences.

2.2 Four Fundamental Transitions

For all of Central and Eastern Europe the twentieth century brought war and dictatorship. The experience of Moldova was unimaginably grim. It is more than remarkable, that after independence the country was relatively free of civil strife, even when the economy collapsed catastrophically. The absence of major civil strife might be explained in part by the overwhelming support of the vast majority of Moldovans for independence. At independence, Moldovans faced four fundamental social and economic transitions, each of which would have been a formidable challenge on its own:

1. From nation to country, which required the construction of the state institutions appropriate to manage the affairs of a country, *the countryhood transition*;
2. From an authoritarian to a democratic regime, which necessitated the creation of the space in which open debate and contestation of power could occur peacefully, *the political transition*;
3. From central planning to the regulation of markets, which rendered most of the institutions of economic management anachronistic, *the regime transition*; and
4. From social delivery of basic needs to market provision, which implied a

revolution in the manner by which the population was employed, provisioned with basic necessities, educated, and provided with health care, *the socio-economic transition*.

The countryhood transition in Moldova involved institution building, beginning with the creation of basic state institutions that are the mainstays of public administration in countries: ministries of foreign affairs, defence, finance, and international trade. Even existing institutions whose basic function did not change, such as departments of health, education and social welfare, required reorganisation because of the basic change in their status from conduits and implementation agencies for decisions made in Russia, to policy and decision making ministries.

The problem of national policy management after 1990 was not due to lack of capable administrators and professions. The management difficulty arose because administrators and professions found themselves in institutions that were not designed to carry out the tasks of a country. The government's proposals in 2005 for a comprehensive reorganisation of ministries and their functions represent a major step towards correcting this problem.

Across the countries in transition, one of the most intractable aspects of institution building has been creating the mechanisms to regulate markets out of the agencies and personnel of central planning. The problem goes far beyond establishing the 'rule of law' and 'fostering private sector development'. The period of transition is by definition one in which laws and regulations change. Uncertainty about the legal framework is inherent in the transition, since laws are implemented by institutions that are being created. In established market economies, implementation of the legal framework involves interpretation of laws, drawing heavily on legal precedent which, by definition, does not exist in transitional economies. Corruption, public and private, should be analyzed in this context.

2.3 External Support for Pro-poor Growth

Moldova is a low income country with limited fiscal resources. Success in achieving pro-poor growth requires a disciplined fiscal effort by the government and from donors and lenders budget support and debt reduction. The government's record of economic management qualifies it for both, especially when Moldova is compared to other low-income countries that currently receive budget support and have qualified for debt relief, through the HIPC initiative or other debt reduction mechanisms.

The case for debt reduction is strong. In the early and mid 1990s, Moldova was classified by the World Bank as a middle income country, not eligible for concessionary loans on terms that characterise credits from the International Development Association (IDA). Toward the end of the decade on the basis of a corrected estimation of GDP per capita by the World Bank, this classification was changed, to low income status, and further loans provided on IDA terms. Restructuring the multilateral debt would have a substantial impact on fiscal resources; reimbursing the excess interest would have a dramatic effect. There would be no basis for making this restructuring conditional upon policy, since the restructuring would represent correcting a mistake made by lenders, rather than motivated by the insolvency of the borrower. The funds resulting from the restructuring could be used to expand the pro-poor economic and social programmes that are discussed in this report. The case for action on the lending mistake is strengthened because during 1992-1998 Moldova consistently received less development assistance as a portion of GDP than the average for transition countries, and did not reach that average until 1999. Had it received the average, in some years it would have been able to cover its external current account deficit, and substitute for loans on commercial terms.

We recommend:

1. It is appropriate that World Bank and IMF loans on non-IDA terms be immediately and unconditionally changed to those terms, and the country reimbursed for the excess interest paid;
2. Donors and lenders accept the EGPRS as the basis for providing budget support to the government; and
3. Greater efforts should be made by donors and lenders to base their partnerships with the government on the principle of national ownership of development policy.

2.4 Economic Performance and Policy, 1990-2004

When the Russian economy entered into precipitous decline in the early 1990s, Moldova followed it down. While the collapse of the Russian economy dictated a collapse in Moldova, it did not dictate that Moldova's decline would be so much greater than the average for all Soviet republics. Moldova's *extreme* collapse in part followed from a misdiagnosis of the country's characteristics at the outset of the transition, which resulted in a series of inappropriate policies. The mistake in calculating per capita income was part of a larger mistake of presuming the country to be more developed than it was, and more capable of adjusting to the demands of a market economy than was the case. The fundamental problem was not to open a closed economy, but to re-orient the openness from the Soviet administrative trading system to market-based international commerce.

This reorientation of trade required establishing the state institutions of international commerce, as well as facilitating investments in modernisation of production. Before it established these conditions, the government of Moldova was encouraged to pursue a policy of general trade liberalisation, which had the inevitable result of rendering domestic production non-competitive with imports. The shock of rapid trade liberalisation was magnified by exchange rate policy in the early years of the transition. The continuous appreciation of the Leu from early 1994 through the first quarter of 1998 resulted in a decline in exports. The Russian financial crisis provided the shock that led to the collapse of the Leu-dollar rate.

To make matters worse, loans contracted from multilateral and private lenders at commercial or near-commercial rates were used to cover recurrent public expenditure. Economic analysis tells one that loans should be contracted only if they can be serviced. Servicing debts requires either that 1) the loan creates assets to generate foreign exchange to cover debt service, or 2) the borrower anticipates a growth of exports that will service the debt. Borrowing to fund current expenditure violates the first condition, and borrowing when exports were falling violates the second. Thus, faced with an unsustainable balance of payments and an enormous budget deficit, as a result of the designation as a middle income country, the governments of the time had no alternative but to pursue an unsound debt accumulation policy.

In summary, the late and slow recovery of the Moldovan economy was substantially magnified by the pursuit of unsustainable policies: premature trade liberalisation and an unsound fiscal strategy that resulted in a contractionary dead-weight of debt servicing that continues to the present.

The recovery and growth of the economy after 1999 was driven primarily by the inflow of remittances. Inherent in remittance-driven growth are several possible problems: 1) the level of remittances may not be sustainable; 2) the tempo of growth beyond the management of the government; and 3) large scale emigration may negatively effect the quality of the domestic labour force. Employing fiscal, monetary and exchange rate policy to foster faster growth, with an emphasis on public investment, would complement the expansionary effect of remittances, and create a strategy for a transition to a development framework more securely based on domestic economic potential.

Fiscal Policy

Centrally planned economic systems derived their government revenue by taking a share of the operating surplus of state enterprises, which in most of the countries accounted for virtually all of production and distribution. When transition policies wiped out the surpluses of most enterprises, massive government deficits resulted. Thus, the loss of fiscal control was structural, not the result of mistakes in policy or lack of competence of civil servants.

While narrowing the fiscal gap represented a necessary step towards macroeconomic stability, the result was a more serious gap, in social provision, a major contributor to the most fundamental gap of all, between the level of deprivation and meeting basic social needs. It is essential that future fiscal deficit targets derive from the goal of poverty reduction, as well as the needs of macroeconomic stability. This means using fiscal policy actively as an instrument of growth promotion.

Sustainable rates of growth are unlikely to return Moldovans to their standard of living of 1990 in less than a half century. Thus, poverty reduction requires that the public sector play a major role in social provision. Emphasis on private provision of education and health care has and will continue to be a vehicle to perpetuate poverty and inequality.

Since 1998, Moldovan governments have not merely brought the fiscal deficit under control, but maintained it significantly below the three percent criterion of the European Union. Was the government to maintain the current level of revenue, allowing expenditure to rise toward a three percent deficit would provide 'fiscal space' for pro-poor public investment. Such a modest deficit would not have inflationary effects in a small, open economy.

While officials at the National Bank of Moldova recognise this, their main deficit concern, which they share with colleagues in the Ministry of Finance, is possible 'crowding out' effects on private investment. Fiscal deficits result in crowding out if they put upward pressure on interest rates, and private investment is interest rate sensitive. Even if upward interest rate pressure resulted from fiscal deficits, actual interest rates are so high that the effect of the fiscal deficit would be insignificant. Further, the crowding out effect is partly dependent upon how the expenditure that generates the deficit is spent. If the deficit results from public investment that complements private investment, this could nullify the crowding out.

It is realistic to conclude that while a crowding out effect of the fiscal deficit is a possibility, given the level of interest rates in Moldova and the likely use of increased public expenditure for infrastructure, there would be little practical impact.

Monetary Policy and the Exchange Rate

The National Bank of Moldova (NBM) is assigned the task of managing the exchange rate. Nowhere in its terms of reference is it explicitly required that the NBM should target inflation. The team was informed that in 2004 the NBM 'narrowed' its interpretation of its mission, to one primarily focussed on inflation targeting. The primary instrument it has used to realise this has been the NBM base interest rate. This has resulted in consistently high real values for the NBM rate, and damagingly high private commercial rates.

These real interest rates represented a major relative price misalignment in the economy. The 'Golden Rule' from growth theory states that long term real interest rates should not exceed the sustainable rate of real per capita growth. Based on growth during 2000-2004, that sustainable rate can be estimated as four percent. By this rule, private borrowers faced commercial interest rates misaligned by a factor of four.

While the private rates probably reflect market manipulation, the NBM rates reflect a concern over the return of unmanageable inflation. The NBM base rate is an inappropriate instrument to use to deal with this anxiety, because hyper-inflation was a transitory phenomenon of the change from central planning to market regulation. Since the hyperinflation of the early 1990s, Moldova has displayed considerable price stability, except during the shock of the Russian financial crisis when exchange rate depreciation again provoked an inflationary burst. All evidence suggests that inflation in Moldova is a structural phenomenon resulting from domestic supply constraints and the inflow of remittances, and is not sensitive to interest rates.

The Moldovan government and its monetary authorities could safely pursue a low interest rate policy without provoking inflation. The effect of such a policy would be to stimulate growth, which would enhance poverty reduction. Even should this be accompanied by moderate inflation in the low teens, and there is little reason to think it would, research suggests no link between growth rates and inflation up to about forty percent. Abandoning inflation targeting would prove to be a pro-poor policy option.

As serious as the distorted interest rates is the behaviour of the exchange rate. After a long period of stability from 1999 through 2003, the Leu appreciated in the second half of 2003 and throughout 2005, by fifteen percent. In part due to the appreciation, the country ran a massive trade deficit during these thirty-two months. Since capital inflows were relatively small, the only credible explanation for the appreciation is the inflow of remittances, a large part of which go unrecorded.

The remittance effect on Moldova's exchange rate has been similar to that manifested in countries passing through an export commodity price boom and ones receiving large inflows of concessionary or commercial capital. In effect, the exchange rate disconnects from export competitiveness, to rise or fall in reaction to purely financial flows. For Moldova, with its large trade deficit, this is a very serious matter. Further real appreciation could undermine export performance by rendering marginal producers unprofitable, and discouraging the entry of new producers. It is quite clear that in Moldova exchange rate movements that undermine the production of tradables are not pro-poor. We conclude that prudent and pro-poor exchange rate policy would involve more aggressive intervention to manage the exchange rate.

The NBM is a competent and professional organisation. Its operations suffer from the absence of formalised mechanisms of accountability which exist in almost all European countries. Its functions would be enhanced by mechanisms that created parliamentary and public oversight, to foster transparency through accountability.

2.5 Macro Policy for Pro-poor Growth

Based on our analysis of the Moldovan economy and objectives defined by the government, we recommend:

1. Since independence, fiscal policy has excessively constrained growth, and a new fiscal strategy is needed to correct this.
2. Increased government expenditure could be growth-enhancing and pro-poor, and is likely to 'crowd-in' private investment by Moldovans.

3. The increased government expenditure could be funded through a larger fiscal deficit, financed either through bonds sales to the public or by monetisation of the public debt. Neither method of finance would have a substantial impact on inflation.
4. As great as the social expenditure deficit is in Moldova, increased government expenditure should focus on public investment.
5. Private sector interest rates are excessively high in Moldova, and represent a major price distortion that has contributed to decline, stagnation and artificially delayed recovery. The NBM should consider further interest rate decreases, aiming for a real rate in the range of four to five percent. For this to result in lower commercial rates, stricter regulation of private market power is required.
6. The government should consider amending the law regulating the relationship between it and the NBM, to include mechanisms for direct accountability of the NBM to parliament and the public; the Federal Reserve System of the United States provides one model of how this could be done;
7. The NBM guidelines could be altered to mandate actions to maintain a competitive exchange rate. Because of the creeping over-valuation of the Leu due to inflows of remittances, more aggressive management of the exchange rate is required.

3. PUBLIC EXPENDITURE AND TAXATION

3.1 The Public Budget

The public budget of Moldova should be used to accelerate economic growth, generate employment and direct resources toward poverty reduction. The fiscal space for fostering pro-poor growth will remain limited until the government can refinance its remaining multilateral and bilateral debt. To do so, it needs cooperation from its multilateral and bilateral creditors. Its successful efforts to reduce its external debt place the government in a stronger position when it negotiates with these creditors. In addition to debt, the government has some flexibility to expand its range of options. In part, its success hinges on its ability to mobilize domestic resources. It has already reformed its tax system, and more can be done to improve revenue generation.

The government should assign a larger share of public expenditures to economic services, and to public investment in economic infrastructure. Since much of the country's infrastructure has deteriorated, this investment is badly needed. It could impart a stimulus to economic growth, because appropriately designed public investment can 'crowd-in' private investment.

Mobilizing tax revenue is crucial for implementing an investment-led growth and poverty reduction strategy. However, revenues of the consolidated budget were about a quarter of GDP in 2003, down from a third of GDP in 1997. They are projected to decline further, to 22.5 percent of GDP in 2007. Expenditures in the budget have been reduced even more drastically than revenues, from forty percent of GDP in 1997 to less than a quarter in 2003. It is clear from the low budget deficits that the government has implemented a relatively tight, if not contractionary, fiscal policy in recent years.

Moldova has been advised to increase its reliance on indirect taxes, mainly the Value Added Tax (VAT). In 2005, indirect taxes accounted for over forty percent of state revenue**.** However, indirect taxes are projected to decline as a ratio to GDP and revenue generated from the VAT is expected to rise marginally, according to the Medium Term Expenditure Framework (MTEF). These trends in indirect taxes place a burden on direct taxes to raise revenue. At the same time that revenues are expected to decrease, contributions to social and medical insurance are programmed to increase. Increases in expenditures for social protection can be pro-poor and are badly needed. But as long as debt servicing remains high, public investment and the provision of essential public services will be constrained.

The government lowered the tax rate on corporate profits to make Moldova an attractive tax haven for foreign investors. At the same time that the government lowered the tax rate, it projected that corporate tax revenue will increase slightly from just under eleven percent of all revenue in 2004 to slightly over twelve in 2007. However, if firms have successfully avoided a higher tax rate, there is no guarantee that they will abandon avoidance at a lower rate of fifteen percent. Nor is it certain that foreign investors will move into Moldova principally because of low corporate tax rates. More crucial than the tax rate are the profit opportunities that the economy generates, which in part depend on the ability of the government to use public expenditures, especially public investment, to stimulate the economy. As the economy grows and corporate profits increase, moderate rates on profit income, such as twenty-five percent, should represent no significant disincentive to foreign investment.

The challenge facing the Government is that direct taxes have fallen as a percentage of total revenue since 1997. Given the decline, it is ill advised to lower tax rates on personal and corporate incomes. This report recommends that the 2003 structure for personal income taxation be maintained, and that corporate profit taxes return to twenty-five percent, which would contribute to a sustainable fiscal structure consistent with growth and poverty reduction.

Two major arguments have been advanced in favour of lower tax rates: that they would reduce tax evasion by reducing the 'shadow economy', and that the tax burden contributes to poverty by reducing growth. With regard to the first, the rather narrow tax base and the size of the 'shadow economy' in Moldova are not primarily the result of tax rates, nor due to government regulations, though the latter could be reformed. The 'shadow economy' is a structural phenomenon, which characterises all low-income countries in which a large portion of the labour force is self-employed and casually employed. With regard to the second, increasing the progressivity of the personal income tax would reduce the burden on the poor while maintaining aggregate revenue. Without a reliable estimate of the gains in tax compliance as a result of rate reduction *in Moldova*, embarking on the policy courts fiscal disaster.

3.2 External Debt

The external debt is a tragic legacy of the early transition period, when average income dropped precipitously to the level of a low-income country while international financial institutions did not offer concessional terms for lending. The external debt burden continues to constrain the government's ability to allocate public revenue for growth and poverty reduction.

Measured by present value, Moldova's external debt was 126 percent of its exports in 2002, placing it in the ranks of other low-income transition economies that have a substantial external debt burden. Despite promises, the international development agencies have not launched initiatives to provide significant relief of the debt burdens of these transition countries, and this should be a priority. The Moldovan government managed to pay off its trade credits, renegotiate its Eurobond debt, and conclude agreements on bilateral debts with Romania and Turkey. It is not without irony that these middle income countries have been more generous in debt relief than much richer countries.

In order to finance its budget deficit in the 1990s, generated primarily by external debt servicing, the government had little alternative but to increase domestic debt. The external debt burden forcing more domestic debt at high interest rates emphasises the problematical nature of the original IBRD-terms loans, which created no assets that would generate an income stream sufficient to repay them.

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

3.3 Public Investment

The Moldovan government has no Public Investment Programme to rationalize its small capital budget. This absence and reliance on external assistance to finance public investment contributes to the lack of coherence of public investment. Moldova needs a consolidated and coordinated Public Investment Programme that is more ambitious, more geared to investing in growth, and more focused on poverty reduction.

An examination of trends in social and economic expenditures during 2000-2004 underscores the relative neglect of the economic services. While expenditures on both education and health increased during this period, those on agriculture, transport and communication declined. Overall, the share of social services in GDP increased from twenty percent to twenty-one, while the share of economic services declined from 4.3 to 4.0 percent. Economic services are programmed to decline further, to 3.2 percent in 2007, while social services will remain virtually constant at 21.4.

Given the importance of agriculture and agro-industry to future growth and exports, the lack of expenditures on economic services for the sector, particularly public investment, is not optimal. Moreover, the lack of public investment in infrastructure for transport, communication and energy indicates an erosion of the potential for long-term sustainable growth. Rural and agricultural infrastructure is essential for Moldova's industrial development as well as its agricultural development. Even compared to neighbouring transition economies, Moldova allocates relatively less to economic services and relatively more to social services. Such an allocation of public resources suggests that the full recovery from the catastrophic decline of its economy in the 1990s will be more protracted than anticipated.

3.4 Fiscal Policies for Pro-poor Growth

Based on the analysis above, the report proposes the following policy measures:

1. While we support the government's commitment to reducing tax evasion, reducing tax rates is unlikely to contribute to this goal. Reducing evasion of the personal and company taxes could be achieved through mechanisms that have proved successful in other European countries. The government should concentrate on raising tax revenue within a more progressive structure.
2. The government could strengthen the efficiency of the VAT, and design it to have a progressive structure.

3. The rate on corporate profit tax should return to twenty-five percent to make it consistent with the top rate for personal income tax.

4. Two concrete measures would facilitate pro-poor budgeting. First, the Ministry of Finance could institutionalise a poverty impact assessment of each annual budget. Equally important would be a gender impact assessment of the budget focused on, but not limited to, the impact on poor households.

6. Without delay creditors should enter into negotiations with the government aimed at restructuring external debt with the applicable rescheduling and grace periods for repayment and interest rates.

7. The IMF should facilitate and give full support to the government in its negotiations with Paris Club bilateral creditors. The starting point for such negotiations is the general recognition that Moldova should have been provided with concessional, instead of non-concessional, lending beginning with the first loans it contracted in the early 1990s.

8. The reduction in expenditure on economic services should be reversed in order to increase the growth capacity of the economy.

9. The government should establish a public investment programme (PIP) to rationalise and increase desperately needed capital expenditures.

4. POVERTY, INEQUALITY AND POLICY IN MOLDOVA

4.1 Introduction

Both income-poverty and human-poverty sharply increased after 1991 in Moldova, and by 2005 had not recovered to their pre-transition levels. Poverty in Moldova combines a) low income, b) high mortality and morbidity, c) declining access to subsidized health and education, d) growing social exclusion, and e) a disempowering lack of participation by the poor in decision-making. Demographic factors, such as gender, old age and disability, were not major guides to the poverty of households, and differences in poverty incidence are not significantly related to level of education, except for those with higher education whose rate is almost zero.

An important characteristic of poverty in Moldova is the volatility of household status; that is, the movement of households into and out of poverty over short periods of time. This has major implications for policy, since it implies that the identification of poverty households in one time period may not apply to the same households in a subsequent period.

4.2 Characteristics of Poverty

For people in rural areas, the relative risk of poverty and extreme poverty was very high compared to households in cities. Poverty in rural areas resulted from low agricultural productivity and limited employment opportunities outside agriculture. The overwhelming majority of rural residents farmed the plots assigned to them by the land reform, or hired themselves out as rural labourers on larger farms, with little opportunity for non-farm earnings.

Poverty among pensioners was extensive, but not significantly different from the national average, and their risk of extreme poverty was a bit lower than the national average. The lower level of poverty among pensioners in Moldova is due to the almost universal coverage of the state pension inherited from the socialist era, which survived the fiscal collapse of the first decade of transition. The enhancement of this universal pension programme should be a major element in the government's poverty reduction strategy.

Evidence from most other countries shows that female-headed households frequently face a higher than average risk of poverty. While gender discrimination was robust in Moldova, the data indicate that female headed households faced a slightly *lower* level of poverty than male headed ones. If valid, this might be explained by three factors: women's level of education being equivalent to men's (a legacy of the Soviet era); the industries that collapsed primarily hired men; and female headed households may be households receiving remittances.

The statistics suggest that widening access to higher education would at best create the supply side conditions for poverty reduction, for there must be jobs for the educated to take. The fundamental employment problem in Moldova, at all levels of education, is demand, not qualifications. While the highly educated are less likely to be unemployed, a substantially larger number of tertiary graduates are unlikely now to do more than raise the average qualifications of the unemployed.

As one would expect, in Moldova the unemployed face a higher risk of poverty and extreme poverty. Workers employed in the private sector have a somewhat higher risk of falling into poverty than those working in the public sector, primarily because the majority of private sector employees is employed in agriculture.

4.3 Inequality and Poverty

Catastrophic economic collapse was responsible for well over half of the increase in poverty over 1991-1996. Poverty also rose because of a marked worsening of the distribution of income. The Gini index of the distribution of gross earnings rose phenomenally in a short period of time, from 0.25 in 1989 to 0.39 in 1992, to stabilize near that level during 1993-95. During 1997 and the first half of 1998, output recovered slightly, and inequality increased further, to a Gini coefficient of 0.42. The modest recovery was reversed when the economy contracted during the Russian financial crisis. In 2001 a sustained economic recovery finally began. Inequality declined during 2001-2003, with a rise in the income share of the bottom quintile. Part of the increase in inequality in the early 1990s was unavoidable, given the changes in economic system and output collapse, and the subsequent protracted stagnation. Part was dysfunctional, due to the weakness of the legal and institutional framework of the first years of transition, which was unable to prevent accumulation of wealth in the hands of a few. These inequality changes were an important contributor to the rise in poverty. Policy seeking to reduce poverty must aim at reducing the level of inequality, such as increasing the progressivity of taxation.

In the report we ask what would be the poverty outcome if in the 1990s policy makers introduced policies to restrict the growth of inequality. The results of the calculations show that to cut poverty in half by 2007 requires generating a sustained and rapid growth of GDP in the range of eight percent, without a further deterioration in the distribution of income. A similar reduction in poverty would be achieved if Moldova grew at a more achievable *and more egalitarian* four percent a year. Both growth and greater equality are essential for poverty reduction: either growth or greater equality alone would be insufficient. .

4.4 Policy Implications

The statistics on poverty suggest several implications that are the basis of policy recommendations found elsewhere in this report:

1. The 'poor' is not a stable category, because households move in and out of it over short periods of time.
2. Inequality has been a major cause of poverty.
3. The universal state pension is a major mechanism of poverty reduction.

4. Widening access to education, while desirable in itself, would not have a substantial poverty reducing effect, because employment is limited by aggregate demand; and

5. Growth *and* greater equality are essential for poverty reduction, and any policy aiming at this objective must include both mechanisms.

5. MIGRATION, EMPLOYMENT AND POVERTY REDUCTION

5.1 Migration from Moldova

Through remittances, migration served as a major survival mechanism for households during the 1990s, preventing an even worse economic collapse, and has been the primary mechanism for the recovery since 2000. In addition, remittances reduced the government's dependence on conditionality-based borrowing, allowing for flexibility in macro policy. However, the inflow of remittances has the effect of appreciating the exchange rate, and making exports less competitive. The social costs of migration have been unacceptably high, the impact on the domestic labour force negative, and the level of remittances unsustainable.

There are substantial differences between official statistics and unofficial estimates of migration from Moldova. The data on legal emigration suggest that yearly outflows during 1992-2003 range from five to nine thousand. Estimating illegal migration is extremely difficult. In 2000 the Department of Statistics and Sociology estimated that were 234,000 Moldavians working abroad legally and illegally. An estimate close to this was obtained by the Labour Force Survey of 2003. In 2004 an independent survey conducted by the Moldova Microfinance Alliance estimated that between 265 and 285 thousand Moldovans had gone in search of work. All of these are far less than the media reports of one million Moldovans working abroad.

The majority of migrants, almost sixty percent, go to Russia and about thirty percent go to EU member states. Of EU countries, Italy is by far the most common destination, accounting for almost twenty percent. Female migrants are more likely to go to Mediterranean countries than to northern Europe or members of the CIS. This pattern conforms to the Soviet period when Moldovans sought seasonal work in agriculture and construction in other parts of the Soviet Union, particularly in Russia and Ukraine.

5.2 Migration and Poverty Reduction

The underestimation of remittances in household budget surveys leads to some overestimation of poverty. In spite of this, the surveys show that the *ex-post* impact of remittances in reducing poverty is very large. Many more families would have remained below the poverty line if the possibility of migrating had not been there. A rough estimate is that migration reduced the incidence of poverty in 2002 by some 20-25 points, and that these sharp gains in income-poverty were accompanied however by a worsening in poverty. The indeterminacy in these numbers indicates the difficulty in measuring aggregate poverty and identifying poverty households.

Remittances have the possibility of increasing future consumption through income generating investments. The vast majority of respondents intended to use the assets accumulated from migration for consumption. Business investment seems a priority for very few. Any secondary impact of investment on income poverty reduction through future consumption therefore seems limited in Moldova. As in many other high migration countries, one of the greatest challenges for government policy makers is to change this and facilitate the flow of remittances into employment generating activities.

5.3 Migration and the Labour Market

The dynamics of the educational sector and the migration process have seriously affected the domestic supply of skills in Moldova. The enrolment of children from the poorest households at the upper secondary level has declined to fifty percent, compared to seventy-one for the richest quintile. At the university level, the situation is worse. The enrolment rate for the poorest women and men has consistently declined over time to about four percent in the mid-2000s. For the richest quintile, enrolment not only improved, but was more than four times than that of the poorest quintile. Various social illnesses, some of which are by-products of poverty, alcoholism, drug dependency, and a high criminality rate, further depleted the quality of the labour force.

Migration from Moldova strongly affected the domestic supply of skilled labour. Almost fourteen percent of the population and twenty-three percent of the workforce worked abroad in 2003. Over one half of the workers abroad were under age thirty, and eighty-eight percent under forty-five. During 2000-2004, thirty-six thousand doctors left the healthcare system, and twenty-eight thousand teachers left the education system to work abroad. By any measure, these represent a serious brain drain. Migration of unskilled workers led to higher than normal dependency ratios and to severe family problems, with children left by their parents growing up without care and adequate education. Remittances would benefit the supply of skilled labour if they were used for education. In other countries migration has brought benefits from new skills of the returning workers, but there is little evidence of this in Moldova.

5.4 The Social Impact of Migration

Trafficking in human beings has been an outrageous aspect of migration in Moldova. This trafficking involves various methods of misleading potential migrants, especially females into the sex trade. The root causes for the supply of Moldovan women to the sex industry are poverty, social exclusion (especially for the Roma population), and domestic violence.

Trafficking of people fragmented communities and families, depleted human capital, deprived households of expected remittances, and caused child neglect. Migrants working illegally in host countries were subject to exploitation and abuse from criminals organising the migration, employers and local authorities. Illegal migration contributed to the expansion of crime networks in Moldova, which also deal in arms, drugs, and other contraband.

Migration has adversely affected children. When children of migrants remain at home under the care of relatives or neighbours, they fall risk to leaving school early, moving away from home, and ending up as street children. Children themselves became subject to human trafficking. According to the data from the Ministry of Interior, Moldova became a major source in supplying underage girls to Russia for sexual exploitation, with an estimated five thousand trafficked there annually.

5.5 Policy Suggestions

Moldova is faced with a number of possible migration scenarios and it may not be able to choose the one it would prefer. The status quo is unlikely to continue. The social costs of trafficking and associated negative aspects of irregular migration are not acceptable for society. Moldova requires a policy framework which builds on the positive aspects of migration and minimises the negative. Designing this policy would be a political exercise. A public consultative process is needed to create a consensus on the costs and benefits of migration. The fundamental issue is whether Moldova would be a society dependent on migration and remittances, in return for the possibility of a quicker return to pre-transition living standards, or whether the vulnerability of such a society requires a progressive reduction in the importance of migration and remittances.

The Migration Policy Concept of the Republic of Moldova was adopted by parliament in October 2002. The Migration Department is supported by the donors and lenders to improve migration management, develop and strengthen strategies and policies and develop appropriate agreements with destination countries. Given the importance of migration and remittances, it is surprising that the EGPRS has little to say about the subject. It does, however, identify broad directions for the future, all of which are important, and deserve the financial and technical support of the international community.

First, the government should bring legislation on migration in accordance with the international standards. The other PRSP actions are closely linked and relate to conducting a comprehensive study of the migrant population, creating an information system, and improving the management of migration processes.

Perhaps the most important economic issue associated with migration is how to encourage and facilitate households to direct part of remittances to productive investment. International experience suggests that compulsory measures are only effective when employment is organised through employment contracts with the government of the migrants as one party. The mechanisms to foster investment must match the characteristics of private and public financial institutions. The design of these is beyond the expertise of this report, which can only suggest general guidelines. Voluntary mechanisms to foster investment from remittances could include:

1. Encouraging commercial banks to offer foreign currency accounts;
2. Measures to reduce the costs of remitting funds;
3. Ensuring a well-regulated and effective financial sector, including non-banking financial institutions such as micro-finance mechanisms; and
4. Developing a foreign currency bond with transparent taxation.

6. EMPLOYMENT, PRODUCTIVITY AND POVERTY

6.1. Employment and Poverty

Equitable economic growth is essential for reducing poverty in a sustained manner, and does so through employment that generates livelihoods above the poverty line. The main problem in Moldova is that well-paid jobs are not created in sufficient numbers to lift the working population out of poverty rapidly. Of the people who were in poverty in 2002, seventy-five percent had work. Their problem was that the work did not pay sufficiently to escape poverty. Thus, the challenge for Moldova is the creation of employment opportunities associated with increased productivity so that the employed population can obtain incomes sufficient to escape poverty.

Unemployment has fallen, but employment has not risen. From 1999 to 2004, the rate of unemployment fell from eleven to seven percent, and the absolute number of unemployed people also declined. The fall in unemployment in great part resulted from a steady decline in the working age population, due to out-migration and an increase in the numbers of people becoming economically inactive, the 'discouraged worker' phenomenon.

6.2 Employment, Wages and Productivity

In 2003, the level of employment stood eighteen percent below the 1996 level in agriculture, sixteen percent below in industry and nineteen percent below in services. After the Russian crisis, employment recovered in both agriculture and industry, but not in services. While employment has stagnated or declined in most sectors, output and value-added have increased. The difference between GDP growth and employment growth is even greater after 2000. Between 2000 and 2003, overall GDP grew at four percent per annum, and employment declined by 2.4 percent.

The employment-output relationship has implications for the growth of productivity and labour income. By definition, the failure of employment to keep pace with production meant that labour productivity increased. During 1996-2003 aggregate productivity grew at 4.8 percent per annum. Along with the slow growth of employment and rising productivity went an increase in real wages beginning in the mid-1990s. This reversed during the Russian crisis but rose again afterwards. The apparently high rate of increase of real wages, almost eight percent per annum, must be placed in the context of the catastrophic collapse in the early 1990s. Given the decline in the real value of money and the social wage during the first half of the 1990s, it is quite possible that the living standards of workers dropped to such a low level that worker productivity was undermined. That real wages seem to have outpaced the growth of labour productivity could be a process of adjustment toward a more sustainable 'efficiency wage' level.

To some extent, the failure of employment to recover during the recovery should be expected in a transition economy. As in other transition countries, enterprises in Moldova carried more workers before the transition began than would be justified under market criteria. As market forces impinged on enterprises, enterprises shed this labour. As a result, employment growth lagged behind output growth. As a result, the pressure to migrate abroad continued, keeping the measured rate of unemployment down, but at considerable social cost.

6.3 Women's Employment and Remuneration

Changes in the structure of employment in the economy have different impacts on men and women, as a result of embedded discrimination. As in other countries, women dominate in health and social work, education, hotels and restaurants and, surprisingly, finance. The latter pays the highest monthly salaries across sectors, but accounts for only two percent of women's employment. Health, social work and education, on the other hand, account for over forty percent of women workers and are among the lowest paid sectors in the country. Approximately fifty-seven percent of women worked in sectors with wages below the national average, while for men the figure was forty-seven percent.

The anti-discrimination legislation of Moldova is quite strong on paper, and, if effectively implemented, could reduce the pay differential between men and women. However, enforcement is not effective, perpetuating the inequality despite enlightened legislation. There is widespread insensitivity to the discrimination against women in Moldova. Legislation against pay discrimination, for example, is easily evaded within a discriminatory culture by relegating women to low-paid jobs.

Strong leadership by the government is necessary to overcome gender discrimination, and the public sector can be a positive example. Moldovan women perform an enormous volume of unpaid work within the family, and play a leading role in many community organisations. At the same time they are absent from decision-making, partly because of the lack of a coherent and supportive state framework and partly because of the patriarchal mentality which still affects the whole of society, including women themselves.

6.4 Generating Wage Employment

The rate of firm closure in Moldova during the 1990s was one of the lowest among European and Central Asian transition economies. Enterprise level data for 2001 show that expanding enterprises created jobs at a slower rate than the contracting firms lost them. Thus, it was not so much the severity of job destruction as the sluggishness of new job creation that proved the main drag on employment in Moldova, and this sluggishness can be explained by demand-constraining macro policies. In the face of severe demand constraints, it is not surprising that new enterprises found it difficult to emerge and the existing ones found it hard to expand.

Whatever may be the problems with the labour market in Moldova, it is not 'inflexible' with regard to wage 'adjustment'. Real wages collapsed in the first half of the 1990s, indicating excessive downward wage 'flexibility'. Falling wages did nothing to reduce employment decline, contrary to the orthodox model of labour markets. The simultaneous collapse of wages and employment in the 1990s indicated the weakness of the bargaining power of workers, which resulted from at least three factors: 1) the absence of an independent trade union movement at the beginning of the transition; 2) lack of bargaining power due to growing unemployment; and 3) ineffective regulation of employers by the public sector.

6.5 Labour Market Policies

To increase employment that would reduce poverty, the following policy direction would be appropriate:

1. An employment strategy that covers policy actions at the macro, sectoral and micro levels. Macro policies can create more rapid growth, sectoral policies can make growth more broad-based and micro policies can enhance workers' access to economic opportunities.
2. Macro policies would include active fiscal policy based on public investment. The most important constraints on employment growth in Moldova are lack of demand and productive investment. An active fiscal policy would be growth-enhancing through public investment, supported by low real interest rates, and a modestly undervalued exchange rate to foster exports.
3. Sectoral Policies should seek to raise productivity in agriculture and link agriculture to agro-industry in order to create widespread employment that generates decent incomes. The government should direct public investment and provide incentives to the commercial banking system to provide credit to these purposes.
4. Micro policies should focus on providing education and skills to workers and supporting trade unions in all sectors, including agriculture. Because labour markets are ineffective and inefficient, it is through trade unions that productivity increases will translate into real wage increases. The Ministry of Labour and Social Welfare follows this approach.
5. The government can also stimulate private investment by making regulation more transparent. While changes in the regulation of enterprises and markets can contribute to employment creation, the necessary underlying condition is still an accommodating macroeconomic framework. Without such a framework, institutional reforms would have little impact.
6. Given the level of un- and under-employment, market forces alone are unlikely to foster job security and wage increases that would lift works out of poverty. Therefore, the ability of workers to bargain for conditions and wages through unions should be enhanced.

7. AGRICULTURE AND SUSTAINABLE POVERTY REDUCTION

7.1 Agriculture's Role in Moldova's Growth Strategy

Agricultural development is critical to Moldova's future. It could contribute to closing the trade gap, increase rural incomes, and possibly reduce migration. It represents an important medium-term vehicle for assuring the recovery of the Moldova economy and laying the necessary basis for the eventual re-industrialisation of the country. However, without forging strong links to agro-processing, agriculture will be unable to grow either rapidly or in a sustainable manner.

There are structural bottlenecks in the sector, and between agricultural producers and processing companies, that require policy action in order to make rapid and sustainable growth possible. The principal problems are underdeveloped markets for inputs, output and finance. Also weak or absent are supportive institutions, such as output marketing and input purchasing cooperatives (so-called 'single-purpose cooperatives'), which can increase the bargaining power of small farmers. Further, most of the agricultural sector has suffered from years of insufficient investment. As a result, rural roads, market infrastructure, irrigation systems, and communication networks have deteriorated.

Gender aspects of the land reform have been poorly documented. Rural women made up a majority of the land proprietors because men migrated to work in construction, technical services and commerce, losing their right to title under the land reform. However, there appeared to be few female managers of cooperatives or large farms although definitive statistics on this issue are lacking. As in other sectors, improved statistical information by gender is an urgent priority in order to fully understand the role of women.

7.2 Post-Independence Agriculture

The restructuring of collective and state farms proceeded unevenly after independence. Rights to land and other assets were distributed among households, and could be exchanged. Because so many households were eager to leave collective and state farms, the November 1994 law halted the process of privatisation. A year later the Constitutional Court declared the limitations on leaving collective and state farms to be illegal, and the process of privatization began anew in 1996.

By October 1996, some ninety thousand private farmers, individually or in groups, worked one hundred and thirty thousand hectares, five percent of Moldova's arable land. The remaining farm population remained in collective farms that had been nominally restructured, or in new farm associations and production cooperatives that had been created from the collective farms. These new institutions, 'corporate farms', essentially functioned as slightly smaller *kolkhozes*. The National Land Program (NLP) of 1998, supported by external funding agencies, accelerated the process of land reform. In 1999, a law on farm debt provided additional incentives for dissolving collectives by arranging debt restructuring and consolidation. At the end of 2000, nearly 1.7 million hectares and the majority of state farm assets were transferred from over one thousand bankrupt *kolkhozes* and *sovkhozes* to about one million former farm employees. Orchards and vineyards were also distributed to households according to the latter's size. The result was to fragment a large share of land holdings into over three million small privatised parcels.

On average, each owner received three parcels of land, with an average parcel being one-half hectare. The program included the establishment of a register of land titles, and an extensive education campaign for farmers on their legal rights and market opportunities. Some of the new landowners chose to farm the land with family labour. Others leased their land and other assets to the newly created corporate farms, which had been formed out of the collective farms, and either worked on them as members or employees or received lease payments. Thus, the privatization process led to a dual agrarian structure polarized between one part based on a myriad of small-scale farms of one to five hectares and another part based on a few large corporate farms, such as limited liability companies, joint stock companies,

Agricultural markets and related services remain weakly developed. In the aftermath of the redistributive land reform, many of the more than one million beneficiaries did not have the necessary skills for efficient agricultural operations. It was expected that the emergence of agricultural markets would transfer land from less efficient to more efficient producers and would lead to a more competitive agricultural sector. The government has viewed fragmented landownership and the predominance of small farm size as a bottleneck for agro-industrial development. Hence, it launched several policy proposals to consolidate land and create production cooperatives. These initiatives have encountered both domestic and international opposition because they are seen as a step towards reversing some of the main outcomes of the redistributive land reform of the late 1990s. The more important of these initiatives were cancelled in 2005.

Although the statistics on land distribution should be treated with caution, they do suggest that small farms are economically efficient. Further, land consolidation has already taken place through lease markets, and is likely to continue. The principal explanation for the lack of efficiency in agriculture may not be small farm size, but the underdevelopment of markets for both inputs and outputs.

As a result of the structural changes and general economic collapse, agriculture contracted dramatically during the 1990s. In 2003, agricultural production was only at forty-five percent of its 1990 level. Livestock production proved much more vulnerable to structural changes than crops, decreasing by nearly two-thirds during 1990-2003. In 2001, after the second phase of redistributive land reform, agriculture registered strong growth, which might have continued into 2003 but for a severe drought that destroyed the wheat harvest.

Despite the decline of output, and the constraints of the 1990s, there have been positive developments. A recent study showed that commercial producers of high value products using advanced production technologies, including irrigation, registered higher yields for some crops than the average in Romania, Bulgaria and Hungary. This suggests that Moldovan producers have the potential to achieve international competitiveness.

7.3 Agricultural Markets and Poverty

The underdevelopment of markets for fertilizers, seeds, machinery and credit is a serious problem. Access to inputs declined during the transition to a market-based economy and new input markets did not take the place of state provision. Because of the dramatic reduction of livestock, organic fertilizer is scarce in rural areas. Small agricultural producers have virtually no access to commercial lending. Since land prices remain low and other farm assets are scarce, farmers possess little collateral for borrowing.

With the support of external donors, institutions have arisen to offer micro-credit to farmers. The total amount is small and directed mostly to financing working capital. While such credit is important, loans for long-term productive investment are more important, but are in short supply. The same shortage of credit applies to rural non-farm enterprises, which are very weakly developed in rural areas. The lack of credit is a major constraint to both agricultural and non-agricultural development. This is a constraint that public policy can do a great deal to remove by providing various incentives to financial institutions to offer more loans for such development.

7.4 Policy Suggestions

The following are recommendations that would contribute to the development of agriculture:

1. The government should focus its policies on helping agriculture regain its position of comparative advantage in high value crops and facilitating its linkages to the agro-industrial sector. A central ingredient of this policy focus is public investment in roads, irrigation infrastructure, rural markets and communication networks, which would 'crowd in', or stimulate, private investment.
2. The development of agro-industry is central to the revitalization of the agricultural sector, particularly in ensuring the latter's linkages to export markets. The institutional and policy environment should encourage new entry into agro-industry, and institute transparent import and export procedures.
3. Agricultural producers, particularly small ones, need training and extension services in order to produce more and higher-quality commodities. This could be facilitated by agro-processors and exporters, who are familiar with the requirements of their target markets.
4. The government can use fiscal measures to stimulate the establishment of out-grower schemes that can promote improved product quality and increase farmers' income.
4. Developing physical marketing infrastructure could significantly strengthen and diversify supply to markets and boost farm-gate prices.
5. The weak bargaining position of small peasant farmers could be partially overcome by promoting single-purpose cooperatives and associations, which focus on input purchase and output marketing. Tax policies and legislation that encourage the formation of such organizations could make an important contribution.
6. The main bottleneck for agricultural producers in Moldova is the under-development of markets. Since these markets interlock, an integrated policy response towards developing them is needed.

8. SOCIAL POLICIES FOR HUMAN DEVELOPMENT

8.1 Policy Framework and Priorities

The central issue of social policy is the basis on which these social services and benefits should be distributed. The recommendations made in this chapter for social policy derive from the following guidelines: the system for the distribution of social services and benefits should be operationally practical, affordable within the national budget, transparent to the beneficiaries, administratively feasible at reasonable cost, and not require excessive government intrusion into the private realm of households.

The distribution mechanism that most conforms to these guidelines is *universal eligibility with categorical targeting*. '*Universal eligibility*' means that there is no restriction on access (sometimes called the 'citizenship principle'). 'Categorical targeting' means that a programme is directed to an objectively and simply identifiable group of the population, such as children under a certain age. An alternative method of distribution is *needs testing*. In this approach, one or more criteria are used to discriminate between households which are 'needy' and those which are not, with the benefit programme restricted to the former. As an operational matter, needs testing is most frequently based on income level; a household qualifies for the benefit if its income lies below the relevant level (i.e., the household is 'poor').

While not opposed in principle to distributing benefits based on means testing, this report recommends that its use be limited in Moldova. First, poverty surveys reveal that there is a high year-to-year movement of households in and out of poverty. This implies that identification of the poor would require annual repetition, implying a high administrative cost. Second, the accurate measurement of incomes is especially difficult in Moldova. The country has the difficulties common to all low-income societies, e.g. a high proportion of self-employed, plus a characteristic of migration countries, e.g. a quite large level of unrecorded remittances. Third, the required frequency of measuring incomes and seeking information on matters known only to the household itself would imply a high degree of government intrusion into private space.

We conclude that while needs testing should not be ruled out as a method of distribution, it should not be the basic framework for education, health, and social benefits. More practical and transparent would be categorical targeting. One such programme, the basic old age pension, has shown itself in many countries to be an effective protection of households against poverty.

Our recommendations on social policy must conform not only to the nature of poverty in Moldova, but also to the country's characteristics. A common recommendation for low income countries is that on equity grounds, health expenditure should focus on preventative treatment and non-hospital care. While both are important, due to the relatively high life expectancy in Moldova, the poor are as likely, or more likely, to suffer from maladies requiring hospitalisation as the non-poor. In general, it is important for social policy to recognise that Moldova is not a typical low income country attempting to combat poverty with limited resources. It is a country which has fallen into low-income status over a short period of time. A majority of Moldovans, only fifteen years before this report was written, enjoyed education services, health care, and social protection close to a First World standard. In the short run, temporary measures are necessary to alleviate the worst social problems. The long term goal would be to regain the level of services that was lost during the transition.

8.2 Human Development Indicators

Moldova entered its transition with robust human development outcomes. By the mid-1990s, these achievements were a memory. During the first half of the 1990s, the health of Moldovans seriously deteriorated, because of eroding standards of living, poor access to health care, and its declining quality. Life expectancy declined to sixty-five from sixty-nine years and infant and maternal mortality rates increased. Sexually transmitted diseases took on almost epidemic proportions and half of the population did not receive treatment for these diseases.

During 2000-2004 the decline in social indicators was reversed: life expectancy for males and females improved, infant mortality rate declined, the child mortality rate fell, and the maternal mortality rate also declined. Despite these improvements, health outcomes in Moldova remain unsatisfactory. Life expectancy of sixty-eight years is one of the lowest in

Europe; the infant mortality rate is more than twice that of high human development countries; and the maternal mortality is four times the European average.

In the household survey of 2002 one in every five Moldovan considered herself or himself to have 'bad' or 'very bad' health. The self-defined health status deteriorates considerably with age, with more than half of the population over sixty years of age reporting bad or very bad health. Two-fifths of the population considered itself to suffer from a chronic condition.

8.3 Enhancing Human Development

Social policy to enhance human development in Moldova should focus on reducing human poverty. The efficiency and effectiveness of policy is dependent on the overall macroeconomic framework and broad poverty reduction strategy. Across the sectors, there are synergies among policies that should be maximized. Policy should not be limited to strategies, but should also address institutional strengthening.

The government has shifted health expenditure to primary care. It has been suggested that a large part of the Moldovan population's health needs can be met, if well funded and supplied, by an effective primary care system. If so, then a basic package of services, fitting within the available resources, should be made available to all on the basis of medical need. Suggestions have been made that this can be done at a relatively modest cost and will improve utilization of health care by lower income groups, thus resulting in overall better health outcomes. However, it would not be a pro-poor strategy in health to have a two-tiered health system, in which the poor are limited to primary care, and access to hospital treatment dependent on payment.

In education in Moldova, there is a persistent and widening inequality in opportunities because of skewed access to opportunities. The differential access implies greater inequality in the future and a lower rate of poverty reduction for any rate of economic growth. To improve the access of the poor to education, it is essential to reduce out of pocket costs, both formal and informal. Reduction of the incidence of informal payments and bribes in higher education may require a review of entrance procedures.

Poor and rural families, for whom quality education in lyceums and universities has been out of reach, are likely to be more dependent on general secondary and vocational education. The demand for secondary vocational education appears to be falling, and graduates of these institutions face difficulties in finding employment in the domestic labour market. The policies in this area need to be reviewed.

In order to increase the value of education to households, particularly for poor and rural households, improved functioning of the labour market, and improved labour market opportunities for rural and poor populations are needed. Policies to address these needs lie, for the most part, outside the education sector but are addressed in elsewhere in the report.

8.4 Social Policy for Poverty Reduction

A pro-poor social policy in Moldova would have the goal of reducing poverty, rather than merely alleviating it. This implies that social policies facilitate the poor in acquiring the means to permanently exit poverty. From this perspective, social policy does not provide 'safety nets' that catch the few or many that fall into poverty. Social policy is part of a growth strategy that progressively reduces the conditions that generate poverty.

In a low-income country, social policy faces many trade-offs, and there are inherent limits to its capacity to reduce poverty and provide equitable access to services and benefits. The measures listed below recognise the trade-offs and limits, guided by the principle that policy should not endorse the division of Moldova between the poor and the non-poor, but should foster systems that progressively eliminate that division. That objective would be achieved by combining social insurance and assistance programmes with a more equitable access to health and education, within a macro framework of progressive taxation and public investment.

1. Because of the nature of the Moldovan economy, its structure (relatively few formal sector wage earners) and characteristics (importance of remittances), there are serious practical difficulties to using income testing for access to benefits. The inherent arbitrariness of income testing that results from this structure and characteristics suggests that the its use be avoided when alternatives are feasible.

2. A benefit system based on targeting categories of the population with universal access has proved poverty reducing in Moldova, with the old age pension an example. This approach should be extended to other population groups.

3. Progressive taxation is the key to funding pro-poor health and education systems.

4. Constraints on revenue limit the quality and extent of public health services. This requires clear priorities for health expenditures. Policies should be avoided that would institutionalise a two-tiered health system, in which free access is to a minimal system which is income tested, and other health services are obtained through private payment. Institutionalising a two-tiered system would institutionalise poverty.

5. Primary and secondary education should be provided to all without charge. This requires increased funding for teachers' salaries, education materials, and construction of facilities. The capital expenditure would be part of a public investment fostering growth strategy.

6. Unequal access to university education cannot be eliminated in the foreseeable future; however, it can be moderated by income tested funding of university fees within a system of access on the basis of ability and school performance.

Chapter 1:

Introduction

1.1 Purpose of this Study

This report is part of a larger UNDP project on the macroeconomics of poverty reduction, which at the time this study began had covered six East and Southeast Asian and several Central Asian countries. The Bureau for Development Policy of UNDP has helped to initiate a broad range of global, regional and country programmes designed to help fashion more pro-poor economic policies. The primary purpose of this set of activities has been to broaden the dialogue on pro-poor policies at the national, regional and international levels. While each report stands on its own, addressing the specific circumstances of each country, taken together they provide a consistent analysis and vision of the poverty reduction process. The main findings of the project are presented in series of synthesis reports organised by topic. Of particular relevance to this study is the fiscal synthesis paper (Roy and Weeks 2004), whose principles are applied here.

1.2 Gender Analysis of the Transition

Prior to considering the aspects of the transition, it is essential to recognise that gender is central to understanding the transition process. Further, gender equality plays an important role in growth, employment and poverty reduction, and cannot be ignored. The fundamental policy changes associated with the transition process are likely to affect men and women differently because of their different positions, roles, and responsibilities in society. The unequal treatment of men and women cannot only be questioned on human and equity grounds but is also economically inefficient. As a result, the development of effective economic policies requires gender analysis and the mainstreaming of gender into the development of the policies themselves, including the budgeting process.

It is unfortunately the case that the statistics necessary to adequately incorporate gender into the analysis of the transition, and into pro-poor growth, do not for the most part exist in Moldova. With some exceptions, the data that disaggregate between men and women are the common-place statistics that one finds in even the least gender-sensitive countries: mortality rates, life expectancy, school enrolment, for example.[1] This is a serious oversight that should be addressed immediately by the Moldovan government; all the more immediately because there would certainly be funds from donors to cover the cost of collecting and analysing the necessary numbers.

1 The Department of Statistics and Sociology (DSS) published Women and Men of Moldova in 2004 (in Romanian and Russian but not English). Gaps in disaggregated data include, among many others, disaggregation on credit and school results. Other gaps include information on violence against women and sexual harassment. There is a chapter entitled 'Gender-based Policies' in the Annual Social Report 2003, of the Ministry of Labour and Social Protection that contains disaggregated statistics. The DSS labour market studies, including the Labour Force Survey, have basic gender disaggregation, though not to the extent recommended by ILO statistical guidelines.

Striking evidence of the lack of gender perspective on the transition in Moldova, and other countries passing through a similar process, is the virtual absence of any rigorous or even through treatment of the conditions of women under central planning and the subsequent market regulation. A few points are beyond dispute: 1) before 1990, women's access to employment was considerably better than after that date; 2) child care was more available, without 'user fees', facilitating women's employment; and 3) the deprivations suffered by the Moldovan population resulted in a dramatic increase in women's unpaid work. Because the central planning system ended less than two decades ago, it would not be difficult to collect the information to systematically analyse the impact of the transition from a gender perspective. Again, it is likely that external funds, from research foundations if not from development agencies, could be obtained to collect the information and analyse it. All is necessary is for the government to give the task its appropriate priority.

Given the lack of statistics necessary for a rigorous gender analysis, this report is reduced to the inadequate approach of using the available information and attempting to draw reasonable inferences about what that information does not directly reveal. As highlighted in the policy summary, it is essential that the Department of Statistics and Sociology introduce immediate and thorough policies to ensure that future economic reports on Moldova do not suffer from the fundamental weakness that this one does.

1.3 Four Fundamental Transitions

For all of Central and Eastern Europe the twentieth century brought the ravages of war and dictatorship. While it is not possible to assess objectively which country suffered most, it is beyond controversy that the experience of Moldova was unimaginably grim. In the first decade of the century a great ethnic pogrom left communities divided and hostile; to be followed by a second in the bleak summer of 1941, when the country fell under military occupation, which would last for over three years. The end of the Second World War brought peace, but a peace that many Moldovans viewed as a new foreign occupation. No visitor to the country can for long remain ignorant of the social divisions created by this history. Therefore, it is more than remarkable, that after independence the country has been so free of civil strife, even when the economy collapsed catastrophically.

Perhaps, the absence of major civil strife can be explained in part by the overwhelming support of the vast majority of Moldovans for independence. However, upon independence, Moldovans faced four fundamental social and economic transitions, each of which would have been a formidable challenge on its own:

1. from nation to country, which required the construction of the state institutions appropriate and adequate to manage the affairs of a country, *the countryhood transition*;
2. from an authoritarian to a democratic regime, which necessitated the creation of the space in which open debate and contestation of power could occur peacefully with political stability, *the political transition*;
3. from central planning to the regulation of markets as the regime of economic management, which rendered most of the institutions of economic management anachronistic, *the regime transition*; and
4. from social delivery of basic needs to market provision, which implied a revolution in the manner by which the population was employed, provisioned

with basic necessities, educated, and provided with health care, *the socio-economic transition*.[2]

In other words, it was necessary at the same time to design an appropriate state apparatus, create a civil society, transform the functions of the state, and construct market mechanisms which could provide livelihoods and basic needs. No post-Soviet society has succeeded in carrying out all four of these transitions. The countries having greatest success, or least disaster in transition, did not face the need for the countryhood transition, or bordered on or were incorporated into a Western European country (Poland, Czech Republic, Hungary, Slovenia and the German Democratic Republic).[3]

The countryhood transition in Moldova involved concrete and specific institution building, beginning with the creation of basic state institutions that are the mainstays of public administration in countries, but do not exist in provinces: ministries of foreign affairs, defence, finance, and international trade.[4] Even provincial institutions whose basic function did not change, such as departments of health, education and social welfare, required reorganisation because of the basic change in their status from conduits and implementation agencies for decisions made in Russia, to policy and decision making ministries. In this context, a sharp distinction must be made between institutions and personnel. The problem of national policy management after 1990 was not due to lack of capable administrators and professions. The management difficulty arose because these administrators and professions found themselves in institutions that were not designed to carry out the tasks of a country.

Because institutions evolve from practice as well as from statute, the transformation of these institutions into effective management units could not be done quickly;[5] tough small changes can have a major impact. In the context of building appropriate institutions, it is the impression of the authors of this report that some representatives of international agencies, and many Moldovans, do not fully appreciate the difficulty of institutional transition. This is manifested in a tendency to attribute all the problems of policy implementation to bureaucratic inefficiency, lack of commitment by public servants, and a culture of corruption. While no large organisation, public or private, is free of these maladies, the public management problem in Moldova is much more fundamental. Recent research has demonstrated that institutions, including public institutions, are essential for sustained

2 These transitions provide the basis for an analytical division of countries in the context of the general transition process after 1990. We refer to three categories: the 'Central and Eastern European Countries', which includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia; 'Albania and the former Yugoslavian republics', Albania, Croatia, Bosnia & Herzegovina, Macedonia, and Serbia and Montenegro; and 'the former Soviet republics', Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The first group includes those countries which have been formally independent since the end of the Second World War, and those which quickly integrated into western Europe (the Baltic states and Slovenia joined the European Union in 2004. The second and third groups include newly independent countries that were previously components of a formally federated unit, with the exception of Albania. The latter is included in this group because of its previous non-integration with either Comecon. This division is similar to that used in the tables in EBRD reports (see EBRD 2004).

3 See Chapter 2 for a discussion of the transition across countries.

4 As a republic of the Soviet Union, Moldova was a member of Comecon, with the bureaucracy associated with the trading block. However, this was quite different form a ministry of external trade.

5 In his edited volume, *In Search of Prosperity,* Rodrik writes, 'Determinants of development such as institutions and geography change slowly, or hardly at all,' (Rodrik 2003, p. 9), adding 'moderate changes in country-specific circumstances (policies and institutional arrangements), often interacting with the external environment, can produce discontinuous changes in economic performances, which in turn set off virtuous or vicious cycles'.

growth (see Rodrik 2003), and arise form a historical process. Frustration over the ineffectiveness of Moldovan institutions is understandable and can be a source of positive change; to attribute the blame for the ineffectiveness to the institutions themselves or those that serve in them abandons historical perspective, and enters into a reductionist 'black box'. Less than fifteen years after independence, it is not possible to judge whether the process of building effective institutions has proceeded quickly or slowly.

These observations are not to deny or justify corruption, either in the public or private sector. They place corruption in its context: corruption manifests itself in individual behaviour, but its causes are systemic, inherent in the transition process. Reducing corruption is a difficult task that is part of the democratic transition to open and transparent government operations.

What should be beyond controversy is that Moldovans have excelled at the creation of political space in which conflicts can be managed with limited civil strife, an achievement that has allured several of the former Soviet states. We have been surprised to discover that in practice there is considerable disagreement about this conclusion, especially with regard to the intentions of the current government. To an extent this is understandable *among Moldovans*, who for over five decades lived under governments dedicated to restricting political rights. Governments rarely resist the temptation to enhance their political strength and undermine their political opposition, and Moldova is not an exception to this general rule. However, Moldova has seen many changes in government through elections, it has resolved one potential internal conflict over secession, and has not been at war over the other for a decade. No other country of the Commonwealth of Independent States has been at peace with a democratically election government.[6] Therefore, it is surprising that some development agencies refer to the 1990s as a decade of political instability and ethnic fragmentation. While there were five changes of government during the decade, each was achieved without violence, through elections that judged by internal and external observers to be open and representative. This would seem a more commendable record than that of other ex-Soviet republics in which the absence of changes in governments represented 'stability' hardly consistent with democratic processes.

Across the countries in transition, one of the most intractable aspects of institution building has been creating the mechanisms to regulate markets out of the agencies and personnel of central planning. The problem goes far beyond establishing the 'rule of law' and 'fostering private sector development'. The first problem with the terms is that they are so vague as to include any policy measure. The second, equally serious problem is that the period of transition is by definition one in which laws and regulations change. It is probably the case that uncertainly about the legal framework is inherent in the transition, since laws are implemented by institutions that are being created. Further, in established market economies, implementation of the legal framework involves interpretation of laws, drawing heavily on legal precedent which, by definition, does not exist in transitional economies.

Third, 'the rule of law' in a country with established market institutions evolves over time, adapting to changing circumstances. In general circumstances change

6 See DFID (2004, 8), which characterises the countries as follows: tension between Armenia and Azerbaijan over the Nagorno-Karabakh territory; Kyrgyz Republic, Tajikistan and Uzbekistan involved in conflict over the Ferghana Valley; in Georgia there separatism in the South Ossetia territory and the spill over from the war in Chechnya, both providing violence; and civil wage raged in Tajikistan during 1992-1997. No more than two of these countries can be said to have democratically elected governments.

slowly, allowing for adaptation to keep pace. However, in transitional countries, dramatic and fundamental changes occur over a few years, and the legal system must be created quickly, usually based on frameworks created in mature market societies. The probability that a legal framework so created will be fully adequate for the transitional country is very low. This implies that the inconsistencies among, frequent changes *in* and ambiguities of regulatory statutes are unavoidable. Those opposed to the government for other reasons will tend to interpret these inconsistencies, changes and ambiguities as evidence of malign intent. While this interpretation may have validity, it must be placed in the context of the unstable institutional dynamics of the transition process.

A concrete case of misinterpretation of public sector behaviour due to failure to appreciate the complexity of the transition process is the emphasis in Moldova by many external and domestic actors on corruption. Few governments are free of corruption, and attempts to make relative judgements about the degree of corruption are doomed to failure or to stating the obvious, except when comparing extremes. In the case of Moldova, writings on corruption focus on reporting it as a problem and offering dubious indices of its severity (see for example Obreja, Efim, Gasca, and Potirniche 2002; and Chirtoaca, Nicolae, Gudym and Petrushin 2000). While description and attempts to measure may be informative, the central issues for this report are the causes of corruption and its impact on the development process. A wealth of research shows that the political parties in power in countries affect the form corruption takes, but only to a limited extent are the cause of it. It may appear that the government is corrupt, but this appearance provides little explanatory value if each succeeding government is corrupt. In other words, corruption arises from the institutions and mores of society itself, and prevailing economic conditions.

It is difficult to generalise about the impact of corruption on growth and poverty reduction. It is frequently asserted that the poor suffer most from corruption, either directly through the cost of bribes for services, or indirectly through loss of employment and earnings because arbitrary and mercenary officials discourage private sector development. Informants stressed to the mission members the negative impact on the poor of such corruption in Moldova, but the reports remained at an anecdotal level whose quantitative importance could not be assessed. For example, it could not be determined whether the quantitative importance of government corruption on the poor exceeded or was less than the impact of administered prices of key commodities by private companies, which represents the private equivalent of public sector corruption. Further, the legacy of authoritarian and capricious rule in Moldova has, quite understandably, produced a tendency for parts of the population to attribute the worst of motives to public officials. That the current name of the governing party is 'the Communist Party' reinforces this reaction among its opponents, both domestic and foreign.

Closely related to the issue of corruption is the much-used and abused metaphor, 'the business climate', or more dubious still, 'the investment climate'. Using them is more likely to obscure than to clarify discussions of private sector development, especially when the terms are defined from the point of view of business interests. To keep within the meteorological metaphor, the flora and fauna that will thrive in one climate may or may not do so in another. Carrying on a discussion that suggests there be a single 'climate' in which undifferentiated 'business' will thrive leads to less in-sight into problems that over-sight of crucial distinctions. Further, the metaphorical weather advocated by 'business' is unlikely to incorporate adequately the interest of employees. Thus, rather than ruminating over the 'business climate', those dedicated to pro-poor development should encourage the Moldovan government to design policies of practical compromise that simultaneously serve the interests of private employers, their employees, and those that consume the commodities that the employers and employees produce. Such a compromise requires each party to be sensitive to the interests of the others, and would be implemented through institutions that develop over time.

Directly relevant for poverty reduction is the fourth transition, from social delivery of basic needs to market provision. With regard to employment, and the incomes derived from it, the first decade of the transition to a market economy was a dismal, if not catastrophic failure for the overwhelming majority of Moldovans. Indeed, it is difficult to find a modern example of such an atrocious economic collapse in peace time under any economic, political or social system, except from another transitional country. Equally catastrophic was the collapse of the social sectors, education, health, and provision for the elderly. Reasonable people can have differing views on progress in country building, institutionalising democracy, and creating a functioning market society. On the provision of basic necessities the judgement is in: the transition was a disaster that challenges the imagination.

1.4 Moldova's Poverty Reduction Strategy

The Framework for this Report

Through its application to Moldova of the experience gained from other studies, this report supports and complements the long term strategy of the Moldovan government as presented in the Economic and Growth and Poverty Reduction Strategy document (EGPRS), which was completed towards the end of 2004.

It is the view of this report that successful achievement of the goals of the EGPRS requires three necessary developments in the economy: narrowing the trade gap, raising aggregate investment, and reducing inequality.

The framework in which those three developments might be realised can be summarised as follows:

a. At the beginning of the twenty-first century, Moldova was a predominantly agricultural economy because of the collapse of its manufacturing sector due to the ravages of the transition and the dispute with Transnistria; however, an agriculture-led growth strategy is not the route to sustainable poverty reduction.

b. While the agricultural sector must provide the exports to close the trade gap and employment opportunities to reduce unemployment in the short and medium term, a viable and sustainable long term growth strategy must be based on the emergence of internationally competitive manufacturing sector.

c. Rising productivity in agriculture and manufacturing will require a purposeful public investment programme that 'crowds in' private investment, both domestic and foreign.

d. Within this long-term framework, expansion and in some cases reorganisation of existing poverty reduction programmes, including the social protection system, is essential, based on the principle of universal provision rather than means-testing.

Some, perhaps many, would disagree with our judgement that Moldova's long term development strategy should be based on industrialisation. The argument is commonly encountered that Moldova is blessed with a mild climate and particularly fertile soil, and, in any case, has demonstrated agriculture to be its so-called comparative advantage throughout the twentieth century. None of these points makes a compelling case for an agricultural, or even an agro-industry, based growth strategy for the long run. Whether its climate is relatively favourable is a subjective judgement, and there are many European countries with fertile soil that, none-the-less, do not have predominantly agricultural economies.

There is some superficial validity to the argument that Moldova has demonstrated an advantage, comparative or absolute, in agriculture and agro-industry. Up to the Second World War, Moldova was overwhelmingly rural and agricultural, as were almost all of the Central and Eastern European countries. This represented a phase of underdevelopment, not an outcome based on natural or economic advantages. After that war, Moldova became a part of the Soviet Union, without even nominal sovereignty in economic decision making. To each part of the Soviet Union was assigned a production role, and Moldova's was agricultural, with the exception of the Transnistria region. No one would argue that these production assignments were solely or even primarily based on either economic or natural endowment criteria. In 1991 when Moldova became independent, it was one of the most rural and agricultural of the ex-Soviet republics because it had been assigned those characteristics by decisions into which its people had little input, and which were made with little concern given to economic efficiency.

If in the medium term agricultural sector can narrow the trade gap, a major step towards sustainable growth would be taken. Simultaneously, the rate of investment should rise. Trusting to a 'favourable business climate' is unlikely to stimulate investment to the level necessary for sustained poverty reducing growth. Fortunately, this problem is feasibly solved by using public investment to 'crowd-in' private investment, as well as creating projects that directly reduce poverty. Along with narrowing the trade gap and increasing investment, poverty reduction requires that, at a minimum, income and wealth inequality not increase. Each rise in inequality, however measured, reduces the poverty reducing effect of growth. Fifteen years after independence, Moldova's income and wealth distribution were among the most unequal among transition countries. Poverty reduction requires that the trend towards greater inequality stop.

The EGPRS and Donor & Lender Response

As is generally recognised, poverty reduction strategy papers (PRSPs) are written by governments to access funding, in particular from the World Bank and the International Monetary Fund. The former cannot initiate a substantial programme without receiving and reviewing this document. Most of IMF lending is not dependent on a PRSP, but a government's access to the concessional-terms Poverty Reduction and Growth Facility (PRGF) is. In November 2004, the Economic Growth and Poverty Reduction Strategy paper of the Moldovan government was reviewed by the Executive Boards of the World Bank and the IMF. The World Bank issued a positive assessment of the document, but asserted that 'slow progress in implementing structural reforms…limit the scope for IDA assistance'.[7] The IMF assessment was similar, 'over time, the EGPRSP could serve as a basis for concessional lending by the Fund, provided the authorities demonstrate a genuine commitment to market

7 There was some ambiguity in the World Bank commentary on the document: The World Bank's Board of Executive Directors today discussed Moldova's Poverty Reduction Strategy Paper (EGPRSP)…and the Joint IDA[1]-IMF[2] Staff Advisory Note…The Bank's Board supported the three-pillar EGPRSP…The Board recognized that the proposed strategy, underpinned by a sound diagnostic of the poverty situation and transition experience, is comprehensive and can, over time, foster growth and reduce poverty. The Executive Directors noted with concern several critical areas where current policies do not match those articulated in the EGPRSP…Directors noted that these [inconsistencies] limit the scope for IDA concessional assistance. (World Bank 2004b)

reforms and establish a credible track record in its [*sic*! their] implementation' (IMF 2004a).[8] An unusual, if not unique, aspect of the mandated joint review by the World Bank and the IMF, was the absence of a firm commitment to concessional lending. This joint review, called an 'Advisory Note' rather than the usual 'Assessment' represents one of only four cases in which the two institutions had made a positive review without a commitment to funding, a commitment that heretofore was the *sine qua non* of PRSP joint staff assessments. Moldova is the only one of the four in which concessionary funding is explicitly denied.[9]

The 'Joint Staff Advisory Note' leaves the EGPRSP in limbo. On the one hand, it was judged to be 'comprehensive and [to] contain critical policy actions that…could help foster growth and reduce poverty', 'has substantial merit' in its treatment of recent economic developments, poverty trends, improvement of the business environment, and strengthening governance (IMF & IDA 2004, p. 9). It was also judged that it 'aligns the proposed priority programs to the MTEF [Medium Term Expenditure Framework], and is based on extensive consultation with a broad range of stakeholders' (*Ibid.*). On the other hand, these laudatory characteristics were not sufficient to induce the Bretton Woods institutions to show a strong commitment to supporting the strategy. It would appear that the functional status of the EGPRSP at the end of 2004 was to serve as a government-generated list of performance conditionalities, in some cases in addition to ones specified in other IMF and World Bank agreements. It is unlikely that the government produced the document for this purpose, and the Advisory Note conforms to assertions by PRSP critics that the documents represent a form of lender conditionality.

At the end of 2004, the reasons for the reluctance of the Bretton Woods institutions to support the EGPRSP were not clear. With regard to the IMF, there would seem to have been no substantial issue of disagreement within its 'core area of expertise, for monetary, fiscal and exchange rate policy all conformed to conditionalities.[10] While IMF-World Bank guidelines require 'adding new conditionality during a review in areas previously without any conditionality would require a clear justification as to why the related issues had become critical to program objective' (World Bank 2002). In early 2005, the World Bank seemed to overcome its reservations, though its position on budget support was still not entirely clear. The IMF position remained unchanged, which was considerably more important

8 In February 2004 document, the IMF listed the following 'disturbing' policies on the part of the Moldovan government: 1) 'in agriculture, recollectivization efforts are reportedly underway'; 2) 'formerly privatized companies have been renationalized'; 3) 'formal and informal restrictions have been imposed on exports of some agricultural goods'; 4) 'the May 2003 territorial-administrative reorganization…reduced local autonomy'; 5) 'the Law on Veterans reintroduced a number of privileges and subsidies'; and 6) commitments to the WTO to liberalize telecommunications were reversed (IMF 2004, p. 50). These issues would not seem to fall into the 'core expertise' of the IMF (see footnote 4). In the source there is no discussion of their importance to the successful implementation of IMF programmes, though such an explanation is mandated.

9 The other countries were Bhutan, Laos and Niger.

10 'In PGRF's, specific [conditionalities] should focus on the Fund's core area of expertise: monetary, fiscal and exchange rate policies; the institutional arrangements underlying these policies; and structural aspects closely related to them, including those in areas of overlapping responsibilities, such as financial sector, tax administration and governance. In general, conditionality should not extend beyond these areas, except for measures deemed critical for maintaining macroeconomic stability' (IMF 2003). Through interviews and review of relevant documents, the Mission Team identified the following issues of contention: 1) pre-shipment inspection, alleged breach of the ceiling for public energy-related debt; 3) the government's introduction of scrap-metal export licensing; and 4) the government's decision to merge the energy and telecom regulatory agencies. These can be compared to the definition of 'core area of expertise' in the previous paragraph.

to the government, since access to Paris Club debt reduction depended upon reaching an agreement with the Fund. A long term view of the performance of Moldovan governments with respect to relations with the IMF would suggest that the Fund would favourably review the EGPRS not withstanding past and present tensions with the government.[11] Table 1, taken unchanged from an IMF document (except for the percentages), shows that for 'performance criteria',[12] government compliance after 2000 with Fund conditionalities was considerably better than or as good as the previous seven years. Measured by 'prior actions'[13] and 'structural benchmarks',[14] performance was quite similar throughout the ten years.

With regard to bilateral donors, the Swedish International Development Agency has been the most consistent supporter of Moldova's development, in level of funding and commitment to partnership. Its approach in Moldova represents a model that could be usefully followed by other bilateral agencies, reflecting the agency's commitment to recipient ownership of the national development agenda (see Weeks, et. al., 2002). The UK Department of International Development has also stressed the importance of ownership, though its programme is considerably smaller. In the UN system, the UNDP is the appropriate organisation to give leadership to the ownership agenda, and it is the intention of this report to provide further content to that leadership towards ownership and away from donorship.

In the conditions they set, donors and lenders must distinguish between actions required by the recipient government in order that the funds be used effectively, and those policies that the donors and lenders have the bargaining power to impose, be they crucial to success or not. An essential characteristic of the 'donorship regime', which prevailed at the time of the independence of Moldova, was an omniscient external judgementalism. The donor or lender reserved the right to pass unilateral judgement on the appropriateness of and commitment to recipient government policies. In a national ownership regime, assessment of policies passes to the recipient government, with consultation with the donor. National ownership does not require external development agencies to suspend all judgements; rather, it implies that those judgements arise out of an interactive process with national stakeholders.

A central characteristic of donorship was the presumption that if development assistance failed in their goals, the blame lay with the recipient government. This approach can be seen in a document from the Overseas Development Institute, which repeats a view commonly found in donor documents: '[recipient] governments need to be convinced of the need for sound policies, rather than coerced' (Foster 2000, 7). This type of comment is often accompanied by invoking the need for the recipient government to show 'political will'. While these comments may seem bland and non-controversial, they are in the donorship tradition. Not

11 The tensions at the time of this mission were not new. The Moldova Economic Trends April 1999 refers to the 'freezing of relations with IMF and WB [World Bank]' (page 4). A representative of a bilateral development agency commented in an interview that 'the policy errors by the World Bank and the IMF [in Moldova] were sufficiently serious and well-remembered that it is not surprising that the government does not eagerly take the advice of the IFIs'.

12 'A performance criterion is a variable or measure whose observance or implementation is established as a formal condition for the making of purchases or disbursements under a Fund arrangement' (IMF 2003).

13 'A member may be expected to adopt measures prior to the Fund's approval of an arrangement…when it is critical for the successful implementation of the program that such actions be taken' (IMF 2003).

14 'Structural benchmarks are similar to structural [performance critieria], except that individual benchmarks are less critical for meeting the program's objective' (IMF 2003).

withstanding the laudable phase, 'rather than coerced', the first comment makes a number of presumptions inconsistent with a dialogue based on ownership:

1. it presumes that there exists a set of sound policies which the donors know and recipient governments do not (the recipient is ignorant);
2. that recipient governments must not only be informed of the sound policies of which they are ignorant, but require convincing of the need to implement these (in the absence of donor advocacy, the recipient lacks the judgement to distinguish good policies from bad ones); and,
3. in the past development failures arose from the mistakes of omission or commission of recipient governments, not in whole or part the result of unsound policies of the donors (development failures are recipient government failures).

These presumptions tended to guide donors and lenders in their relations with Moldova in the 1990s. A variation on the sound policies criticism of recipient governments is that they may be aware of the policies, and aware of the need for them, but fail to implement them because of special interests within or outside of the government. In such circumstances, the argument goes, donors are justified in their criticism of policy choices, and the criticism may strengthen domestic supporters of sound policies. This argument is also in the tradition of donorship, for it implicitly suggests that institutional, political, and economic interests do not motivate donors. The ownership equivalent of the 'sound policies' statement would be: 'donors and recipient governments should engage in dialogue to identify sound policies on the part of each, and each should be convinced of the need to implement these', and this approach would be productive of good policy in Moldova.

In the Moldovan context, two more terms, 'political will' and 'political commitment', require deconstruction. In the absence of concrete specification of the political context in which a government operates, the term 'political will' has limited meaning. 'Political will' and 'political commitment' obscure understanding of policy constraints in a country, rather than facilitate it. Were it possible to define the concepts rigorously, it is doubtful that one could specify a way to judge the degree of will and commitment independently of the outcome they are alleged to determine. More basic, the terms 'will' and 'commitment' fit well into the donorship mode, precisely because they are black boxes and tautological. An external agency could explain project or programme failure by 'lack of political will', with no fear of being refuted. That this approach is increasingly unacceptable in the twenty-first century, which is to Moldova's benefit. Following PRSP guidelines, the development strategy of the country should be established through the democratic process, which has functioned relatively well in Moldova since independence.

It is the view of this mission that while relations between the government and some donors and lenders have been strained, there exists scope for constructive dialogue. This dialogue requires the active endorsement by donors and lenders of the principle of national ownership of development strategy, facilitated in the case of Moldova because of the democratic legitimacy of the government. Putting the principle of national ownership into practice, an essential feature of the PRS process, involves acceptance of a further principle, that economic policies and reforms are not purely technical matters, but issues involving trade-offs and political choice. In other words, if donors and lenders take national ownership seriously, it implies that in some cases they must adjust their views to those of the recipient government.

Table 1: *Moldova and IMF Conditionalities, 1993-2003*

Performance Criteria				
		Met:		
Loan type	**Period**	**Yes**	**No**	**% Met**
SBA	12/93-3/95	32	10	76
SBA	3/95-3/96	29	5	85
EFF	5/96-5/00	72	47	61
PRGF	12/00-12/03	47	9	84

No. Prior Actions & Structural Benchmarks					
		Met:			
Loan type	**Period**	**On time**	**Late**	**Not met**	**% Met**
SBA	12/93-3/95	11	-	3	79
SBA	3/95-3/96	9	-	4	69
EFF	5/96-5/00	51	3	17	72 [76]
PRGF	12/00-12/03	14	4	2	70 [90]

Source: IMF 2004.
NOTES: The loan types are 'Stand-by Agreement' (SBA), 'Extended Fund Facility' (EFF), and 'Poverty Reduction and Growth Facility' (PRGF).
The first two categories are, respectively, 'met on time or with some delay', and 'and 'met with considerable delay'. The first percentage in the last column of the second part of the table includes only the former category, and the number in brackets includes the latter.

Annex: Common Analytical Mistakes about Transition Societies[15]

Concepts and Confusion

Considering growth and poverty in Moldova requires prior discussion of common analytical fallacies about transitional economies, the first step is to clarify terms. It is unfortunate that in the literature on transitional societies, terms which previously had straight-forward, dictionary-based meanings, have to come to assume heavy ideological implications. One of the most important of these is 'reform'.

Strictly speaking, a 'reform' is a policy change of any type. For example, a trade regime can be reformed through tariffs or quotas to alter the level and composition

15 The points made in this annex have been developed further in a UNDP report on poverty reduction policies in Vietnam (Weeks, et. al., 2004).

of imports; similarly a trade regime can be reformed by cutting tariffs and eliminating quotas. In the discourse of current economics, 'reform' always mean actions of the former type, and is by definition a 'good' thing. Those in favour of the latter are described are called 'reformers', and viewed as progressive (typically judged to reflect the 'national interest'), while those in favour of the former are branded as 'anti-reform' and reactionary (typically judged as motivated by 'special interests'). These value-laden terms are misleading, because, for example, at times it may be rational to favour tariff reduction, and other times rational to oppose it. This study avoids use of 'reform', in favour of specific terms: tariff reduction, enterprise restructuring, financial sector reorganisation, etc.

Other ideologically-abused terms are 'open' and 'closed' economies, 'controlled' and 'liberalised' economies, and perhaps most value laden of all, 'market-friendly'. To take but one example, the Moldovan economy is extraordinarily open if one defines openness by the ratio of trade to gross domestic product. However, some spokespeople for external agencies judge it as relatively closed because of its non-tariff barriers to trade. Attempting to encapsulate a country's trade position as 'open' or 'closed' is an essentially ideological exercise that provokes controversy without providing insight. Controversy with insight can be achieved by debating specific policy measures without assigning them value-laden labels.

Perhaps the most fundamental analytical mistake in analysing transitional economies is to treat centrally planned economies as if they were more extreme versions of market economies with a large public sector and numerous regulatory interventions. The two types of economies are not on the same analytical spectrum. The purpose and outcome of centrally planned economies was to eliminate private ownership and, by doing so, to eliminate the market as a regulating force in society to the extent possible. In such economies, prices were not 'distorted', because they had no allocative function. They served merely as accounting tools. The purpose and outcome of regulated market economies was and is to manage and control private markets. The effect of regulatory interventions can accurately be described as 'distortionary' only if one accepts neoclassical general equilibrium welfare economics.[16]

The qualitative distinction between centrally planned and regulated market economies is essential to understanding transitional societies. Transitional societies pass through two phases of policy change before a market based economy is institutionalised: first, there is the radical shift from central planning (the term 'controlled' economy strictly applies) to market based (a 'regulated' economy); and, second, public policy then addresses the question of what degree of public intervention is required for effective functioning of the new, market economy. We refer to these two phases as the *regime change transition* and the *regulatory transition*.

The fundamental policy difference can be illustrated by referring to public sector enterprises (SOEs), of which a number remain in Moldova. Within central planning, enterprises (the modifier 'state' is redundant) are part of an integrated system of non-market production, in which market demand, even household demand, is

16 The term 'distortion' has meaning only in relation when one specifies a non-distorted outcome. To take an analogy, one can say that mirrors in carnivals distort one's reflection because a true image can be defined scientifically. Similarly, a price is said to be distorted if it varies form the price which would prevail under conditions of full employment general equilibrium. However, if that equilibrium is not unique, or if one does not accept the analytical framework that generates it, then the term 'distortion' loses objective meaning. Rejecting the term 'distortion' does not stop one from describing prices and allocation to be dysfunctional, but the judgement is empirical and specific, not general and theoretical.

largely irrelevant. In a regulated market economy, state enterprises (now the adjective becomes necessary) are part of a market system. The central government may grant SOEs monopoly positions, protect them through trade policy, and extend them subsidies, but such enterprises remain market-based.

The mistake of not distinguishing between regime change and regulatory change gives rise to a closely related one, which is concluding that if regime change stimulated growth, then a rapid programme of deregulation will bring higher growth. When the system of central planning collapsed in Europe and Central Asia, these systems were defined as inefficient in all aspects, and all problems during the central planning period were the result of central planning inefficiencies. It was a short step to conclude that all subsequent problems of transitional countries result from the lingering effects of central planning. The dominant tendency was to presume that post-central planning problems would not arise from inappropriate changes in regulatory policies ('reforms'), or from changes made too hastily or in the wrong order. This approach ignores the distinction between regime change and regulatory change. Market deregulation is not a continuation of the dismantling of central planning. Each deregulation policy must be inspected empirically for its economy-wide effects.

Related to the above, one must avoid the error of 'policy optimism', which is especially virulent in transitional countries. At many points in time the growth rate of a country may be only loosely related to its policies, unless those policies are unusually dysfunctional. Many factors beyond the control of the government influence growth, such as the state of the international economy, weather, and the efficiency of national markets. With regard to the latter, 'good policy' may fail to achieve its intended outcome because the instruments available to the government have limited impact on private decisions.

Further, there is the fundamental issue of the stochastic element in policy. Assume that the government seeks to achieve an inflation rate not higher than five percent. It sets monetary policy such that the mean outcome will be two percent. If the standard deviation associated with the policy outcome is three percentage points, then about one-third of the time the outcome will be 'bad', even though, technically, the policy was 'good'. When this report makes its recommendations, it should not assign to the government more influence over the economy that its policy instruments, exogenous environment, and efficiency of markets allow it.

Inequality in Transitional Societies

As in all policy analysis, the goal sought by this study is the enhancement of human welfare. The most important outcomes affecting this welfare are levels of household income, social provision, and inequality. Growth, trade, and structural change are instruments to achieve those outcomes. In the context of human welfare, per capita income provides limited information, especially since the more unequal the distribution of income, the less accurately it approximates a measure of the welfare of the majority of the population.[17]

Our policy judgements and recommendations on the desirable level of inequality derive from the context of Moldova as a transitional economy. Centrally planned economies had low levels of inequality, because prices and incomes were set administratively to generate that outcome. Major items of household subsistence were provided outside mechanisms of ex-

17 The more skewed the distribution of income, the greater the difference between mean and median income, by definition.

change, notably housing, education, and health care.[18] Further, employment was guaranteed for all, though much of it may not have been productive. By contrast, exchange based on private ownership of assets is the fundamental distribution mechanism of market societies, even ones with a large public sector.

Therefore, one should expect asset and the associated income inequality to increase during the transition from central planning to a market society. Part of this increase reflects the inherent inequalities of market societies, and is essential to their effective functioning. Another part arises from an emerging differential access to assets, services, information, political power, and, it should be added in light of corporate behaviour in the developed countries, fraud and theft. The increased inequality associated with the transition from central planning to the market can be divided conceptually between that which is functionally necessary and that which is not. The increased inequality which is not necessary for the operation of a market system can itself be divided between that which is judged by society to be acceptable and that which is not. For example, it might be decided by explicit or implicit social consensus that inherited wealth is acceptable, even though much of it might not be necessary on allocative grounds.

Among the many social choices unavoidably presented to Moldovan society is the degree of inequality that would be acceptable. All societies face this choice. In established market societies the division of political power associated with a country's degree of inequality may restrict the debate over the issue. In transitional countries, the situation is quite different for two reasons: first, asset and income distribution undergo rapid change, with a major impact on all other social policies and choices; and, second, the temporary and transitional nature of distribution makes it amenable to public policy.

Since the institutions of society determine the income distribution in any country, one can treat the alternative growth paths as converging to a 'steady-state' degree of inequality. The key question for social policy, and for this study, is which path of inequality and growth is implied by the institutions of Moldovan society. If those institutions would result in a steady-state degree of inequality that is contrary to social consensus, then the policy issue is how they might be changed.

For policy purposes, it is important to distinguish between poverty and inequality, because different, but complementary, policies are needed to reduce both. Poverty reduction programmes that are targeted at those below a given income level (or some other criterion) may be successful in reducing the number of poor households, but have little or not impact on the level or trend in inequality. Reducing inequality requires, in addition to raising the incomes of the poor, preventing excessive concentration of wealth in the hands of a few, and fostering the growth of a middle class.

Dynamics of Poverty in Transitional Societies

The distinction between the phases of transitional countries, regime change and regulatory change, provides insights into the dynamics of poverty in Moldova. During the central planning period, Moldova was a middle income country, with relatively high indicators of human development. The poverty in that period was not of the type that a market economy manifests.

18 That the level of income inequality in socialist economies was quite low is not controversial. Relative magnitudes are indicated by calculations that show that the Gini coefficients in the early 1990s for twelve European and Central Asia countries in transition were all lower that for thirty-eight developing market countries, with the exception of only two, Sri Lanka and Rwanda (Dagdeviren, van der Hoeven & Weeks 2002, 406-407).

Market-based economic growth generates poverty, especially in transitional countries, as was demonstrated clearly in Moldova. Unlike in low-income market societies, prior to the regime change Moldova had little or no poverty resulting from landlessness or unemployment. Fundamental to the transformation of the economy to market-regulated was a reallocation of assets on the basis of private ownership. On the one hand, this created new mechanisms for private income generation; on the other it produced a phenomenon new for Moldova, poverty resulting from loss or lack of access to productive assets. Gainful employment became dependent upon private ownership of land; wage employment dependent upon those who owned productive assets; and self-employment on access to credit. The poverty resulting from unemployment and landlessness can accurately be called 'market generated' poverty.

On the positive side, growth reduces basic poverty by raising incomes in existing economic activities, and creates new activities into which people are drawn. On the negative side, inherent in the creation of new activities are allocative changes that generate unemployment and landlessness. It was unfortunately the case that in place of growth, the emerging market economy of Moldova suffered a devastating collapse. The rapid rise in poverty during the 1990s was the result of this economic collapse combined with the loss of the entitlements associated with a planned economy. Whether poverty can be reduced at a sustained rate depends on the balance between market-based employment creation and market-generated landlessness and unemployment. Increasingly, the relationship between poverty reduction and growth will reflect the balance between employment growth and poverty-generating structural change.

Chapter 2:
Economics of the Transition

2.1 Moldova in Comparative Context

The problems of the Moldovan economy in the early years of the twenty-first century cannot be understood without looking back to the last decade of the twentieth century, and to the other countries making the transition from central planning to market regulation. Like Moldova, several of the countries made the independence transition simultaneously with the change of economic and social system.[19]

Sixteen of the twenty-three European and Central Asian transition countries suffered declines of output of fifty percent or more. The seven countries with declines less than thirty percent were in Central or Eastern Europe (Slovak Republic, Bulgaria, Romania, Hungary, Czech Republic, Slovenia, and Poland, in order of severity), while eleven of the fourteen members of the former Soviet Union had declines of fifty percent or more (the exceptions being Belarus, Uzbekistan and Estonia, all in the minus forty percent range). These economic and social disasters are summarised in Table 2.1, in which the countries are ordered by the size of decline from 1990 to the lowest point of each.[20]

When such extreme economic declines occur, precise measurement is impossible. The declines for most of the countries in the table were associated with the destruction of entire industries, collapse of social service provision, massive changes in relative prices, and hyper-inflation. These factors make it difficult if not impossible to find a set of price and quantity weights to calculate changes in real incomes. Further, even were accurate calculation possible, it is not clear what 'less' or 'more' severe decline means, if anything, when one society's production falls by half or more.

With these warnings made, a cautious interpretation of Table 2.1 provides some insights into the experience of Moldova (also see Figure 2.1, which shows the same statistics graphically by country categories). First, most catastrophically devastated were the republics of the former Soviet Union, which make up the first twelve countries in this not-to-be-envied league table. The eleventh country is Russia itself, followed by five more ex-Soviet Republics, with only conflict-affected Croatia intruding into this group of post-Soviet states at number thirteen.[21] Of the fifteen ex-republics, only relatively 'unreformed' Uzbekistan is closer to the Central Euro-

19 In the tables and charts in this chapter that compare across countries, EBRD statistics are used through 2002 or 2003. A country-by-country up-date for 2003 and 2004 would run the risk of non-comparability. When national data from Moldova are used, the tables and charts include 2003 and, in some cases, into 2004. Differences appear between EBRD and Moldova national statistics, arising in some cases from definitions used.

20 The tables and charts with cross country comparisons have different terminal years because of problems of statistical consistency. Statistics through 2004 and into 2005 for Moldova are presented later in the chapter.

21 That the Slovak Republic, another newly independent country, is next after Uzbekistan further emphasises the difficulty of combining social and economic transition with construction of institutions appropriate to a country.

pean countries in the size of its decline than to the cohort of newly independent ex-Soviet states. The newly independent country that declined least was Slovenia, formerly a Yugoslavian republic. This is the exception that proves the rule, in that it quickly achieved a relatively close integration with the much larger Italian economy. Second, if there is any correlation between declines and the extent to which national economies liberalised, it is overwhelmed by other effects.

Third, and most relevant to this report, statistics show that Moldova suffered the third worst decline of the twenty-three countries and had the smallest recovery. In 2001 its per capita income was measured to be only nine percent above its lowest value, in 1999.[22] Only one country came close to such a small improvement, Uzbekistan, whose decline was less than one-third of Moldova's. The extent of Moldova's decline and the weakness of its recovery are shown in detail in Table 2.2. In this table, percentage changes in gross national product are accumulated in each successive column. For each country, the year in which the cumulated change turned positive is highlighted in bold, and recovery to the level of 1991 set in a bordered cell. Sixteen of the other twenty-seven countries showed a positive growth rate during 1991-1996. Moldova did not have a positive growth rate until 1997, and that weak increase of two percent turned sharply negative during 1998-1999, primarily due to the Russian financial crisis. It was not until 2000 that recovery as such began, at which point twenty of the countries had begun their recoveries. Positive growth over four years, 2000-2003, brought Moldova's GDP to less than thirty percent of what it had been in 1991. Only two other countries came remotely close to this dismal level of recovery, Georgia and Ukraine (about fifty and forty percent, respectively, of their 1991 levels). Moldova's absolutely and relatively weak recovery is shown graphically in Figure 2.2, where the other twenty-two countries are divided into analytical groups and the difference between their average growth rates and Moldova's is charted. For over ten years, from 1991 to 2002, there is not a positive value; that is, Moldova's growth rate was less than each of the group averages in every year.

The extent of Moldova's decline and, equally important, the weak recovery from that decline, have been underscored in order emphasise the enormity of the developmental task facing any Moldovan government. Were the economy to sustain the 2000-2003 average of five percent, it would take over twenty-five years to regain the level of GDP and per capita income of 1991.[23] Due to the severe worsening of income distribution, it would take much longer for the bottom quintiles to regain their standard of living in 1991, perhaps fifty years were income distribution not to worsen from its degree of inequality in the early 2000s.

While it is obvious that falls in per capita income drive households into poverty, less obvious is the extent to which increases in poverty are magnified by increased inequality. Table 2.3 seeks to quantify this effect. Using statistics from a study by Milanovic of the World Bank, the table reports estimates of headcount poverty and the Gini measure of inequality for transition countries. A regression equation was estimated, using the absolute change in the poverty index as the dependent variable (reported in column 3), and the absolute change in the Gini coefficient (column 6) and the decline in per capita income (from Table 2.2, above) as the independent variables (the statistical result is reported in the notes to Table 2.3). The last column reports the result of using this cross country regression

22 Given problems of accurate measurement, this small increase lies within the margin of measurement error; that is, one cannot reject the hypothesis that by 2001 there had been no recovery.

23 This assumes, as during 1991-2003, no population growth.

in which the percentage change in the poverty share is a function of the change in the Gini coefficient and per capita income. The coefficients are used to calculate the poverty impact of each variable. This exercise estimates that changes in distribution, measured by the Gini coefficient, accounted for forty-five percent of the calculated change in poverty across all the countries. For Moldova inequality accounted for twenty-eight percent of the increase in poverty. The inequality effect for Moldova is below the cross country average because its fall in output was so large, not because inequality rose less (it rose more than the average).

Lack of relevant data makes it impossible to assess the extent to which the increase in poverty was concentrated in specific groups and regions of the country. Central to the analysis of poverty incidence would be to investigate the extent to which households headed by women fell into poverty. The limited statistics available are presented in Chapter 4, but these are insufficient for the task. As suggested in Chapter 1, the Department of Statistics and Sociology should give priority to the collection of data which would allow an analysis disaggregated between men and women.

Tables 2.2 and 2.3 indicate the absolute and relative severity of Moldova's decline: in none of the other countries for which there are comparable data did the measure of poverty increase so much (sixty-five percentage points, compared to fifty for the next highest), or even rise within fifteen percentage points of Moldova's.[24] It is possible that no country at peace has ever suffered such a phenomenal increase in poverty over such a short period of time.

More than in any Central and Eastern European country and six of the eight Central Asian countries, inequality in Moldova resulted from redistribution from the lowest quintile to the highest (see Table 2.4). Moldovan households in the lowest quintile had the smallest expenditure share of any of the fourteen Central and Eastern European countries, with the exception of Russia. When eight Central Asian countries are included, only in Uzbekistan and Russia are the expenditure shares of the lowest quintile significantly lower. At the other end of the distribution, the richest twenty percent in Moldova enjoyed the fourth highest expenditure share among the twenty-four countries. As well as the extreme changes at the ends of the distribution, the shares of the second and third deciles for Moldova were notably low, indicating that relative income losses extended into the middle class. This grim conclusion points to the importance of implementing policies in Moldova that have a broad-based impact on growth and employment as well as directly on poverty.

2.2 Per Capita Income and Development Assistance

Up to this point, the catastrophic decline of the economy and the rise in poverty have been discussed without reference to Moldova's per capita income. This has been possible because the relative magnitude of the decline is generally agreed, while there has been controversy over the level from which that decline began. It may seem that in the context of such a catastrophic collapse, debating levels is largely irrelevant to the point of pedantry. But, quite to the contrary, identifying the appropriate per capita income for Moldova for the early 1990s emerges as an extremely practical issue affecting the country's debt liabilities. Because Moldova was officially considered to be a middle

24 These poverty measures differ from those analysed in Chapter 4. Those in Table 2.2 are probably a better estimate, because the poverty line used by the poverty monitoring unit in the Ministry of the Economy is extremely limited in what it includes as basic needs. This is discussed in detail in Chapter 4.

income country in the early 1990s by the World Bank, Bretton Woods lending was not on concessional terms. The debt servicing and fiscal implications of not being a low income country in the early 1990s continue to burden the country. Among the international agencies, the responsibility for defining the income status of a country lies with the World Bank. A low-income country is in effect a country that is eligible to borrow from the World Bank's concessional lending branch, the International Development Agency. In the first half of the 1990s, the per capita income ceiling for IDA loans was about US$ 800.

The second data column of Table 2.5 shows the per capita income attributed to Moldova during 1991-1999 in the World Bank's official annual report on development, the *World Development Report*. In 1991 the World Bank reported a statistic of US$ 2173, which was reported in subsequent reports to fall sharply over the next eight years to US$370. If one accepts this reported time series as accurate, then Moldova dropped into low income status in 1997, at which time the World Bank first made loans to Moldova on IDA terms. However, it is clear that the time series cannot be correct. First, it implies a decline far greater than the generally accepted estimate. Second, beginning in 1993, when national income estimates became, it differs from the much lower number of the IMF and the National Bank of Moldova.[25] Third, and most important, the World Bank time series on per capita income is inconsistent with the bank's reported annual changes of Moldova's income over the same years.

One can presume that the 1999 figure for income per capita is correct, since it was reported after the others, and use the percentage changes to calculate and correct earlier years. The result is a per capita income of slightly over US$ 1000 in 1991, almost exactly half the number reported in the *World Development Report 1993*. As a result, Moldova had dropped into the low-income category by 1993; i.e., below US$800 income per capita. Thus, the World Bank's own correction of the Moldovan statistics implies that from 1993 onwards, its loans, and those of the IMF, should have been on concessional terms. However, it was not until late in the decade that loans were made on IDA terms. From 1993 into 1998, however, Moldova borrowed almost US$ 250 million at near commercial rates from the World Bank alone (see the Annex to this Chapter, 'Debt Chronology').

The per capita income of Moldova, no later than 1993, placed the country in the World Bank's 'low income' category, and this is now accepted by the Bank itself. However, Moldova was not extended that privilege by the Bank, the Fund or the European Bank for Reconstruction and Development until 1997, after which new multilateral funding has been small. An obvious policy action follows: the Moldovan government's request that its multilateral debt be restructured with concessional terms should be accepted. Indeed, the use of a miscalculated per capita income by the multilateral lenders justifies reimbursing the excess interest paid over more than a decade--perhaps directly through debt reduction. Restructuring the multilateral debt would have a substantial impact on the commitment of fiscal resources over time; reimbursing the excess interest would have a dramatic immediate effect.

There would be no basis for making this restructuring conditional upon policy changes, since the restructuring would represent correcting a mistake made by lenders, rather than motivated by the potential insolvency of the borrower. The funds resulting from the restructuring could be used to expand the pro-poor

25 Apparently it is highly unusual for the national income statistics used by the IMF and the World Bank to differ. Moldova may be the only case in which a difference persisted for several years.

economic and social programmes that are discussed later in this report. During discussions with relevant multilateral representatives in Chisinau, two arguments were made as to why this could not be done forthwith. First, it was argued that it need not be done: since the Moldovan governments of the time willingly agreed to the non-concessional loans, the lenders bear no responsibility for the mistake. It is not likely that this argument represents the official position of either the World Bank or the IMF. If such an argument were valid, it would exclude debt relief in any form, and the institutions are committed to such relief through several mechanisms, including the HIPC. Second, by charter, terms of reference and practice, the Bretton Woods institutions are not commercial banks, but institutions that act in the interest of the borrower, not their own self-interest. Therefore, it is the role of these institutions to make the borrower aware of the most favourable terms upon which it can contract loans (indeed, commercial banks have the same obligation by the laws in most developed countries). This implies that when a mistake is made by a Bretton Woods institution, it is the obligation of the lender to correct it in the interest of its client, the borrower.

The case for action on the lending mistake is strengthened by considering more generally the support by development agencies for Moldova during the early years of the transition. Figure 2.4 shows that over the years 1992-1998 Moldova consistently received less development assistance as a portion of GDP than the average for transition countries, and did not reach the average of other country groups until 1999. Had it received the average, in some years it would have been able to cover its external current account deficit. By substituting for loans on commercial terms, the aid would have substantially reduced annual debt service payments.

The lower level of development assistance to Moldova cannot be explained by the failure of the various governments during the 1990s to meet the conditionalities of donors and lenders. On the contrary, Moldovan governments were judged at the time as implementing a 'model of sound reforming…a perfect laboratory of reform' (from the *Economist* in 1995).

While there were notable exceptions, most obviously Sida, during the 1990s the international development agencies did not serve Moldova well,[26] treating it as a middle income country for lending when it was not. This resulted in less concessional assistance and the accumulation of a heavy debt burden. It could be argued that international agencies, like the Moldovans themselves, were faced with an unprecedented crisis, resulting in mistakes of judgement made in good faith. Since those mistakes have been identified as such by a range of commentators foreign and domestic,[27] it is appropriate for development agencies to redress their effects.

2.3 Macroeconomic Performance and Policy, 1990-2004

Policy Framework during Moldova's Transition

The foregoing comparative discussion of transition countries lays the basis for a close consideration of Moldova's economic performance. The central issue is how to explain the relatively poor performance of

26 '[Moldovans] were coached and guided by an increasing number of international experts, who appeared to have a road map and prescribed the course ahead…[T]he road map was at best inadequate…' (Ronnas & Orlova 2000, 15).

27 The mistakes of the international agencies on lending terms and advice on transition in general have given rise to some degree of disillusionment among Moldovans: 'Our common expectations that [the] market would arrange everything did not come true' (CISR, Moldova in Transition July 2001, 4).

the country compared to other transition economies, and draw out the implied lessons for current policy. To review performance, Moldova's transition is divided into three periods, based on straight-forward definitions using a three year moving average of the annual growth rate: 1990-1994 when the rate of decline worsened in each successive year (the 'collapse'); 1995-2000, when growth remained negative, but rose towards zero ('stagnation'); and 2001-2004, when growth rates were positive ('recovery'). These three periods are shown in Figure 2.5, with both annual values and three year averages charted.

Prior to 1990, Moldova was a small appendage of the Soviet production system; 'a small unit of a huge enterprise', as one Moldovan economist has put it. When the Russian economy entered into precipitous decline, it was to be expected that Moldova would follow it down. However, while the collapse of the Russian economy dictated a collapse in Moldova, it did not dictate that Moldova's decline would be so much greater than the average for all republics.

Moldova's *extreme* collapse in part followed from a misdiagnosis of the country's characteristics at the outset of the transition, which resulted in a series of inappropriate policies derivative from this misdiagnosis. The mistake in calculating per capita income was part of a larger mistake of presuming the country to be more developed than it was, thus, more capable of adjusting to the demands of a market economy than was the case. Closely linked to this was the view that the Moldovan economy was 'closed', and would reap substantial static and dynamic benefits from trade. In fact, the economy was highly open since exports and imports represented a large portion of national income. The fundamental problem was not to open a closed economy, but to re-orient the openness from the Soviet administrative trading system to market-based international commerce.

This reorientation of trade required establishing the state institutions of international commerce, as well as facilitating investments in modernisation of production and marketing in the newly created private sector in order to achieve competitiveness, both in manufacturing and agriculture. However, prior to establishing these conditions, the government of Moldova was encouraged to pursue a policy of general trade liberalisation, which had the inevitable result of rendering domestic production non-competitive with imports, especially those from Western Europe. While a more gradual liberalisation of the trading regime would have still resulted in eventual bankruptcies of both state and privatised enterprises, it would have provided the opportunity for some enterprises to adjust to the new pressures of international commerce.

The shock of rapid trade liberalisation was magnified by the exchange rate policy followed in the early years of the transition. As discussed later in this chapter, after the government created the Moldovan Lei in 1993 the new currency was pegged to the US dollar, an arrangement that was part of on-going IMF programmes.[28] The combination of dollar movements and domestic inflation resulted in a continuous appreciation of the Lei from early 1994 through the first quarter of 1998. This policy was maintained despite market signals of its inappropriateness, as the current account deficit, after declining from 1993 to 1994, rose from less than ten percent of GDP in early 1994 to twenty percent in early 1998. The over-valuation of the Lei was further indicated by a decline in exports over the same period. It was to be expected that an external shock would provoke a collapse of the exchange rate. The Russian financial crisis provided that shock, and

28 From the second quarter of 1995 through the second quarter of 1998, the average Lei-dollar rate was 4.61, with a quarterly coefficient of variation of slightly less than two percent. Over the same period, the consumer price index rose by fifty percent.

from the second quarter of 1998 to the second quarter of 1999 the Lei-dollar rate rose from 4.8 to 10.7.

The instability generated by over-valuation that brought on a currency collapse was exacerbated by other closely associated policy miscalculations. As noted above, the loans that the government obtained from multilateral and private lenders were at commercial or near-commercial rates,[29] and were used to cover recurrent public expenditure during a period when the economy fell into precipitous decline. All economic analysis (and commonsense) tells one that loans should be contracted only if there is a realistic prospect that they can be serviced. Servicing debts requires either that 1) the loan involved directly or indirectly creates assets which will generate a flow of income at least sufficient to cover debt service, or 2) the borrower anticipates a growth of exports that will service the debt. Borrowing to fund current expenditure violates the first condition, and borrowing when exports are falling violates the second. Given that even the IMF's optimistic growth targets for the 1990s were below the rate of interest at which the Moldovan government was contracting debt (and the target growth rates were far above outcomes), the debt accumulation policy was unsound, both in the short and long run. It is difficult to regard the debt accumulation policy as anything other than unsound, both in the short and long run. It was unsound in the short run because the debts were accumulated contrary to responsible fiscal policy, and unsound in the long run because of the unsustainable fiscal burden the commercial interest rates perpetuated.[30]

During 1900-1994, the economy was in 'free-fall', the rate of decline increasing under the first IMF programme, which began in 1993. Stabilisation and structural adjustment loans, at IBRD terms through 1997, were not associated with positive growth: decline continued to the end of the decade. Belatedly, in 2001 growth turned positive, after a decade of negative rates except from the modest 1.6 percent rate in 1997.

In summary, one can conclude that the late and slow recovery of the Moldovan economy was in part caused by the pursuit of unsustainable policies: premature trade liberalisation that generated a large deficit on goods and services, an over-valued exchange rate that exacerbated that deficit, and an unsound fiscal strategy that resulted in a contractionary deadweight of debt servicing that continues to the present.

The recovery and growth of the economy after 2000 was fostered primarily by the inflow of remittances, discussed later in this report. The large inflows fostered growth by relieving the import constraint. In addition, remittances reduced the government's dependence on conditionality-based borrowing, thus potentially allowing for flexibility in macro policy. However, inherent in remittance-driven growth are several possible problems: 1) derivative as they are from the immigration policies of the destination countries, the level of remittances may not be sustainable; 2) there are no effective short-term policy instruments to influence remittances, causing the tempo of growth to outrun the management of

29 In 1992 the European Union lent Moldova US$ 31.6 million at LIBOR plus three percentage points, and the IBRD in 1993 lent US$ 86 million a variable rate of 4.85 to 7.8 percent. In 1994, the EBRD extended two loans totalling almost thirty million dollars at the LIBOR plus one percentage point. Debt on commercial terms from all lenders continued to accumulate in 1995 and 1996, to US$ 41 and US $300 million, respectively. See the annex to this chapter showing a chronology of debt accumulation.

30 The exception to these rules was the debts incurred by the government for the import of energy. While these debts to Russia were, strictly speaking, unsound in economic terms, the government had no choice, since the country was almost wholly dependent on imported energy. The dilemma facing the government was either to contract onerous debt, or have the economy and society suffer even more. The same argument does not apply to multilateral debt.

the government; and 3) large scale emigration may negatively affect the quality of the domestic labour force. Employing fiscal, monetary and exchange rate policy to foster faster growth, with an emphasis on public investment, would complement the expansionary effect of remittances, and create a strategy for a transition to a development framework more securely based on domestic economic potential.

Fiscal Policy

Moldova's fiscal performance since independence must be placed in the context of the transition from central planning to market regulation. Centrally planned economic systems derived their government revenue by taking a share of the operating surplus of state enterprises, which in most of the countries accounted for virtually all of production and distribution. When the transition process wiped out the surpluses of most enterprises, which was the case in all these countries except Vietnam and China, massive government deficits resulted.

In general, the more closely integrated the country into the Soviet trading system, Comecon, the more severe was the impact on its production and, therefore, government revenue. Since this integration was qualitative as well as quantitative, it is difficult to assess its degree across countries. However, there can be no doubt that for over forty years the Moldovan economy essentially operated as a cog in the machine of the Soviet economy. Manufacturing was disastrously affected during the transition because much of its production provided direct inputs to Russian factories.[31] The possibility that Moldovan factories could be financially supported to convert to new markets and products, as in Vietnam and China, was not pursued. The manufacturing sector was also negatively affected by the *de facto* separation of the Transnistria region, which had been considerably more export oriented than the rest of the country.

Table 2.6 shows the fiscal consequences of the economic collapse across transition countries, and Figure 2.5 compares Moldova to the Newly Independent States (NIS) and Central and Eastern European (C&EE) country groups. From a position of no deficits in the late 1980s, the cross-country average rose to over eleven percent of GDP during 1992-1993. While greater than the average, the Moldovan deficit was far from the worst, a grim distinction that goes to its fellow ex-republic, Armenia. Previous discussions stressed the distinction between Central European and Baltic countries, on the one hand, and the former republics on the other. The difference between the two groups is striking in Table 2.6 (see also Figure 2.5). During the years of exploding deficits, not one country in the former group had an average deficit of ten percent or more, while only three Soviet ex-republics, Azerbaijan, Kazakhstan and Turkmenistan, did not.

Especially for the former Soviet republics, a coherent fiscal policy, in the sense of using taxation and expenditure instruments to manage the economy, was impossible in the early 1990s. These were years during which fiscal systems were in the process of construction. Until tax and expenditure administration was established, purposeful implementation of policy could not be done.[32] Thus, it makes little economic sense to refer to fiscal policy as 'loose' in the 1990s since the means by which policy could be implemented were weak. By the mid-1990s, deficits had been sub-

31 Ronnas and Orlova write, 'The plants were invariably designed with the Soviet rather than the Moldovan market in view and many were entirely dependent on their supply of inputs from outside Moldova as well as markets for their output in other republics' (Ronnas & Orlova 2000, 28).

32 'The Republic of Moldova is a new state of Europe, with unconsolidated laws, institutions, and procedures of political, economic and public life' (CISR, Moldova Economic Trends July 1998, 5).

stantially reduced in all former republics, except for those whose deficits had not been large. None-the-less, these were still not years of fiscal implementation, but of continued fiscal construction and struggles to reduce unsustainable deficits. Fiscal tools were unusable for economic management.[33] Expenditure reduction in Moldova was draconian in the extreme. Although government expenditure in 1999 was the same share of GDP as it had been in 1993, GDP itself had fallen by more than half.

Throughout most of the 1990s it would be a mistake to treat the governments of these countries as having firm control over their fiscal systems, particularly taxation. This loss of control was structural, not the result of mistakes in policy or lack of competence of civil servants. The new taxation systems, based on sales, income and company taxes, were rarely accompanied by adequate enforcement mechanisms, in part due to lack of experience with them, and the low morale of woefully under-paid civil servants new to their tasks. Analysis of the problems of fiscal sustainability in Moldova by reference to the government's failings or yielding to special interests underestimates the systemic difficulties of fiscal policy during the transition process.[34]

Perhaps in no newly independent country were the problems of fiscal management and low morale of civil servants worse than in Moldova. The non-sustainability of the fiscal position of the country in the 1990s was inherent in the transition process, not the result of lack of government 'will' or 'commitment'. By the early 2000s, every transition government presided over an annual average deficit of less than five percent of GDP except four, only one of which was a former Soviet republic (Kyrgyz Republic). The reductions in the fiscal deficits across countries over the eleven years provide strong and obvious evidence that the deficit levels were primarily a systemic problem of transition, which government policy could affect only to a limited degree. The fiscal position of Moldova corresponded to the pattern across countries. After deficits ranging from six to eleven percent of GDP during 1993-1997, the average fell to less than two percent during 1998-2004 (for Moldova, see Figure 2.6), which reflected the slow adaptation of the economy to market regulation.

Unacceptable human suffering lay behind these statistics on deficit reduction, for they were achieved in most of the countries through draconian real reductions in social expenditure. While narrowing the fiscal gap represented a necessary step towards macroeconomic stability, the result was a more serious gap, namely, that in social provision, which has been a major contributor to the most fundamental gap of all, between the level of deprivation and meeting basic social needs. This deprivation gap is enormous in Moldova and unlikely to be substantially narrowed in the foreseeable future through market processes alone. It is essential that future deficit targets derive from the goal of poverty reduction, as well as the needs of macroeconomic stability. This requires using fiscal policy actively as an instrument of growth promotion.

33 'There are some internal constraints…which impede a stimulatory fiscal policy…These constraints are the following: political constraint (uncertainty linked with Transnistria region, or low viability of executive bodies); obsolete social infrastructure...; external and internal…public debt servicing; [and] significant share of the shadow economy…' (CISR, Moldova in Transition July 1998, 9)

34 An example of such an emphasis is the following passage from the CASE report on the impact of the Russian financial crisis: 'Moldovan fiscal policy in recent years was driven by inertia and pressure from [interest groups]. This statement is reflected [sic! supported] by the slow path of structural reforms and the general weakness of the state. Loose fiscal policy in turn reduced the determination in reforming the state structures' (Radziwill, Serbatchi & Zaman 1999, 20). This statement assumes that systemic obstacles to the changes required to achieve fiscal sustainability did not exist.

Further, the statistics showing the decline in social provision do not provide the information necessary to assess the relative impact on men and women. It is known that redundancies in the public sector affected women more than men, and the collapse of social services provided through enterprises, such as child care, reduced female access to the labour market.

The extent to which the Moldovan government might use fiscal policy as an instrument of growth and poverty reduction is discussed in the next chapter. Relevant at this point is the fundamental social issue of the appropriate level of revenue and expenditure to achieve the social goals for the government, especially poverty reduction. In the previous section it was concluded that sustainable rates of growth are unlikely by themselves to return the poor to their standard of living of 1990 in less than a half century. Therefore, poverty reduction requires that the public sector play a major role in social provision. Emphasis on private provision of education and health care has and will continue to be a vehicle to perpetuate poverty and inequality. This is not an ideological judgement, but a fact of Moldova's low income status.

With this context in mind, one can consider the goal of the government to move the average tax share in GDP towards twenty percent, from thirty percent during 1994-2003. Two major arguments have been advanced in favour of this policy: that lower marginal and average tax rates would reduce tax evasion and that Moldovans are so poor that the current tax burden contributes to their poverty. Both arguments require close inspection. It may or may not be the case that lower tax rates would reduce evasion, but lower marginal rates for the majority of households could be consistent with the same average tax share within a progressive personal and corporate income tax structure. Further, without a reliable estimate of the gains in tax compliance as a result of rate reduction in Moldova, embarking on the policy of reducing rates courts fiscal disaster. A more reliable method for reducing tax evasion might be improved enforcement of the tax laws. One presumes that the evasion-of-taxes argument goes as follows: within the existing tax code, households and businesses calculate the trade-off between the benefits of evasion and the costs of being apprehended; if the tax rate were reduced, more taxes would be paid because the expected benefits of evasion fall. It follows from this argument that more taxes would be paid were the probability of being apprehended as a tax evader to rise, and if the penalties for evasion were increased. Developed country experience would suggest that the mechanisms and technology of monitoring tax payers provides a powerful way to reduce evasion. Here, the question is, whether the increase in public enforcement expenditure necessary to reduce evasion would result in a net increase in public sector resources. This would seem the more promising approach for the government, given the resource needs for poverty reduction.

Closely related to the evasion argument and specific to the company tax, it is argued that since the Moldova rate is above the Russian rate, transfer pricing by companies shifts profits out of Moldova. While this is a serious problem, lowering tax rates is not a sustainable policy vehicle to resolve it, since Moldova's neighbours, including Russia, could retaliate by lowering theirs. A more viable strategy would be to initiate discussions among governments in the region to harmonise tax policy and cooperate on enforcement. Further, were the government to take as its corporate tax benchmark the Russian rate, this would be quite damaging to Moldova's prospects for EU entry. As pointed out below, countries with tax rates far below the EU average are unlikely to receive serious consideration for entry. In effect, emulating Russian corporate tax rates would be part of a policy of staying out of the European Union.

A very practical consideration casts into doubt the wisdom of reducing the tax share. The Moldovan government and, apparently, a majority of the population, support the country's application to enter the European Union at some point in the future. To achieve this goal, any Moldovan government would have to provide a level of social provision, consistent with its per capita income, to some minimum standard. Since no country in the European Union, including the new entrants in 2004, has a tax share as low as twenty percent, it is unlikely that this share would be viewed by EU members as a satisfactory basis for candidacy. At the time this report was written, several of the new entrants into the EU had come under criticism by pre-expansion members for their alleged 'tax-haven' status. It is quite unlikely that in the future new entrants would be allowed both to avail themselves of the subsidy programme for underdeveloped regions, and have tax rates that could potentially induce companies to relocate from existing members to new entrants.[35]

Most important of all, the degree of income inequality in Moldova and its per capita income imply that earnings from employment will not be sufficient to achieve substantial poverty reduction in the future, even should the poor only share proportionately in the benefits of growth. Therefore, a key element of a poverty reduction strategy must be provision of a substantial 'social wage'[36] Given the government's other expenditure commitments, for external and internal debt service, national defence and security, public infrastructure, and general administration, it is extremely unlikely that sufficient revenue would remain to cover even a minimalist poverty reduction programme were revenue to be twenty percent of GDP.

A final issue of fiscal policy, which is discussed further in the next chapter, is the appropriate size of the central government deficit. Since 1998, Moldovan governments have not merely brought the fiscal deficit under control, but maintained it significantly below the famous three percent of the 'Maastricht criterion' of the European Union. Were the government to maintain the current level of revenue, allowing expenditure to rise consistent with a three percent deficit would provide 'fiscal space' for pro-poor public investment, as discussed in the next chapter. The argument that such a modest deficit would have inflationary effects has no empirical support, especially in a small, open economy.[37] Officials at the National Bank of Moldova recognise this, and their main deficit concern, which they share with colleagues in the

35 See the discussion in Judt (2005).

36 This commonly used term refers to basic needs that could be purchased in the market, but are provided by the public sector, such as subsidised housing and health care without user fees.

37 The high rates of inflation in Moldova and other transition countries in the 1990s were not the result of fiscal deficits. Both inflation and the deficits were the result of the collapse of the old economic system before the new one was in place. With few exceptions, the transition countries would seem no more inflation prone than the Western European countries. This is suggested by a simple hypothesis test, in which the inflation rate is a function of the fiscal deficit as a portion of GDP (proxy for money creation), and the rate of growth of GDP (real demand pressure). The statistical estimation covers 1998-2004, after the hyper-inflation associated with the period of regime change of the transition countries. Only Belarus, Serbia and Montenegro and Uzbekistan, out of the twenty-seven transition countries, suffered high inflation rates after 1997. These are assigned dummy variables. The statistical result is: ln[inflation] = .096 + .299 ln[Fiscal Deficit] + -.167 ln[GDP growth] + .189 [Romania]
+ .223 [Srb&Mntgr] + .531 [Belarus] + .167 [Uzbek]
R^2 = .466, F = 25.18, DF = 173
The deficit and GDP growth are non-significant. All of the country dummies are significant at less than one percent probability. The equation suggests that 'structural' inflation is slightly less than ten percent (the intercept). Across countries, the inflation rates were significantly lower for 2002-2004 than for 1997-2001. If a dummy variable is used to divide these periods, the post-2001 structural inflation rate is 3.2 percent across countries. While this is a crude exercise, it supports the widely-held view that inflationary pressures subsided after the turn of the century, replaced, some would argue, by deflationary pressures.

Ministry of Finance, is possible 'crowding out' effects on private investment.

As government officials are well aware, deficits themselves do not generate crowding out. Fiscal deficits result in crowding out if they put upward pressure on interest rates, and private investment is interest rate sensitive. As we see below in the discussion of monetary policy, nominal and inflation-adjusted interest rates have been quite high in Moldova, above the so-called Golden Rule (the real interest rate equal to the long term sustainable rate of per capita income growth). Therefore, even were there upward interest rate pressure resulting from fiscal deficits, actual interest rates are so high that the effect of the fiscal deficit would seem insignificant. Further, the crowding out effect is partly dependent upon the purpose for which the government expenditure that generates the deficit is spent. If the deficit results from public investment that complements private investment this could nullify the crowding out caused by the increase in the interest rate as a result of increased public expenditure. For example, if public investment in infrastructure, such as roads, lowers private sector costs, this would raise the rate of return on private investment more than the increase in the interest rate.

Finally, one presumes the crowding out refers to domestic private investors, since foreign investors have greater opportunity to raise funds in money markets outside of Moldova. There are several influences that might crowd out domestic private investment, of which the interest rate effect of deficits may be a relative minor component. One source of crowding out of domestic private investment is foreign investment.[38] Empirical evidence suggests that this is considerably more important than the fiscal deficit. The 'crowding out' effect of FDI on domestic investment is strongly suggested by Figure 2.7.[39] It is realistic to conclude that while a crowding out effect of the fiscal deficit is a possibility, given the level of interest rates in Moldova and the likely use of increased public expenditure, the practical impact would be insubstantial.

38 Basic theory predicts this. Assume that domestic and foreign investors have equal access to all investment possibilities. At any moment, there is a finite set of investment opportunities, and businesses chose them in descending order of the rate of return. For each rate of return, the more that are taken by foreign investors, the fewer are left for domestic investors, and vice-versa. If due to technological access, skills or other reasons, some opportunities are more accessible to foreign investors and others more accessible to domestic investors, then crowding out is reduced.

39 Using data from the NBM, the following regression was estimated for 1994-2004:

$[DPI/GDP]_t = \alpha_O + \alpha_1[FsDf/GDP]_t + \alpha_2[FDI/GDP]_t$

[What is FsDF??] Defining domestic private investment (DPI) as gross domestic investment minus public investment and direct foreign investment, the following results were obtained:

$[DPI/GDP]_t = 15.378 + -.266[FsDf/GDP]_t + -.946[FDI/GDP]_t$

T-statistics (13.25) (-1.51 nsig) (-4.60 sig @ .01)

Adjusted R-square = .814, F = 17.53, sig. @ .01

The coefficients are of the predicted sign, but that for the fiscal deficit is non-significant. The elasticity of domestic private investment with respect to foreign investment is not significantly different from unity; that is, the hypothesis that crowding out of domestic investments by foreign investments is total is not rejected. This is not necessarily an argument against FDI, since it may in some sectors create more efficient production units than domestic investors would.

Box 2.1 Deficits and Inflation

This report concludes that fiscal policy has been too restrictive in Moldova, and that the government could run a small deficit without threatening macro stability. Why does the report make this argument?

Government expenditure, when there is no increase in public revenue, increases aggregate demand, whether it causes a deficit or not, and this can be inflationary under specific conditions. How much it increases aggregate demand depends on the famous 'multiplier', the amount national income must increase in order to generate 'leakages' (saving, imports and taxes) that equal the increase in expenditure. In a small, open economy like Moldova's, increases in expenditure of a few percentage points of GDP are unlikely to be inflationary, because the excess demand generated will be satisfied by imports. The same analysis and conclusion apply to any form of expenditure, public or private.

Fiscal deficits can have an inflationary effect depending on how they are financed and the supply response of the economy. If the government sells bonds to the private sector, and spends the money from those sales, a deficit results or the existing deficit increases. However, no increase in the money supply results, so the effect is not inflationary, though it can have a negative effect on private investment (see Box 2: Crowding Out).

If the government finances the deficit by selling bonds to the central bank or to a government institution, such as a pension fund, the money supply is increased by the amount of the increase in the deficit (the deficit is 'monetised'). The increase in the money supply cannot exceed the increase in the deficit. The quantity theory of money, the basis of orthodox monetary analysis, states that the maximum value of the ratio of the increase in the price level to the increase in the money supply is one. Thus, an increase in the fiscal deficit of one percentage point, totally monetised, would increase the money supply by one percentage point, and have a maximum inflationary effect of no more than one percentage point. This is a very small increase compared to Moldova's rate of inflation during 2000-2005. As with an increase in aggregate demand, the excess demand generated by the increase in the money supply would be partially satisfied by an inflow of imports. Thus, the net inflationary effect would be less than the theoretical maximum

Box 2.2: Crowding out and Crowding In

The emphasis placed on public investment in this report requires consideration of one of the major arguments against it, so-called crowding out. The argument that public investment in Moldova would crowd out private investment is somewhat surprising. It is typically the case that those who make this argument also urge governments to undertake major policy changes to encourage inflows of foreign investment, usually without expressing strong concern that the latter might crowd out private domestic investment, though the same analysis applies to all forms of expenditure, public or private.

The mechanism by which crowding out occurs is through the interest rate. Under some circumstances, government borrowing to finance its investment can push up the commercial interest rate. Given the high commercial rates of interest in Moldova, government borrowing is unlikely to have a substantial effect.

In general, crowding out occurs when an economy is near full employment. When there are unutilised resources, there is resource space for an increase in all types of expenditure, public and private. Even if government borrowing did push interest rates up, this is unlikely to have a negative effect on economic growth. Crowding out of private investment is unlikely to be complete, either in theory or practice. That is, the elasticity of private investment with respect to government expenditure of any type will be less than minus one. As a consequence, public investment would be growth-inducing both in its demand and capacity effects, unless the return on the marginal private component of investment (the part 'crowded out') were sufficiently higher than on the public component. In this case the growth impact would be negative. This can be shown formally using the simple Harrod-Domar model, where y is the rate of growth, v is the incremental capital-output ratio, and *i* is the share of investment in output. Let the subscripts *pr* and *pu* be private and public investment, respectively. Without public investment, the warranted (potential) rate of rate of the economy is:

$$y_o = [v_{pr}][i_{pr}]$$

Let the 'crowding out' ratio be a (the faction by which public investment reduces private investment). Then, the new growth rate with public investment is:

$$y_1 = [v_{pr}][\, i_{pr} - ai_{pu}] + [v_{pu}][i_{pu}]$$

Subtracting y_1 from y_o, one gets:

$$y_o - y_1 = i_{pu}[av_{pr} - v_{pu}]$$

Crowding out will reduce the rate of growth if and only if, $v_{pu} > av_{pr}$. If the capital-output ratio for public investment is smaller than for private investment, public investment never reduces the growth rate, no matter what the value of a, assuming its upper limit to be unity ('total crowding out', one hundred percent). If crowding out is total, the growth rate falls only if public investments are more capital-using than private ones. Thus, the negative impact of public investment on the capacity-creating source of growth occurs only under the very restrictive conditions which crowding out is total and private investments use less capital per unit of output. The former is unlikely and the latter can be avoided by judicious public choice of investment projects.

Monetary Policy and the Exchange Rate

The National Bank of Moldova, the institution responsible for the execution of monetary policy, is explicitly assigned the task of managing the exchange rate under the law creating it; indeed, 'The main objective of the National Bank is to achieve and maintain the stability of the national currency'.[40] Nowhere is it explicitly required that the NBM should target inflation. Indeed, in the provisions of the law dealing with objectives (Chapter I, Article 4), general functions (Chapter I, Article 5), monetary and foreign exchange policy (Chapter II), and the functions of the governing body (Chapter III, Articles 25 and 26), the words 'inflation' and 'price stability' do not appear. However, the current interpretation of the function of the NBM places emphasis on domestic price stability:

> From the very beginning the main objective of the NBM is to realize and maintain the stability of the national currency that ultimately provides the reduction of the inflation rate, the ensurance of the general level of prices and of the exchange rate of the MDL (NBM website, 'Monetary Policy').[41]

In line with this statement of policy, the NBM during 1998-2004 engaged in what a NBM official called a 'managed float'. However, this intervention appears to be minimalist, with the primary focus of the NBM being price stability, implemented through adjustments in interest rates. In 2004 the NBM 'narrowed' its interpretation of its mission to one primarily focussed on inflation targeting. However, seeking price stability in this manner is unlikely to be a success, since officials of both the IMF and the NBM expressed scepticism as to the effectiveness of interest rates in influencing the price level. In the Moldovan context, a more growth-fostering objective of the NBM would be purposeful management of the exchange rate.

From a theoretical perspective, one can treat Moldova as a 'small, open economy'; that is, as a 'price taker' in its external trade.[42] If one assumes the operation of the Law of One Price, then the effect of interest rate adjustments can be considered by using the Mundell-Fleming model, the IMF's standard framework for analysing external adjustment. In this approach, domestic prices of traded commodities cannot systematically differ from external prices, except due to tariffs (which affect

40 This and the other documents establishing and regulating the NBM can be found on the NBM website (http://www.bnm.org/english/index_en.html). It is useful to quote in detail from the Law on the National Bank of Moldova (Chapter I, Article 4):

The main objective of the National Bank is to achieve and maintain the stability of the national currency. In order to achieve this objective the National Bank establishes and maintains monetary, credit and exchange market conditions conducive to the orderly, balanced and sustained economic development of the Republic and especially of the market-based financial and foreign exchange system.

The first function of the Bank listed under Article 5 is 'to formulate and to promote the state monetary and foreign exchange policy'. It is given authority to use its assets to achieve this. In Chapter V, Article 53 the foreign exchange that it holds is defined as one of those assets. Chapter I, Article 15 empowers it to enter into domestic open market operations and Article 16 grants it the right to 'buy, sell and deal in foreign exchange' and 'determine the rate at which it will buy, sell or deal in foreign currencies'. Chapter V, Article 51 gives it the power to intervene in a variety of ways to regulate private dealers in foreign exchange.

The document, 'Regulation on Foreign Exchange Regulation ['regulation' a second time??]on the Territory of the Republic of Moldova', defines the exchange rate as follows: 'the price of foreign currency expressed in [an]other foreign currency set, as in accordance with the provisions of this Regulation, by the National Bank of Moldova (official exchange rate) or by authorized dealers…'

41 Comparing this to the text in Romanian, it would appear that 'provides' would be better translated as 'requires', and the word 'ensurance' should be 'maintain'.

42 This assumption does not exclude the possibility that private market power manages prices of imported commodities.

the margin between the two, but not their relative movements). It follows, therefore, that domestic inflation will tend to reflect international inflation and the prices of non-traded goods if the exchange rate is constant.

In these circumstances, theory predicts that the main result of changes in interest rates is reflected in capital flows. If the domestic rate of interest lies above the 'international' rate, capital will flow into a country, as private agents seek cheaper borrowing abroad, and external speculators seek to gain from holding their funds in the high interest rate country. However, in Moldova, the most important source of financial inflows is remittances by citizens abroad, which have little sensitivity to the domestic interest rate. Thus, high interest rates in Moldova could achieve neither of their objectives, neither reducing inflation nor attracting capital.

However, the inflow of remittances has the effect of appreciating the exchange rate, as occurred during 2003 and 2004, thus making exports less competitive. The higher interest rate would discourage investment by Moldovan companies but have little impact on foreign direct investment. Though there is no research on the strength of these effects in Moldova, their impact may have been quite strong in the late 1990s and early 2000s. Both nominal and real interest rates set by the NBM have been extremely high since independence (see Table 2.8 and Figures 2.8 and 2.9), except during years of high inflation for the latter. Attempts to moderate inflation after independence by raising nominal interest rates to three-digits proved fruitless; indeed, inflation fell once interest rates began to decline from the punitive levels of the early 1990s (again see Table 2.7). Subsequently, the NBM brought nominal rates down into the teens, but this still resulted in punishingly high inflation-adjusted rates during 2001-2004 (except in 2003; again, see Figures 2.8 and 2.9). During 1995-2000, after the hyperinflation had ended and when nominal NBM rates were over twenty percent (except for 1997), the inflation adjusted NBM rate was five percent, which commercial banks passed on to borrowers at a multiple of over three, namely, at an average of sixteen percent. Facing such a punitive borrowing rate, it is not surprising that private sector investment was weak--affordable to those companies that could borrow externally.

After 2000, the NBM base rate averaged approximately half what it had been over the previous six years, yet the inflation adjusted base rate rose by a percentage point, and the commercial lending rate remained the same. These real rates represented at the time of this report a major relative price misalignment in the economy. The famous 'Golden Rule' from growth theory states that long term real interest rates should not exceed the sustainable rate of real per capita growth.[43] Based on growth during 2000-2004, that sustainable rate can be estimated as four percent. Thus, private borrowers faced commercial interest rates misaligned by a factor of four. To place this in perspective, one can speculate on the effects on employment were the average wage level in Moldova to increase by four hundred percent.

An equally serious misalignment has been the enormous gap between deposit and lending rates. On an annual basis, lending rates exceeded deposit rates by over forty percent during 1996-2004. The tiny annual variation in this interest rate differential (its coefficient of variation being less than

43 It became fashionable in the 1980s and 1990s for some economists to 'trump' the Golden Rule' with the argument that high rates of interest in developing countries represented 'risk premiums', which could allegedly be justified on efficiency grounds. However one justifies interest rates above the long term sustainable rate of per capita growth, it remains true that they represent a barrier to reach that rate of growth.

0.10) strongly suggests commercial banks exert considerable market power.[44] The policy implication is that in so far as the NBM cannot affect the rate differential, stimulating private investment requires much lower base rates. If the ratio of the base rate to the commercial lending rate is taken as a guide,[45] bringing real lending rates down close to the Golden Rule rate, say six percent, would require a base rate of two percent.[46]

There can be little doubt that the NBM base rate and private sector interest rates were seriously misaligned in Moldova during the 1990s and the first half of the 2000s, as were the relative prices of lending and holding deposits. While the private rates probably reflect market manipulation, the NBM rates reflect a concern over the return of unmanageable inflation. As argued above, the base rate is an inappropriate instrument to deal with this anxiety, because hyper-inflation was a transitory phenomenon during the change in the economic regime from central planning to market regulation. Since the hyperinflation of the early 1990s, Moldova has displayed considerable price stability, except during the shock of the Russian financial crisis, when exchange rate depreciation again provoked an inflationary burst (see Figure 2.10).

Evidence suggests that the Moldovan government and its monetary authorities could safely pursue a low interest rate policy without provoking inflation. The effect of such a policy would be to stimulate growth, which would enhance poverty reduction. Even should this be accompanied by moderate inflation in the low teens-- and there is little reason to think it would--research suggests no link between growth rates and inflation up to about forty percent (Bruno & Easterly 1999). Inflation may or may not be 'bad for the poor',[47] but abandoning inflation targeting would prove unambiguously pro-poor.

A further reason for the NBM to consider initiating a more purposeful exchange rate policy is the impact of remittances, to which we alluded above. In this chapter we do not analyse remittances in detail, but restrict the discussion to the exchange rate effect. After a long period of relative real stability from 1999 through 2003, the Leu appreciated in the second half of 2003 and throughout 2004 (see Figure 11). Measured by its dollar rate, its value adjusted by domestic inflation rose by fifteen percent. The generally accepted effects of exchange rate appreciation are that it renders tradable commodities less profitable and thus discourages both production of import substitutes and exports. Since, as we see in the next subsection, the country ran a massive trade deficit during these thirty-two months, the appreciation must have resulted from financial inflows. Since capital inflows were relatively small, the only credible explanation for the appreciation is the inflow of remittances, a large part of which go unrecorded.

The remittance effect on Moldova's exchange rate has been similar to that manifested in countries passing through an export commodity price boom or countries receiving large inflows of concessionary or commercial capital. In effect, the exchange rate disconnects from export competitiveness, to rise or fall in reaction

44 It is the view of NBM professionals that commercial banks in Moldova are extremely profitable, as the rate differential would suggest.

45 Calculation from Table 2.7 yields a ratio for the nominal rate during 1995-2000 of 2.00, and during 2001-2004 of 2.19. The standard deviation across all ten years is quite low, .3. This suggests that commercial banks practiced mark-up pricing of loans.

46 The ratio of the real base rate to the real lending rate for 1995-2000 was three, and for 2001-2004 it declined slightly to 2.73.

47 The evidence from other countries does not support the general conclusion that inflation hurts the poor disproportionately (van der Hoeven 2004).

to purely financial flows. For Moldova, with its large trade deficit, this is a very serious matter, even were remittances sustainable at the level of the first half of the 2000s, (which they probably are not). Most of Moldova's exports are sold in highly competitive international markets, and especially its agricultural exports. The effect of a real appreciation could undermine export performance by rendering marginal producers unprofitable, and discouraging the entry of new producers. It is quite clear that in Moldova, exchange rate movements that undermine the production of tradables are not pro-poor.

It is generally agreed that remittances cannot be monitored, and can be regulated only to a limited degree. This means that the use of 'open-market operations' to sterilise remittance flows, even if the domestic bond market were sufficient deep to do so, would always occur in response to exchange rate movements, rather than in anticipation of them. Since after-the-event intervention is a fact of economic life in this sector of the economy, a more effective *post-facto* intervention would be to operate directly on the exchange rate through the buying or selling of Leu. Thus, for a range of reasons, we conclude that prudent and pro-poor exchange rate policy would involve more aggressive intervention to mange the exchange rate.

The government should consider a policy of managed undervaluation of the exchange rate, in which the actual trading rate for the Leu stays ahead of the internal price adjustments occurring in response to the Law of One Price. In other words, exchange rate policy would use the lag in the adjustment of internal prices to external prices to keep the Leu marginally undervalued. This recommendation is complicated by the negative impact it would have on external debt servicing. This makes the debt relief by external agencies, discussed above, all the more necessary. As for fiscal policy, the debt burden resulting from miscalculation of Moldova's per capita income is a barrier to effective exchange rate policy. Nominal devaluations could also have negative welfare effects, particularly on the poor, through their impact on energy prices. This problem could be mitigated by applying energy subsidies, as was done in the 1990s.

Our comments indicate that pro-poor growth would be fostered if the parliament and the government gave the NBM a broader mission than currency stability. This broadening of mission would be consistent with the realities of the Moldovan economy. Our review of 1990-2005 suggests that inflation is a structural phenomenon resulting from supply bottlenecks created by the collapses of the economy, and the enormous inflow of remittances. In consequence, the interest rate is an ineffective tool of inflation management.

The broader mission of the NBM would call for accommodating growth in the short and medium term, and treating currency stability as a medium term rather than a short term goal. This broader mission could be part of changes that would bring central bank regulation more into line with European Union practice. The NBM is a competent and professional organisation. However, its operations suffer from the absence of formalised mechanisms of accountability which exist in almost all European countries. Its functions would be enhanced by mechanisms that create parliamentary and public oversight in order to foster transparency through accountability.

Trade Policy and Poverty Reduction

The international trade position of Moldova involves a simple story: the balance of exports and imports is inconsistent with long term development, and must be corrected as quickly as possible. The enormous trade deficit as a share of GDP has been sustained through remittances.

If remittances begin to fall, the country will suffer yet another severe compression of the economy, causing falling incomes and rising poverty. If remittances are sustained, the result is hardly better, however, for it will imply that Moldova will be relegated to the category of an impoverished exporter of cheap labour.

Table 2.8 provides the basic statistics, and Figures 2.12 and 2.13 provide information on the external balances. During 1994-1995, the export-GDP ratio was about fifty-nine percent, and the import-GDP ratio about sixty-seven, producing a trade deficit that averaged eight percent. Over the years 1996-2003, the former was fifty-two percent and the latter seventy-five, for a trade deficit moving towards one-fourth of GDP. The statistics for the first half of 2004 suggest an even higher trade deficit, though this may fall in relative terms depending upon the realised rate of GDP growth. Except in a very few cases,[48] a country with a trade deficit of this magnitude courts disaster. One source of this disaster is that the country is highly vulnerable to changes in prices of imports, especially petroleum, with the benefits from increased prices of exports much less pronounced. In addition to energy, the trade deficit arises from the net imports of manufactures, which reflect the collapse of much of Moldova's industry.

Over the medium term the most competitive sector for exports will be agriculture, yet net exports of food commodities declined sharply from thirty percent of the average of imports and exports during 1994-1996 to twenty-five percent for 1997-1999, to close to fifteen percent during 2000-2002 (when the data end). In effect, Moldova is substituting remittances for net agricultural exports.

Such a large trade gap is unlikely to be closed or reduced through market processes. Quite the contrary is likely: remittances would prevent exchange rate depreciation, further discouraging export production in agriculture and manufacturing. Even the exchange rate policy suggested above would be insufficient to the task of substantially reducing the current account deficit. Economic theory, as well as experience, suggests that relative price movements bring about marginal changes, but in international trade Moldova requires much more than this. Given the apparent low elasticity of the current account with respect to the exchange rate,[49] the change in the latter necessary to have a major impact on the former would be so large that it would destabilise the economy long before it corrected the balance of payments. The price movements arising from such a massive structural imbalance give rise to catastrophic changes, as the events of 1991-1994 and 1998 already demonstrate.

However, several countries, most notably Vietnam, have corrected trade deficits this large without a severe depression. The policies to achieve this are well-known, and can be implemented in Moldova. They involve providing strong and concrete incentives to export and in some cases targeting these to sectors with export potential. A final observation on remittances is necessary. Experience from

48 One case was Panama in the 1950s and 1960s, which had a large surplus on the service account because of the Canal and an oil pipeline. Even in this case, after two decades of rapid growth, the secular decline in the use of both resulted in intractable problems of adjustment.

49 Assume that the current account is determined by the real exchange rate and the interest rate on dollar deposits (which proxies for the difference between domestic and 'world' interest rates). Since the current account balance shifts between positive and negative, logarithms cannot be used to estimate the model for thirty quarters, 1997.1 through 2004.2 (and there are no quarterly GDP statistics to allow use of a relative measure). The ordinary least squares statistics are:
[crr acc] = -.269 – 1.189 [Real Exchange Rate]$_t$ - .269 [US$ deposit rate] $_t$
t=stats = (-2.82) (-4.53) (-.06)
The interest rate variable is not significant. The exchange rate is of the predicted sign and significant at less than .01, though the calculated elasticity is less than .10.

other countries shows that worker remittances arise from specific circumstances, and are unlikely to be sustainable in the long run. For example, those countries that provided large numbers of workers to the oil-exporting countries in the 1970s suffered from a precipitous drop in remittances when the petroleum price fell in the early 1980s. Reducing the trade gap (thereby reducing dependency on remittances) would be the only way to prepare for a similar development for Moldova.

Table 2.1: *Transition Declines & Disasters 1990-2001, Levels & Changes in GDP*

(lowest value = 100)

Country	Highest value	in the year	1990 value	Lowest =100	2001 value	Percent change			Decline/ recovery*
						high/low	1990/ low	low/ 2001	
Georgia	480	1985	361	1994	146	-131	-113	37	-94
Tajikistan	401	1988	353	1996	126	-120	-112	23	-97
Moldova	**292**	**1989**	**284**	**1999**	**109**	**-98**	**-96**	**9**	**-89**
Turkmenistan	275	1988	253	1997	156	-93	-87	44	-50
Ukraine	252	1989	236	1998	118	-86	-81	17	-70
Armenia	225	1990	225	1993	156	-77	-77	43	-33
Kyrgyz Rep	205	1990	205	1995	128	-69	-69	25	-44
Latvia	196	1989	195	1992	148	-65	-64	39	-26
Azerbaijan	191	1992	na	1996	146	-63	na	38	-25
Lithuania	176	1990	176	1994	135	-55	-55	30	-25
Russia	178	1989	172	1998	122	-56	-53	20	-36
Kazakhstan	169	1989	160	1995	138	-51	-46	32	-19
Croatia	156	1990	156	1993	121	-44	-44	19	-25
Belarus	153	1990	153	1995	145	-42	-42	36	-6
Estonia	154	1989	143	1994	149	-43	-36	40	-3
Uzbekistan	138	1989	137	1995	115	-32	-31	14	-18
Slovak Rep	135	1989	131	1993	137	-29	-27	31	2
Bulgaria	141	1988	127	1997	121	-34	-24	19	-15
Romania	141	1987	124	1992	112	-34	-21	12	-23
Hungary	121	1989	117	1992	133	-19	-16	29	10
Slovenia	116	1990	116	1992	118	-15	-15	17	2
Czech Rep	114	1990	114	1992	121	-13	-13	19	6
Poland	108	1990	108	1992	154	-8	-8	42	35

Source: EBRD 2003; World Bank, *World Development Indicators 2004*.
NOTE: For comparability, the countries are in order of their declines from 1990 to their lowest point.
*Fall or rise in per capita income in 2001 compared to 1990.

Table 2.2: *Cumulative Changes in GDP, European and Central Asian Transition Economies, 1991-2003*

Country	1991-93	1991-94	1991-95	1991-96	1991-97	1991-98	1991-99	1991-00	1991-01	1991-02	1991-03	First positive growth	year of: recovery to 1991:
Bulgaria	-21	**-19**	-16	-25	-31	-27	-25	-19	-15	-10	-6	1994	1996
Czech Rep	-12	**-10**	-4	0	0	-1	-1	2	6	8	11	1994	2000
Estonia	-37	-39	**-34**	-30	-21	-16	-17	-9	-3	3	8	1995	2002
Hungary	-16	**-13**	-11	-10	-5	0	4	9	13	16	19	1994	1999
Latvia	-60	-58	-59	**-55**	-47	-42	-39	-32	-25	-18	-12	1996	no
Lithuania	-43	-53	**-50**	-45	-38	-31	-33	-29	-22	-15	-9	1995	no
Poland	-1	**5**	12	18	24	29	33	37	38	40	43	1994	1994
Romania	-20	**-16**	-9	-5	-11	-16	-17	-16	-10	-5	-1	1994	no
Slovak Rep	-26	**-21**	-15	-9	-3	1	2	4	8	12	16	1994	1998
Slovenia	-13	-7	-2	2	6	10	15	20	23	26	28	1994	1998
Albania	-24	**-15**	-2	7	0	13	22	29	36	41	47	1994	1996
Bos&Herz	-102	-102	**-81**	5	42	57	67	73	77	81	84	1995	1996
Croatia	-41	**-35**	-28	-22	-16	-13	-14	-11	-7	-2	2	1994	2003
Macedonia	-24	-26	-27	-26	-25	**-21**	-17	-12	-17	-16	-13	1998	no
Serb&Monte	-70	**-68**	-62	-54	-44	-42	-60	-55	-49	-45	-43	1994	no
Armenia	-62	**-57**	-50	-44	-41	-34	-30	-24	-15	-2	7	1994	2003
Azerbaijan	-46	-66	-78	**-77**	-71	-61	-52	-41	-31	-20	-11	1996	no
Belarus	-18	-31	-41	-39	-27	-19	**-15**	-10	-5	0	4	1999	2002
Georgia	-91	-102	-100	**-89**	-79	-76	-73	-71	-66	-60	-52	1996	no
Kazakhstan	-26	-38	-46	-46	-44	-46	-43	-34	**-20**	-11	-2	2001	no
Kyrgyz Rep	-40	-60	-65	-58	-48	-46	-42	**-37**	-32	-32	-27	2000	no
Moldova	-48	-79	-80	-86	**-84**	-91	-94	**-92**	-86	-79	-73	1997	no
Russia	-29	-41	-45	-49	-47	-53	-46	-36	-31	**-27**	-21	2002	no
Tajikistan	-47	-66	-79	-83	-81	-74	-71	-62	-52	**-43**	-35	2002	no
Turkmenistan	-20	-37	-45	-51	-63	-74	-57	-40	-28	-23	**-13**	2003	no
Ukraine	-35	-57	-70	-80	-83	-86	-86	**-80**	-71	-66	-60	2000	no
Uzbekistan	-14	-18	-19	-17	-15	**-12**	-8	-4	0	4	5	1997	2002

NOTES: bold – first year of positive growth; shaded – year of recovery to level of 19991. Sources: EBRD 2003, Annex 3.1, and *WDI* 2003.

Table 2.3: *Changes in Headcount Poverty and the Gini Coefficient, European and Central Asian Transition Countries,1987-1994*

Country	Headcount Poverty		Change	Gini	Coefficient	Change	% Change due to
	1987-88	1993-94		1987-88	1993-94		Gini*:
Georgia	na	na	na	na	na	na	na
Tajikistan	na	na	na	na	na	na	na
Moldova	4	65	61	24	36	12	28
Turkmenistan (3)	12	48	36	26	36	10	34
Ukraine(2)	4	41	37	23	33	10	38
Armenia (3)	na	na	na	na	na	na	na
Kyrgyz Rep(1)	5	50	45	26	35	9	37
Latvia	1	19	18	23	27	4	20
Azerbaijan (4)	na	na	na	na	na	na	na
Lithuania (3)	1	49	48	23	37	14	46
Russia	2	43	41	24	36	12	52
Kazakhstan (3)	5	50	45	26	33	7	39
Croatia (3)	na	na	na	na	na	na	na
Belarus	1	11	10	23	22	-1	29
Estonia	1	33	32	23	40	17	58
Uzbekistan (3)	24	29	5	28	33	5	44
Slovak Rep	0	1	1	20	20	0	31
Bulgaria	2	17	15	23	31	8	56
Romania	6	32	26	23	33	10	52
Hungary	1	2	1	23	28	5	51
Czech Rep (3)	0	2	2	19	27	8	69
Slovenia (3)	0	1	1	24	29	5	65
Poland (3)	6	20	14	26	31	5	65
Average	4	28	24	24	32	8	45

NOTES: *Calculated from a cross-country regression using the countries with data, by substituting each country's change in the Gini, holding per capita income (PCY) constant. The regression result is, with T test result in parenthesis under coefficient (ns notes non-significance at .10):
$\ln(d[Pov]) = .184 + 2.765[\ln(dGini)] – 3.058[\ln(dPCY])$
(ns) (.090) (.009)
Adjusted R-square = .532
F-statistic = 10.11 (significant @ .004)
DF = 14

SOURCES: Milanovic 1995, p. 14; Milanovic 1998, pp. 41, 68; UNDP 1998; EBRD 2003, Annex 3.1; and *World Development Indicators* 2003.

***Table 2.4:** Distribution of Expenditure by Quintiles, European and Central Asian Transition Countries, 1996-1999*

Central and Eastern European Countries

country	year	Q1	Q2	Q3	Q4	Q5
Belarus	1998	11.4	15.2	18.2	21.9	33.3
Bulgaria	1997	10.1	13.9	17.4	21.9	36.8
Croatia	1998	8.8	13.3	17.4	22.6	38.0
Czech Rep	1996	10.3	14.5	17.7	21.7	35.9
Estonia	1998	7.0	11.0	15.3	21.6	45.1
Hungary	1998	10.0	14.7	18.3	22.7	34.4
Latvia	1998	7.6	12.9	17.1	22.1	40.3
Lithuania	1996	7.8	12.6	16.8	22.4	40.3
Moldova	**1997**	**5.6**	**10.2**	**15.2**	**22.2**	**46.8**
Poland	1998	7.8	12.8	17.1	22.6	39.7
Romania	1998	8.0	13.1	17.2	22.3	39.5
Russia	1998	4.4	8.6	13.3	20.1	53.6
Slovenia	1998	9.1	13.4	17.3	22.5	37.7
Ukraine	1999	8.8	13.3	17.4	22.7	37.8
	average	**8.5**	**13.0**	**17.0**	**22.1**	**39.4**
	std dev	**1.8**	**1.7**	**1.3**	**0.7**	**5.2**

Central Asian Countries

country	year	Q1	Q2	Q3	Q4	Q5
Armenia	1996	5.5	9.4	13.9	20.6	50.6
Azerbaijan	1995	6.9	11.5	16.1	22.3	43.3
Georgia	1996	6.1	11.4	16.3	22.7	43.6
Kazakhstan	1996	6.7	11.5	16.4	23.1	42.3
Kyrgyz Rep	1999	7.6	11.7	16.1	22.1	42.5
Tajikistan	1998	8.0	12.9	17.0	22.1	40.0
Turkmenistan	1998	6.1	10.2	14.7	21.5	47.5
Uzbekistan	1998	4.0	9.5	15.0	22.4	49.1
	average	**6.4**	**11.0**	**15.7**	**22.1**	**44.9**
	std dev	**1.3**	**1.2**	**1.0**	**0.8**	**3.7**

SOURCE: World Bank, Income distribution data base.

Table 2.5: *Moldova's Per Capital Income from the WDR, 1991-1999*

Year for PCY & title date of WDR:	World Bank				IMF MRED 1996	NBM website
	Low-income Status?	PCY Reported in WDR	Reported Change in PCY	PCY implied by 1999		
1991 (1993)	no	2173	–	1077		
1992 (1994)	no	1300	-16.0	905		
1993 (1995)	**no**	**1060**	-29.1	**641**	**310**	310
1994 (1996)	**no**	**870**	-1.2	634	325	377
1995 (1997)	**no**	**920**	-32.3	429	392	400
1997 (1998/99)	yes	540	-4.2	411		528
1999 (2000/01)	yes	370	-9.9	370		321

NOTES AND SOURCES: PCY Reported in WDR: per capita income reported in *World Development Report*.
Reported Change in PCY: source as for PCY Reported. Change from the previously listed year.
PCY implied by 1999: uses the reported changes and works backwards from 1999.
IMF MRED: IMF (1996), photocopy of data page supplied by IMF.
NBM: National Bank of Moldova

Table 2.6: *Fiscal Deficits as Percent of GDP, Transition Countries, 1992-2002*

Countries:	Averages: All yrs	1992-93	1994-97	1998-02
Croatia	-3.2	-2.4	-.8	-5.5
Czech Rep	-2.5	-.3	-1.7	-4.3
Estonia	-.6	na	-.5	-.7
Hungary	-5.4	-6.1	-6.0	-5.1
Latvia	-2.5	na	-2.5	-2.5
Lithuania	-4.1	-5.3	-3.9	-4.1
Poland	-3.6	-3.7	-2.9	-4.4
Slovak Rep	-5.6	-9.0	-1.9	-7.2
Slovenia	-.6	.5	-.6	-1.6
Albania	-12.3	-19.3	-11.9	-8.1
Bos&Herz	-3.9	na	-1.7	-5.3
Bulgaria	-3.7	-6.9	-6.0	-.5
Macedonia	-3.8	-11.6	-1.4	-2.6
Romania	-3.3	-2.5	-3.3	-3.6
Serb&Monte	-2.2	na	na	-2.2
Armenia	-10.0	-34.3	-6.6	-4.6
Azerbaijan	-3.8	-6.3	-5.2	-1.8
Belarus	-2.1	-3.8	-2.1	-1.4
Georgia	-8.5	-25.8	-6.7	-4.0
Kazakhstan	-4.8	-5.7	-5.8	-3.1
Kyrgyz Rep	-10.5	-14.4	-11.9	-8.6
Moldova	**-6.8**	**-17.1**	**-8.2**	**-2.8**
Russia	-5.9	-13.1	-8.7	-.9
Tajikistan	-8.9	-26.8	-6.3	-1.6
Turkmenistan	-1.0	-6.8	.6	-.8
Ukraine	-6.6	-20.8	-5.9	-1.5
Uzbekistan	-5.8	-18.4	-4.5	-2.3
average	-4.9	-11.3	-4.5	-3.4

SOURCE: EBRD 2003.

Table 2.7 *Nominal and Inflation-Adjusted Interest Rates in Moldova, 1993-2004*

	Nominal			Inflation Adjusted		
Year	NBM	CBL	CBB	NBM	CBL	CBD
1994	150	160	90	-337	-327	-397
1995	21	42	33	21	42	33
1996	18	36	24	-6	13	0
1997	16	33	23	4	21	11
1998	33	30	21	25	22	13
1999	31	36	27	-8	-4	-12
2000	27	33	25	-4	2	-6
2001	13	28	21	3	19	11
2002	10	24	15	5	19	10
2003	14	19	13	2	7	1
2004*	14	21	15	14	21	14
AVERAGES						
1995-00	24	35	25	5	16	7
2001-04	13	23	16	6	16	9

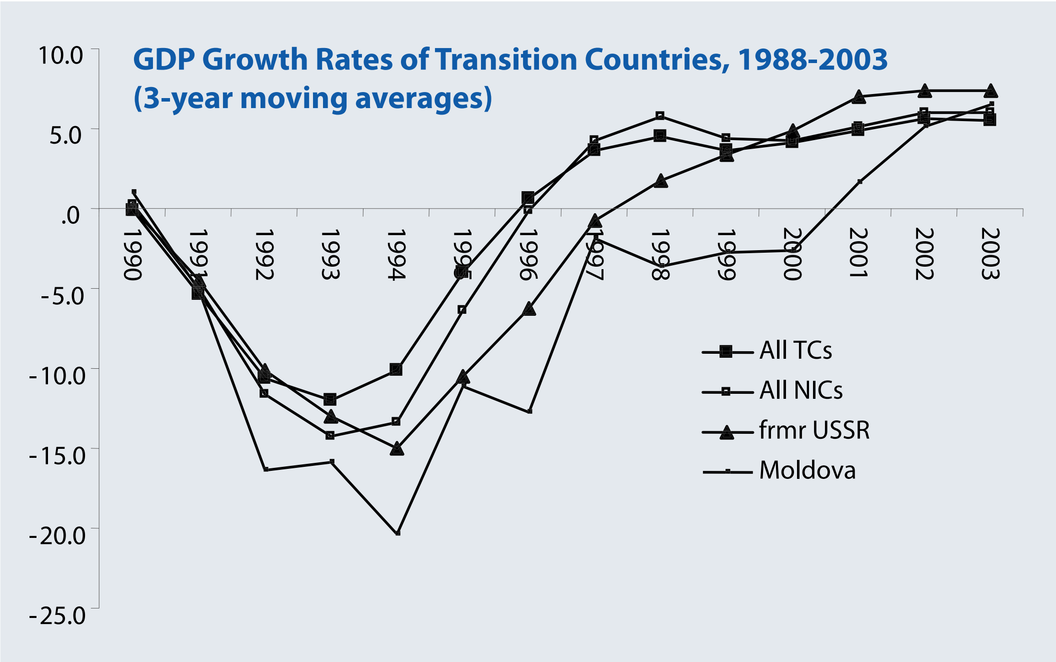
SOURCE: National Bank of Moldova.
NOTES: NBM is the National Bank of Moldova base rate; CBL is the commercial bank lending rate; CBD is the commercial bank deposit rate. The inflation adjustment is the relevant interest rate minus the GDP deflator, or the general consumer price index for 2004.
*Through August 2004.

Table 2.8 *Exports and Imports, 1994-2004*

Item:	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 (2 qtrs)
US $ MILLIONS											
Exports g&s	651	884	929	1057	796	615	644	740	874	1057	592
Merchandise exports	618	739	823	890	644	469	477	569	659	806	466
Imports g&s	751	1006	1249	1434	1230	781	971	1101	1248	1718	934
Merchandise imports	672	794	1076	1238	1032	597	783	882	1038	1428	648
PERCENTAGES											
Exports											
share of GDP	56.0	61.2	54.8	54.7	47.1	52.5	50.0	50.0	52.6	54.0	na
Food/Exports g&s	66.8	71.7	72.0	72.5	75.4	68.0	61.6	62.9	63.0	na	na
Manuf/Exports g&s	27.9	22.7	23.2	25.5	22.6	27.1	33.3	33.7	33.0	na	na
Imports											
share of GDP	64.6	69.7	73.7	74.1	72.8	66.7	75.4	74.4	75.1	87.8	na
Food/Exports g&s	6.5	8.1	10.7	11.1	7.8	5.9	13.1	14.3	14.0	na	na
Manuf/Exports g&s	35.4	41.8	44.2	48.6	57.6	52.1	51.0	55.8	57.0	na	na
TRADE BALANCES											
[X-M]/GDP	-8.6	-8.5	-18.9	-19.5	-25.7	-14.2	-25.4	-24.4	-22.5	-33.8	-30.0*
Food/Trade	31.8	32.3	28.2	26.3	24.0	24.2	14.8	15.6	16.2	na	na
Manuf/Trade	-5.6	-11.4	-16.8	-19.4	-26.6	-15.7	-18.7	-20.3	-22.5	na	na

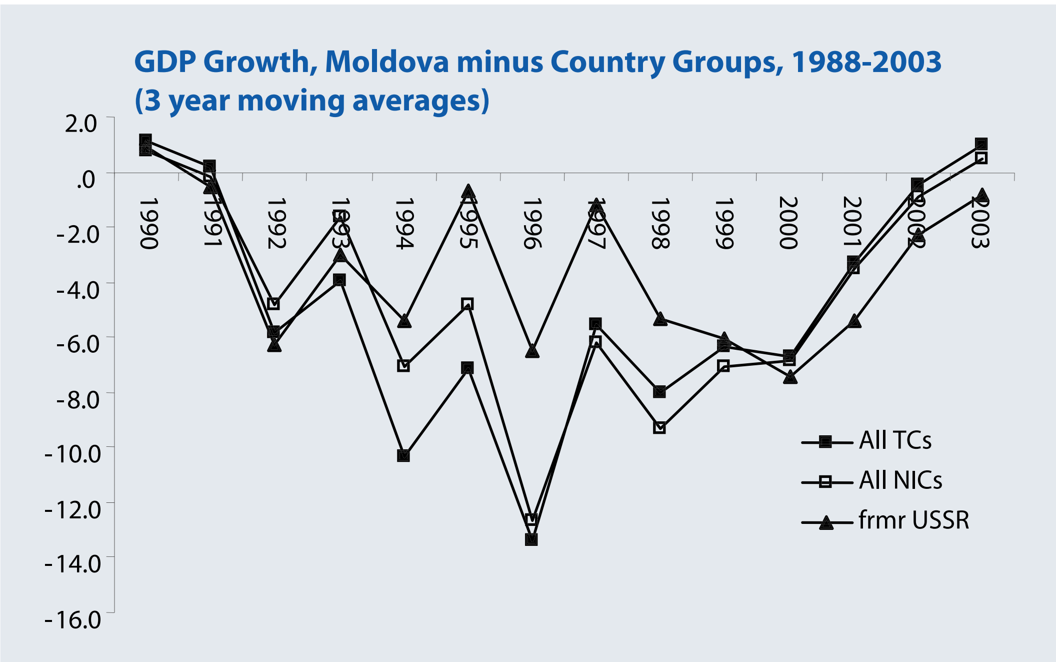
SOURCE: National Bank of Moldova, website, Moldova, Economic Trends, various issues, and World Development Indicators 2002.
NOTES: The last two rows of the table give net exports of food and manufactures as a proportion of the average of the total imports and exports

Figure 2.1:



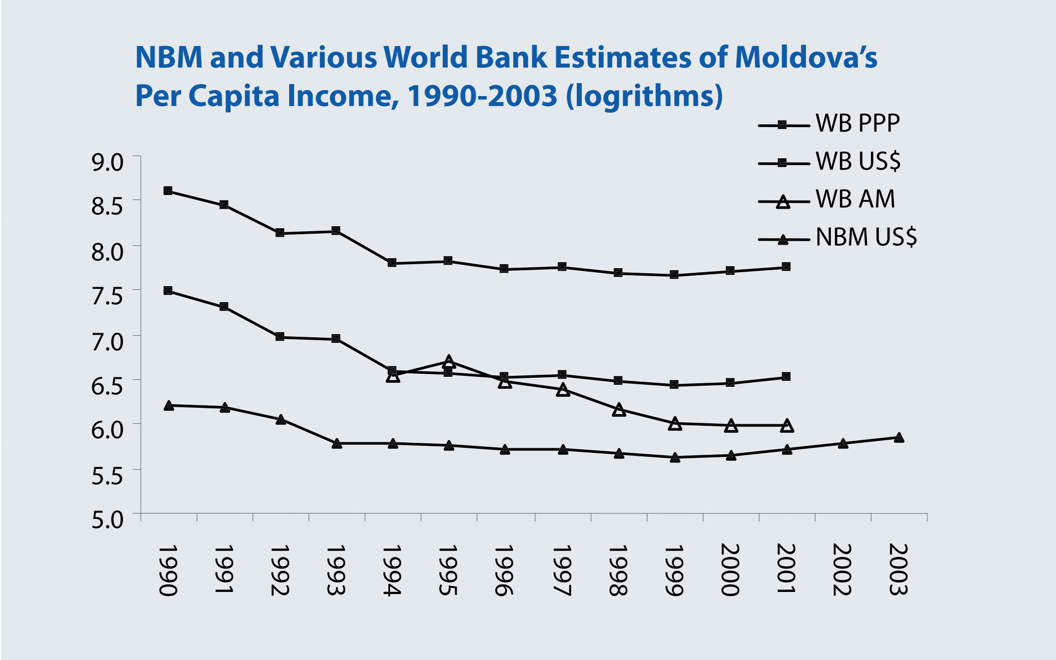
NOTES: 'TC' stands for 'transition countries' (23 in all). 'NIC' stands for 'newly independent countries', and 'frmr USSR' includes the republics of the former Soviet Union.

Figure 2.2:



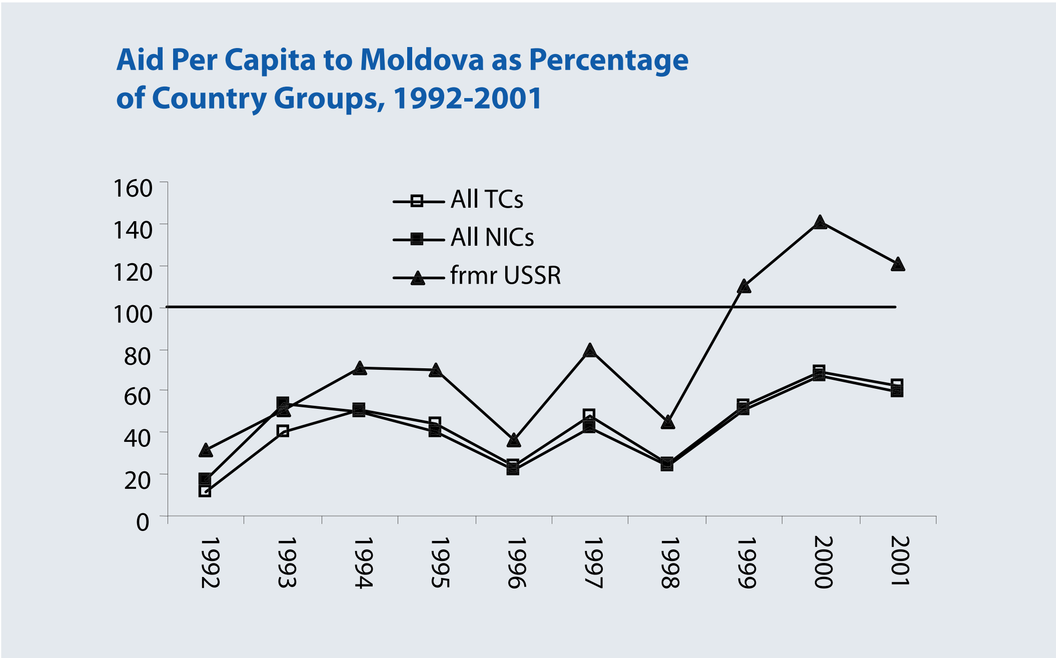
SOURCE: World Bank, *World Development Indicators 2002*.
NOTES: See Figure 2.1 for legend.

Figure 2.3



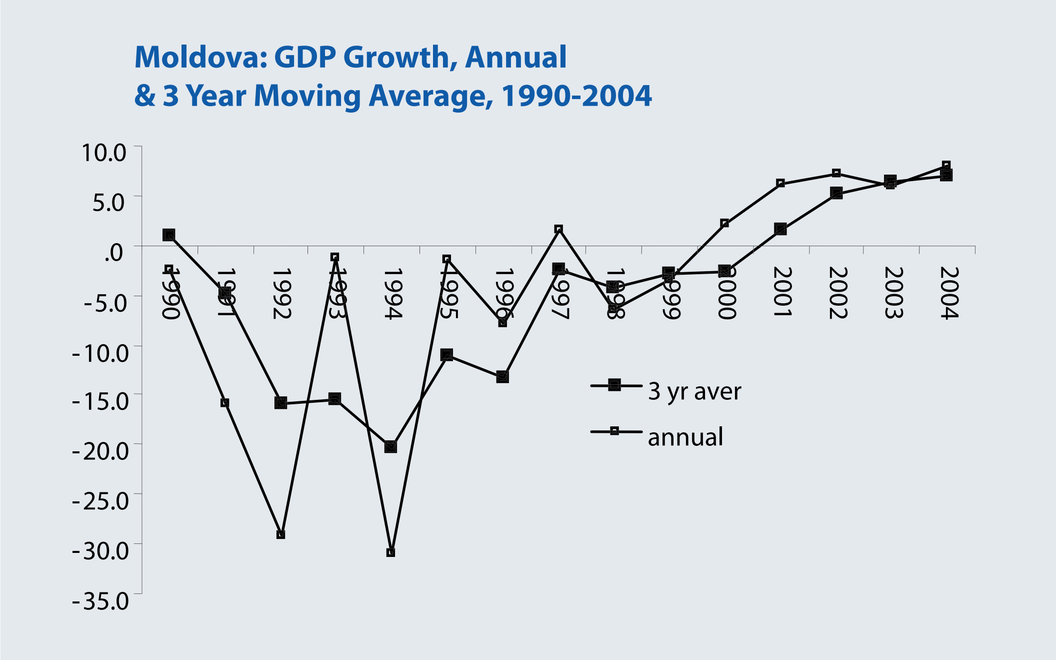
SOURCES: World Bank, *World Development Indicators 2002* and National Bank of Moldova
Notes: WB is World Bank; PPP is purchasing power parity; US$ is constant United States dollars; and NBM is the National Bank of Moldova.

Figure 2.4



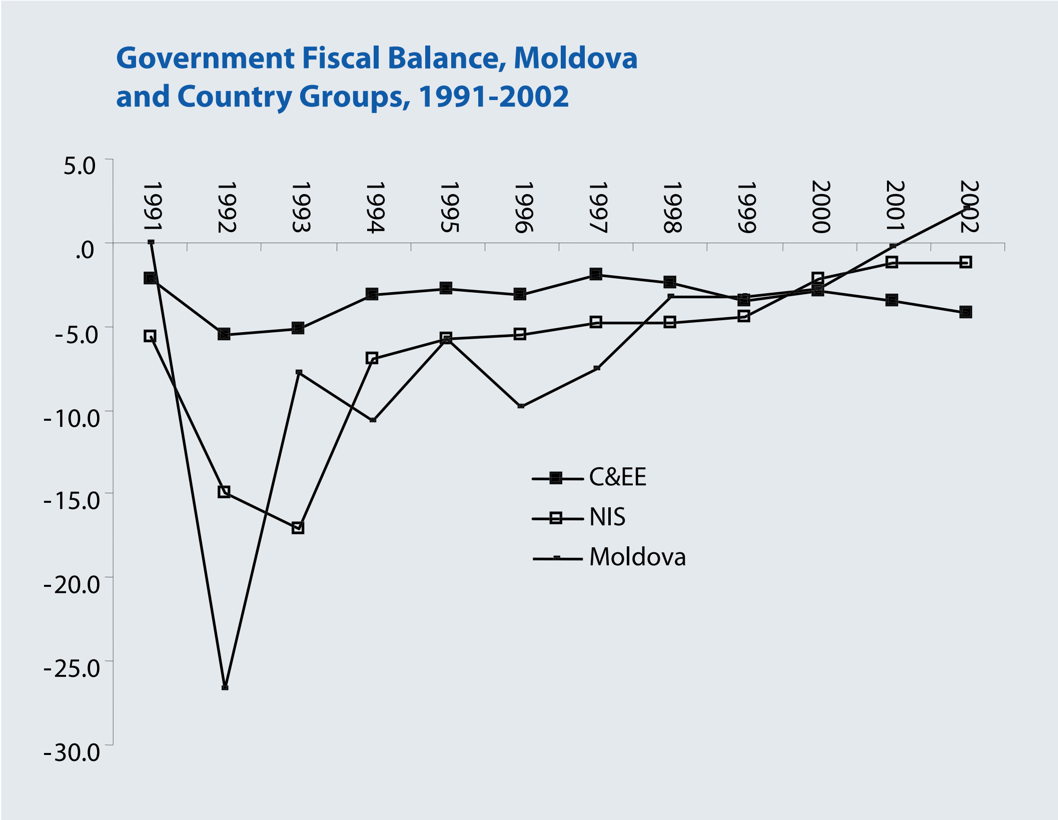
SOURCE: World Bank, *World Development Indicators 2002*.

Figure 2.5



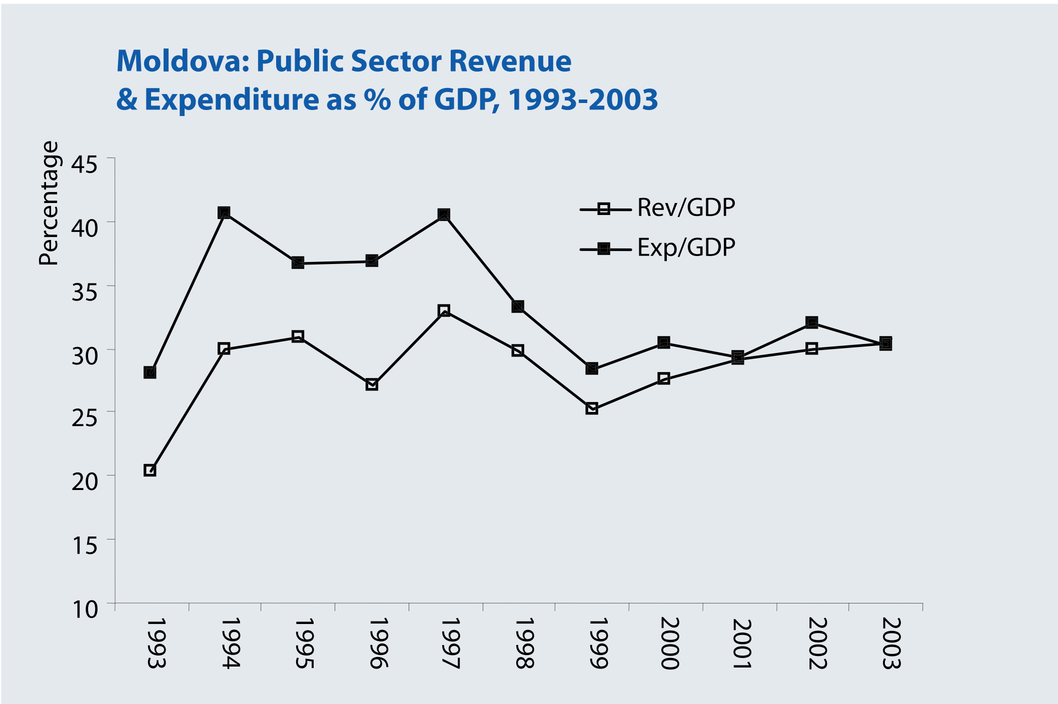
	1990-1994 Collapse	1995-2000 Stagnation	2001-2004 Recovery & Growth
IMF & WB policy	First IMF program Feb 1993; IBRD structural adjustment at LIBOR +;	IMF programme 'off-track' from late 1997, 'revived' in early 1999; IMF calls mid-1998-2000 period of 'intense reform'; No new IMF programmes initiated after Dec 2000; in 1997 WB makes first IDA terms loans;	IMF programmes (PRGF) expire Dec 2003; WB: US$ 13 mn for sectoral projects; 10.6 mn for structural adjustment (all IDA terms)
Revelant events	Transnistria establishes separate government; Leu introduced in Nov 1993;	Remittances become largest forex source; Russian financial crisis 1998;	End of 2004 IMF declines to support the EGPRSP with concessional lending

Figure 2.5:



SOURCE: World Bank, *World Development Indicators 2002*.

Figure 2.6



SOURCE: National Bank of Moldova.

Figure 2.7

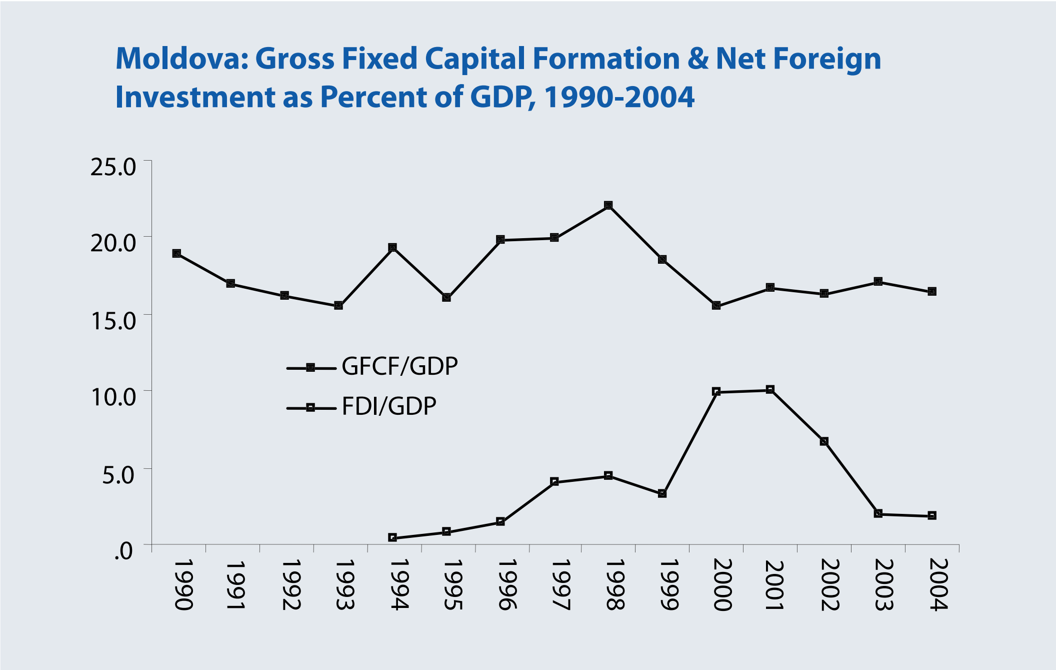
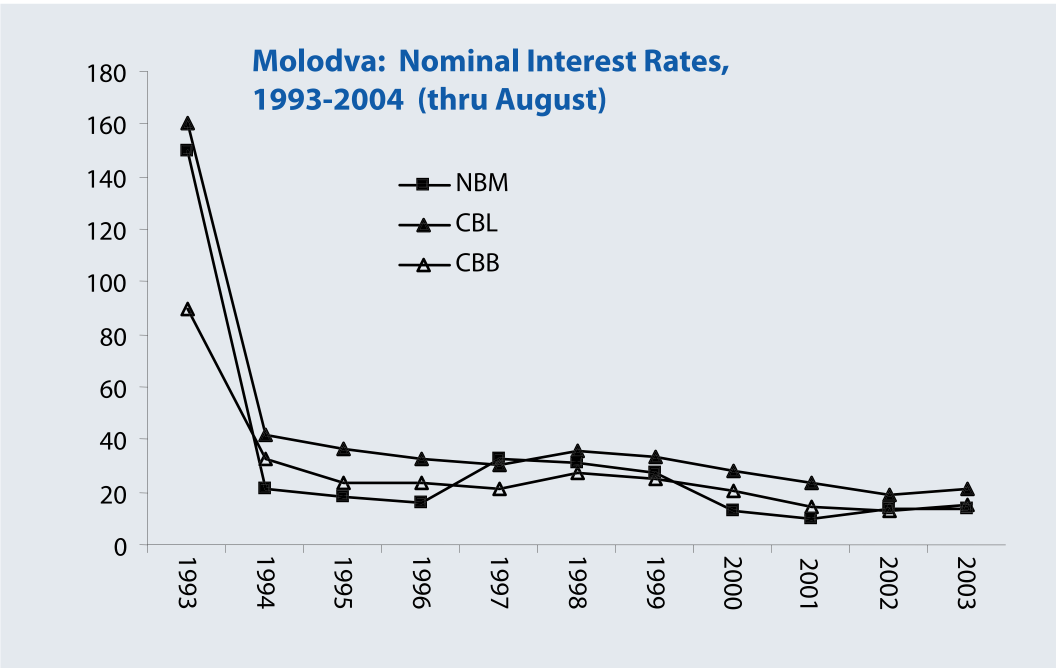
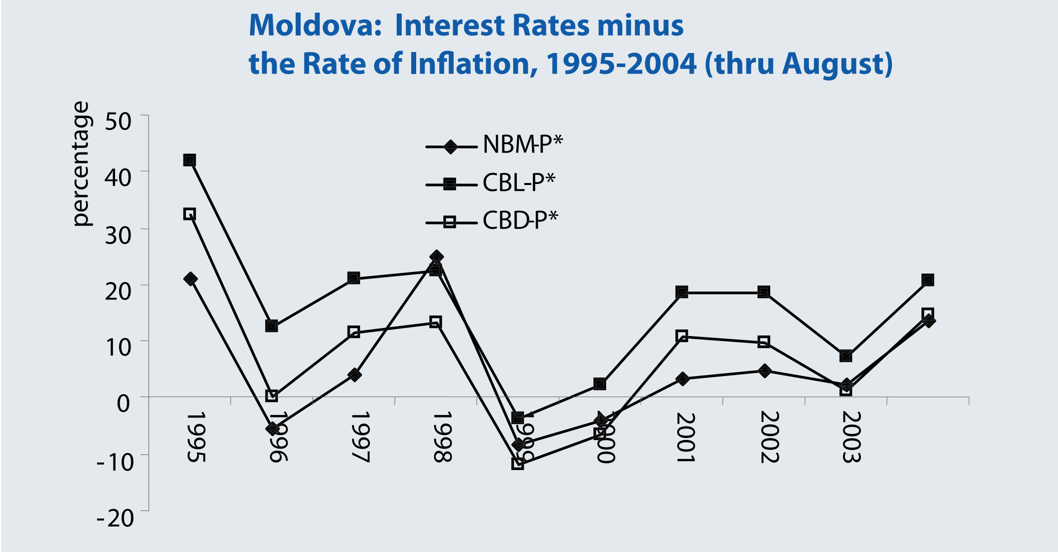


Figure 2.8



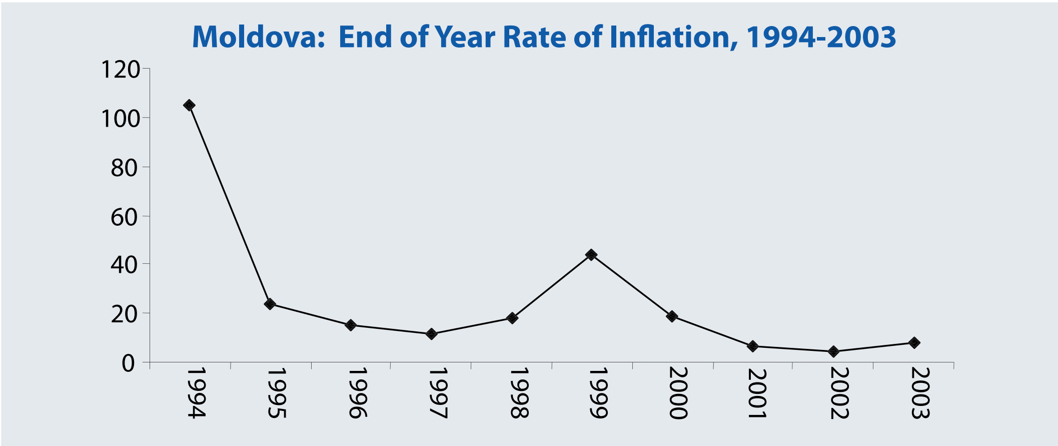
SOURCE: National Bank of Moldova.
NOTES: NBM is the National Bank of Moldova base rate; CBL is the commercial bank lending rate; and CBD is the commercial bank deposit rate.

Figure 2.9



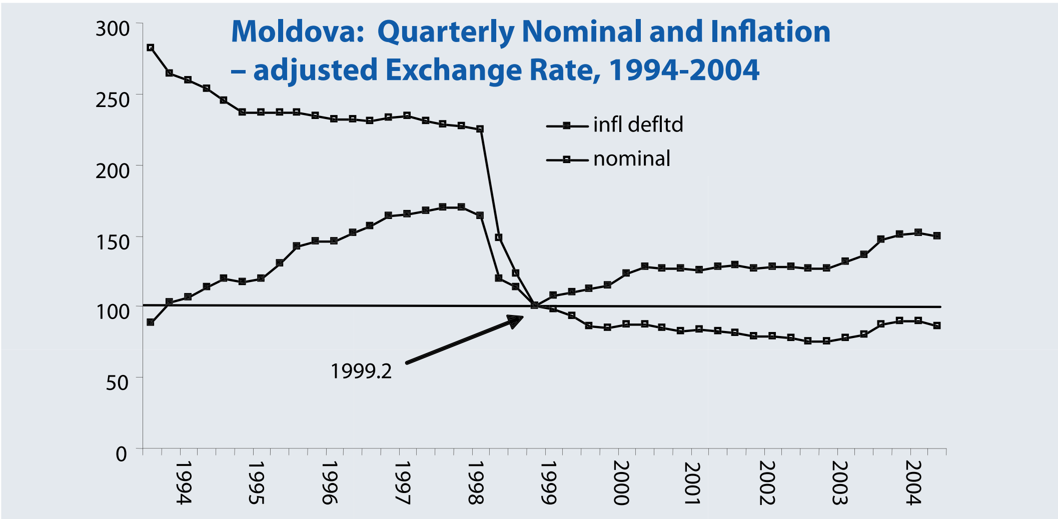
SOURCE: National Bank of Moldova.
NOTE: P* is the inflation rate. See Figure 2.8 for the other abbreviations.

Figure 2.10



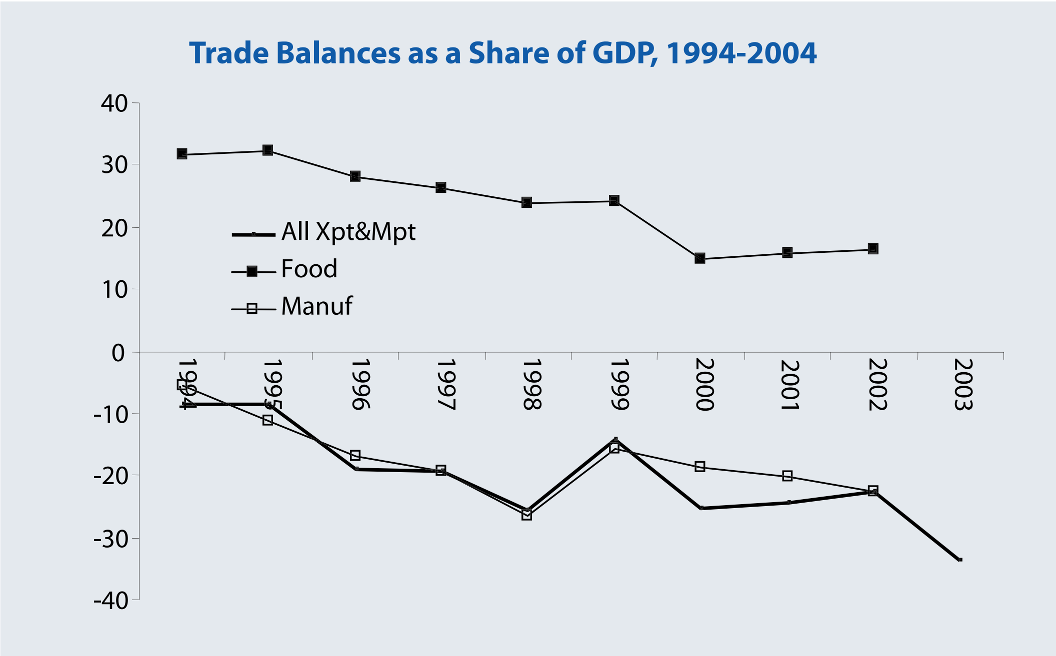
SOURCE: National Bank of Moldova.

Figure 2.11



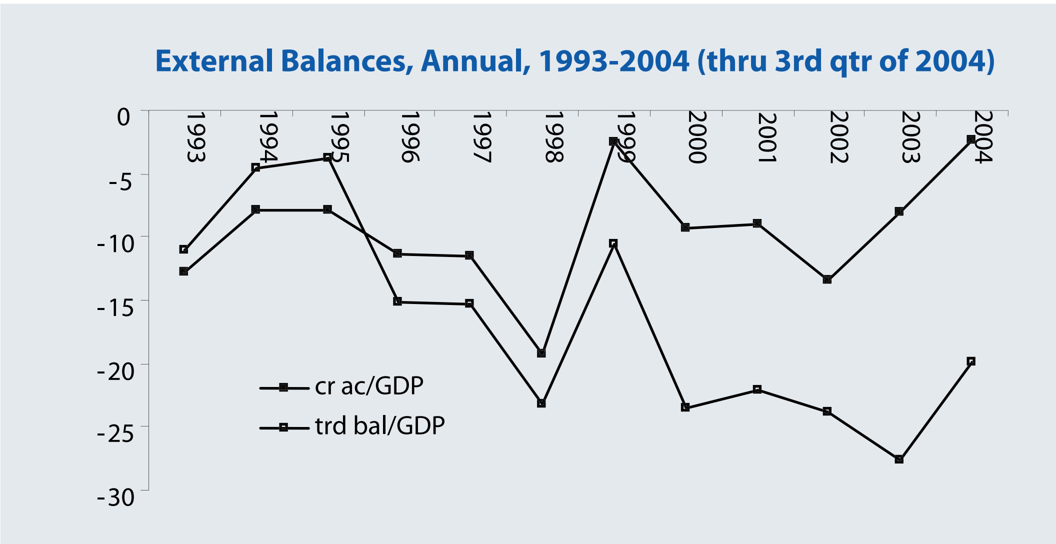
SOURCE: National Bank of Moldova.

Figure 2.12



SOURCE: National Bank of Moldova.
NOTES: Xpt&Mpt is exports and imports; and Manuf is manufactured commodities

Figure 2.13



SOURCE: National Bank of Moldova.

Annex 1. A Chronology of Moldova's External Debt

Lender	Purpose	Amount	Terms	Amount Outstanding 10/7/04
Romania 1991	Import of goods	10100	Without interest	0
USA (Program PL-480) 1992	Import of cereals	9854	2% - first 7 years; 3% - after 7 years	8212
FMC, Belgium 1991	Import of agricultural combines	1470	no information	0
European Community 1992	Import of goods; cereals, drugs, food for children	31590	LIBOR+3%	0
China 1992	Import of goods for children	3758	4%	Transformed into humanitarian aid 31/8/2001
Romania 1993	Import of oils and fuel	14400	Without interest	9400
European Community 1994	Balance of Payments	54000	LIBOR+0.1%	15798
USA (Program PL-480) 1993	Import of cereals	9904	2% - first 7 years; 3% - after 7 years	8666
Russia 1993	Reorganization of debt	88900 22955	LIBOR+1%	0 Restructured on 17/9/97
IBRD Two Rehabilitation 1993	Rehabilitation	60000 25823	CQB+0.5% variable from 4.85 to 7.8%	45143 13187
USA (Program PL-480) 1994	Import of cereals	19869	2% - first 7 years; 3% - after 7 years	18213
IBRD (SAL) 1994	Structural Adjustment	60000	CQB+0.5% (1.37%)	47022
Japan 1994	Rehabilitation	39933	4.5 LTPLR variable from 6.7 to 3.5%	25035
EBRD 1994	Promotion of export of Moldovan wines "Vininvest" LTD	17933 11543	LIBOR+1%	5249 3857
AKA Germany, 1994	Equipment for pharmaceutical complex	7922	Plafond "C" variable from 7.5 to 6.5%	6101
Sparex AG, 1995	Import of technological equipment for production of glass	4605	7.9%	0
AKA Germany, 1995	Equipment for production of glass	6867	Plafond "C" variable from 6.5 to 7.87%	1513
EBRD, 1995	Financing the private sector "Moldova Agroindbank" JSC	12000 6960	LIBOR+1%	0 0
EBRD, 1995	Financing the energy sector "Termocom" JSC	4649 4698	8.95%	2534 2560

Annex 1 (continued)

Lender	Purpose	Amount	Terms	Amount Outstanding 10/7/04
USA (Program PL-480) 1995	Import of cereals	9599	2% - first 7 years; 3% - after 7 years	8799
German Bank Kreditanstalt, I part, 1995	Medical Equipment	6483	LIBOR+0.875%	0 Restructured on 7/6/2002
Commerzbank, Germany, 1995	Financing the budgetary deficit	15000	LIBOR+0.4%; LIBOR+0.5%	0
European Community 1996	Budgetary Deficit	19000	LIBOR-0.125%	10937
USA (Program PL-480) 1996	Import of cereals	12472	2.25% - first 7 years; 3.25% - after 7 years	11979
Russia 1996	Payment for the import of coal, gas	15000	8.156%	0 Restructured in 1999-2000
IBRD (I agricultural project) 1996	Development of agricultural sector	9826	LIBOR+0.5%	8476
IBRD (PSD I) 1996	Private Sector Development	32250	LIBOR+0.5%	28899
German Bank Kreditanstalt, II part, 1996	Medical Equipment	6151	LIBOR+0.875%	0 Restructured on 7/6/2002
EBRD 1996	Rehabilitation of roads	11240	LIBOR+1%	6837
IBRD (Energy Project) 1996	Reform of energy sector	9165	CQB+0.5% (approx. 1.37%)	7786
Dresdner Bank, 1996	Financing the budgetary deficit	10400	LIBOR+2%	0
Commerzbank, 1996	Financing the budgetary deficit	15000	LIBOR+0.4%	0
Merrill Lynch, 1996	Financing the budgetary deficit	30000	LIBOR+2%	0
Gazprom'140, 1996	Paying back the debt to Gazprom	140000	7.5%	0
Russia 1996	Restructuring the debt from 1992-1993	91676	LIBOR+1%	91676 - Moldova; 30388 - Transnistria
AKA Germany, 1996	Import of equipment for processing sugar beets	3821	Plafond "C" varies from 6.0 p.a. to 6.5%	2523
Dresdner Bank AG, 1996	Financing import of petroleum products	23610	LIBOR+1.75%	0
IDA (SAC-II) 1997	Structural Adjustment	45163	0.75%	48493
IBRD (SAC-II) 1997	Structural Adjustment	25000	LIBOR+0.5%	23377

Annex 1 (continued)

Lender	Purpose	Amount	Terms	Amount Outstanding 10/7/04
EUROBOND 1997	Financing budgetary deficit	75000	9.875%	32740
Hewlett Packard 1997	Electronic equipment for schools	18426	6%	0
Drezdner Bank AG, 1997	Import of technological equipment for construction of pharmaceutical complex ("Perfuzon" JSC)	3107	LIBOR+2%, 6% p.a. - after restructuring	2431
TMC Padovan, Italy, 1997	Procurement and installation of technological lines for wine processing "Chirsova" JSC	1980	8.5%	894
EBRD, 1997	Rehabilitation of Chisinau City water supply, "Apa Canal Chisinau" JSC	21021	LIBOR+1%	16725
Hunday, Korea, 1997	Procurement of microbuses "Taxi-Service" JSC	620	10%	0
EBRD, 1997	Financing of the project on petroleum terminal	15296	LIBOR+1%	17985
AKA, Germany 1997	Equipment and payment for services in production of ceramics	9366	Plafond "C" Varies from 5.75 to 6.5%	10235
IBRD (Educational Project) 1998	Development of education	9745	CQB+0.75% Variable from 5.75 to 1.36%	9010
German Bank Kreditanstalt, III part, 1998	Medical equipment	6103	LIBOR+0.875%	0
IDA (Educational Project) 1998	Development of education	4682	0.75%	5143
IDA (PSD-II) 1998	Development of managerial capacity	7379	0.75%	8131
IDA (Cadastre) 1998	Development of land surveys	12690	0.75%	13790
IDA (Rural) 1998	Rural Development	4905	0.75%	5418
Tureximbank 1998	Water supply	15000	LIBOR+2.25%	8333
EBRD 1998	Institutional restructuring of "Moldova-Agroindbank" JSC	8000	LIBOR+1%	0
EBRD 1998	Financing the project on modernization of Chisinau airport	8843	LIBOR+1%	4960

Annex 1 (continued)

Lender	Purpose	Amount	Terms	Amount Outstanding 10/7/04
IDA (Moldovan Social Investment Fund) 1999	Development of social services	14231	0.75%	16017
IDA 1999	Administration of social protection	3942	0.75%	4396
IDA (SAC II) 1999	Structural adjustment	44390	0.75%	49375
Gazprom'90 2000	Payment back of Gazprom debt	63000 27000	7.5% 7.5%	0 0
IFAD 2000	Rural financing and development of small enterprises	6291	0.75%	6690
IDA, Health Care, 2000	Restructuring of health care system	6961	0.75%	7137
Kreditanstalt fur Wederauf, 2002	Restructuring	0	EURIBOR+0.875%	16229
Kreditanstalt fur Wederauf, MEC 2002	Promotion of micro, small and medium enterprises	2572	0.75%	2734
Kreditanstalt fur Wederauf, Sudzucker 2002	Creation of agro-technical service centres	320	0.75%	343
IDA (SAC III) 2002	Structural adjustment	10648	0.75%	11903
IDA (SAC III) 2002	Structural adjustment	10648	0.75%	11903
IDA (Rural) 2002	Rural development	10490	0.75%	11119
IDA (Energy II) 2003	Development of energy sector	1378	0.75%	1369
IDA (Trade&Transport), 2003	Development of transport and tourism	526	0.75%	520
IDA (Water)	Water supply	525	0.75%	540

Chapter 3:

Public Finance for Growth and Poverty Reduction

3.1 Introduction

This chapter examines the role of public finance in supporting a development strategy for Moldova that would accelerate economic growth, generate employment and direct resources toward poverty reduction. Although the Government of Moldova has already succeeded in reducing its external debt burden, the fiscal space it has in which to manoeuvre will remain limited until it is able to refinance its remaining multilateral and bilateral Paris Club debt. In order to do so, it needs greater cooperation from its multilateral and bilateral creditors, as discussed in Chapter 1. Because of its own efforts to reduce its external debt, the Government is in a stronger position when it begins negotiations with these creditors.

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

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

3.2 The Mobilization of Domestic Revenue

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

At the same time that revenues are expected to decrease, contributions to social and medical insurance are programmed to increase. Contributions to state social insurance rose from 6.4 percent of GDP in 1999 to 7.3 percent in 2003, and are projected to increase steadily, reaching 8.3 percent of GDP in 2007. Contributions to medical insurance, which were introduced in 2004, are also projected to increase by 2007.[50] The rise in total contributions to the two insurance funds projected for 2007 contrasts with the decline in other forms of tax revenues.

Revenues for social protection are increasing but not revenues to finance other essential public functions, such as providing essential public services and infrastructure. Moreover, if contributions to such funds are excessive, they can create a disincentive for employers to hire labour because they incur higher direct labour costs. In any economy in which there is widespread underemployment of labour, such a system might be inadvisable. This is especially the case if more of the financing burden is placed on workers. A preferable alternative is often to rely on general tax revenue to finance social protection.

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

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

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

Value added taxes are often recommended as a substitute for trade taxes. But a recent study of VAT taxation and trade liberalization (Baunsgaard and Keen 2004) finds that value added taxes have been successful in compensating for the loss of trade taxes, as a result of trade liberalization, only in high income countries. Middle income countries have been able to compensate for only about thirty five-fifty five percent of the revenue lost from trade liberalization. The most troubling finding, however, is that indirect taxes in low income countries have recovered none of the revenue lost from trade liberalization.

The incidence of the VAT in Moldova has shifted increasingly towards imported

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

goods and away from domestically produced goods. In 2003, VAT revenue on imports was 8.7 percent of GDP, while the revenue from domestically produced goods was 4.3 percent. This was a reversal of the situation in 1997, when the ratio for imported goods was 1.8 percent and that for domestic goods 8.8 percent. This is partly explained by a change in 1999 to a destination method of VAT taxation, which was applied to imports from CIS countries as well as others.

Another part of the explanation could be VAT refunds, which amounted to 2.8 percent of GDP 2003. Also, compared to trade taxes, sales taxation on domestic goods and services are limited in their revenue raising potential in an economy with a large informal sector. Another reason for the lack of revenue is that the minimum threshold for obligatory registration of VAT taxpayers has been raised, purportedly to make the VAT more efficient. A 2003 study of taxation in thirteen transition countries in Eastern Europe, the Caucasus and Central Asia found that in 2000 Moldova had a ten percent effective VAT rate (i.e., actual VAT collections as a ratio to the VAT base) (Stepanyan 2003, p. 15). This rate compared favourably to those in other countries, especially Russia, Azerbaijan and Georgia, but, nonetheless, it had declined from a high of seventeen percent in 1998. A similar trend characterized the VAT efficiency rate (the effective VAT rate as a ratio to the statutory rate): it had declined from eighty four percent in 1998 to fifty two percent in 2000.

Because VAT is levied on imports, foreign trade taxes as such have remained low, accounting, for example, for 1.7 percent of GDP in 2003. Part of the reason that VAT and trade taxes together are low is the establishment of free trade arrangements with countries in Southeast Europe and the CIS. Another part of the reason is that the Government has refrained from raising some import tariffs, even though it is allowed to do so under the WTO accession agreement. Moldova's average import tariff (computed as a weighted mean) was 3.9 percent in 2001 (*World Development Indicators 2004*, Table 6.6). By comparison, the weighted mean tariff was 7.3 percent in Romania, 7.5 percent in Hungary (for 2002) and 12.4 percent in Albania. For the purposes of generating badly needed revenue, rather than for trade protection, some import tariffs could be raised moderately in Moldova without violating WTO rules.

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

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

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

The Government's strategy for boosting direct taxes is to radically reduce tax rates, on the assumption that such a reduction will help broaden the tax base (see the discussion in Chapter 2). Such a 'supply side' approach to taxation will not only diminish the progressive structure of the tax system, but also run the risk of lowering total revenue. This is generally recognised: the IMF has warned, for example, against reducing the rates for direct taxes unless other forms of revenue can be generated to offset the potential losses (IMF 2002, p. 13).

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

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

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

The government has already lowered the tax rate on corporate profits. This rate was a moderate twenty eight percent in 2001, down from thirty two percent in 1997. It fell to twenty percent in 2004. By 2006, within just two years, it is programmed to drop to only fifteen percent; namely, less than half its 1997 level. This strategy is designed, in part, to induce enterprises to enter the formal economy and declare their full profit incomes. It is also designed to make Moldova an attractive tax haven for foreign investors, as allegedly happened in Ireland.

At the same time that the government sharply lowers the tax rate, it projects in the MTEF that corporate tax revenue will increase from 10.8 percent of all revenue in 2004 to 12.2 percent in 2007. However, if firms have successfully avoided a 28 percent tax rate, there is no guarantee that they will abandon such avoidance at a lower rate of twenty or fifteen percent.

Nor is it certain that foreign investors will move into Moldova principally because of low corporate tax rates. More crucial than the tax rate is the profit opportunities that the economy is generating, which in part depend on the ability of the government to use public expenditures, especially public investment, to stimulate the economy. As the economy grows and corporate profits increase, moderate rates on profit income, such as twenty five percent, should represent no significant disincentive to foreign investment.

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

The reforms projected for the personal income tax are much the same as for the corporate income tax. In 2003, personal income up to 12,180 lei was taxed at a ten percent rate, income in the range of 12,180 16,200 lei at fifteen percent, and higher income at twenty five percent. The top rate reflects a reduction from the previous high of thirty two percent in 1997. The intention is that by 2007 the tax rate for low incomes will fall to seven percent, for medium incomes to ten percent, and for high incomes to fifteen percent (see Table 3.1).

This change to very low marginal rates makes the system for direct taxes markedly less progressive. While low income persons will receive a three percentage points drop in their income tax rate, medium income persons will benefit by a five percentage points drop, and high income persons by ten, making the structure considerably less progressive in a country with high inequality. In 2003, the ratio of the middle income tax rate to the low income rate was 1.5, and that of the high income rate to the low income rate 2.5. In 2007, the first ratio will drop to 1.43 and the second to 2.14.

These changes will weaken the vertical equity of the Moldovan tax system. Those taxpayers with a greater ability to pay will enjoy relatively lower taxes. In relative terms, lower income taxpayers will be worse off. Personal income taxes as a ratio to GDP are already low in Moldova compared to other transition economies. In 2000, this percentage was 1.5 whereas the unweighted average for other transition economies was over twice as high, i.e., 3.2 percent (Stepanyan 2003, p. 16)

If the government reduces its highest marginal tax rate for personal income, this rate will be well below the comparable rates for most other transition economies in Central and Eastern Europe and the CIS (Table 3.2). For example, in 2003 the highest marginal tax rate in Bulgaria was twenty nine percent, in Romania forty percent, and in Slovenia fifty percent. Only in Bulgaria would the highest rate be within twenty percentage points of Moldova's. In Western Europe the marginal tax rates tended to be even higher: forty five per-

Table 3.1: *Personal Income Tax Rates and Targeted Changes*

Income Level 2003	Tax Rate 2003	Income Level 2007	Tax Rate 2007	Percentage Point Drop
Low Income	10	**Low Income**	7	3
Middle Income	15	**Middle Income**	10	5
High Income	25	**High Income**	15	10

SOURCE: MTEF 2004.

cent for Italy, forty nine percent for Germany, and fifty nine for Denmark (Table 3.2). Compared to other countries in the region, Moldova has programmed a potentially counter productive 'supply side' experiment with its tax system.

Table 3.2 also indicates that the highest corporate tax rate in Moldova in 2003 was already the lowest of the thirteen countries listed (2003 is the last year for which tax rates are comparable across countries). In recent years, many countries have been under pressure, or been strongly advised, to lower tax rates on businesses. There are countries that have explicitly chosen the path of low corporate tax rates in order to attract foreign investment. Ireland has a tax rate of sixteen percent on corporate income; Lithuania and Macedonia FYR fifteen percent. However, the government should carefully study these experiments in order to determine whether Moldova enjoys some of the same advantages as Ireland, and how successful some of the transition economies, such as Lithuania, have been.

The Stepanyan study found that tax revenue from corporate profits in Lithuania fell from a high of 5.8 percent of GDP in 1992 to 1.9 percent in 1996, and fell further to only 0.7 percent in 2000 (Stepanyan 2003, p. 18). In 1991, the rate on corporate profits in Lithuania was twenty nine percent and in 2000 it was reduced to twenty four percent. Exemptions, such as those on foreign investment, were also part of the problem. This same study found that in Moldova, such tax revenue fell from a high of 4.9 percent of GDP in 1995 to 1.5 percent in 2000. The unweighted average percentage for all countries in this study was 2.5 percent in 2000.

Table 3.2: *Highest Personal and Corporate Marginal Tax Rates by Country, 2003 (percentages)*

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

SOURCE: World Development Indicators 2004, Table 5.6.

If Moldova joins the European Union, it will need a tax system that generates revenue that can finance public expenditures that are comparable to the EU norm. As pointed out in the previous chapter, Moldova's entry into the EU would be undermined if it were viewed by existing members as a tax haven to which companies would relocate. In 2000, general government tax revenue was about twenty two percent of GDP in Moldova (Stepanyan 2003, p. 20). This ratio compared favourably to percentages in other low income countries such as Kyrgyz Republic (about twelve percent), Georgia (fourteen percent) and Azerbaijan (14.5 percent). But the unweighted average percentage for OECD countries was about thirty eight percent. Moldova's strategic objective should be to reach this level of taxation, not reduce it to the level of other low income transition economies.

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

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

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

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

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

In the name of making the tax system more efficient (by lowering rates), some orthodox tax reformers have sacrificed progressivity and, in the process, weakened prospects for raising revenue. But the radical version of such advice comes from 'supply side' economists who believe; without much empirical evidence, unfortunately, that lowering tax rates on personal income and corporate profits will lead to a dramatic increase in revenue. The justification is that the tax base will be broadened if tax rates are lowered, especially for high income earners. However, available evidence suggests that the base for taxation is more likely to be broadened by sustained and broad based economic growth and improved tax administration than by the lowering of corporate and personal income rates. Moldova's stated intention to radically reduce such rates is courting trouble.

3.3 External and Internal Debt Burden

The government of Moldova continues to bear a substantial external debt burden that constrains its ability to allocate public revenue to stimulate growth and reduce poverty. The external debt is a tragic legacy of its early transition period, when its average income dropped precipitously to the level of a low income country while international financial institutions did not offer it concessional terms for lending (see Chapter 2).

In 1992 the external state debt was only US$16.5 million; but by 1997 it had ballooned to over US$ 709 million (Table 3.3). It reached a peak of US$ 781 million in 2000. Since 2000, the government has worked to reduce this burden. For example, it bought back debt owed to Russia's Gazprom and the Hewlett Packard Corporation. At the same time, it sought to reschedule commercial credits held by banks and the remaining Eurobonds, and reschedule the debts owed to bilateral creditors that were not part of the Paris Club. As a result, external debt fell to about US$ 661 million in 2004, which was 25.7 percent of Moldova's GDP.

The government paid a high price by allocating funds to debt reduction that could have been used to stimulate economic growth and foster poverty reduction. Because there were no real choices, this trade off was probably unavoidable. The government can be congratulated on its success in reducing the debt to more manageable proportions but its external lenders could have facilitated this process by offering a substantial degree of debt rescheduling.

Table 3.3: *External State Debt, 1992–2004 (Million US$)*

Year	Total Debt	Year	Total Debt
1992	16.5	**1999**	661.9
1993	188.5	**2000**	781.3
1994	345.1	**2001**	699.8
1995	401.3	**2002**	724.3
1996	540.2	**2003**	751.4
1997	709.1	**2004**	660.7
1998	719.6		

SOURCE: Government of Moldova, Ministry of Finance

In the wake of government's efforts, multilateral institutions now hold sixty three percent of Moldova's external debt, and bilateral lenders thirty three percent. The remaining five percent is commercial debt. Moldova will continue to bear a substantial debt burden as long as the International Monetary Fund does not reach agreement with the government on a Poverty Reduction and Growth Facility (see Chapter 1). Without such an agreement, the government cannot begin negotiations with the Bretton Woods Institutions on its multilateral debt nor start negotiations on its Paris Club bilateral debt. Endorsement of a nationally owned Poverty Reduction Strategy Paper should be a sufficient condition for such an agreement.

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

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

Table 3.4: *Debt to Export Ratios of Selected Low Income Transition Economies*

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

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

In present value terms, Moldova's external debt represented 126 percent of its exports in 2002 (Table 3.4). This places it in the ranks of other low income transition economies (Armenia, Georgia, Kyrgyz Republic, Mongolia, Tajikistan and Uzbekistan) that have a substantial external debt burden. While such debt burdens severely hamper a country's ability to accelerate economic growth, almost none of these countries qualify as 'severely indebted' under the HIPC definition. Only Kyrgyz Republic, with a debt to export ratio of 221 percent, would qualify. The debt problems of this group of low income countries have received scant attention. Despite promises, the international development agencies have not launched initiatives to significantly relieve the debt burdens of these transition countries although such an initiative should be a priority.

Faced with the policies of multilateral and bilateral creditors, the Moldovan government was forced to find its own solutions. It managed to pay off its trade credits, renegotiate its Eurobond debt, and conclude agreements on bilateral debts with Romania and Turkey. It is not without irony that such countries have been more generous in debt relief than much richer countries. The government also bought back its RAO Gazprom debt owed to the Russian Federation, retiring in 2004 an outstanding debt of US$ 140 million, and bought back its debt to Hewlett Packard, retiring an outstanding debt of US$ 11 million.

Despite the absence of support from international financial agencies, the Government has succeeded in making its total debt burden, both external and domestic, more manageable. In 2004, its total state debt represented about thirty seven percent of GDP, down from fifty seven percent in 2002 (Table 3.5). The decline in external debt, from 44.4 percent in 2002 to 25.7 percent in 2004, accounted for almost all of the fall in total debt.

Table 3.5: *Total State Debt, External and Domestic (% of GDP)*

Type of Debt	2002	2003	2004	2007 (Proj.)
Domestic Debt	12.5	10.6	11.6	8.3
External Debt	44.4	36.0	25.7	25.9
Total Debt	56.9	46.6	37.3	34.2

SOURCE: MTEF 2004 and Ministry of Finance.

Once discussions with its Paris Club bilateral creditors and its multilateral creditors begin, the government should be in a stronger position than previously to negotiate debt relief or refinancing. Russia, a Paris Club member, is Moldova's largest creditor, followed by the United States. Germany, Italy and Japan hold relatively small outstanding loans. Some relief on multilateral debt is appropriate since Moldova was forced to accept commercial terms on its borrowing when it should have received concessional terms. Moldova became eligible for concessional terms only in 1997, well after its deep economic crisis. Some multilateral institutions have argued that earlier in the 1990s the Moldovan government did not want concessional terms for their loans. This story is indeed difficult to believe. Even if it were true, this does not absolve the same multilateral institutions, as public institutions, of the responsibility of having provided the government with better technical advice on the kind of loans that it should have assumed.

In order to finance its budget gap in the 1990s, which was generated primarily by external debt servicing, the government had little alternative but to increase domestic debt. This causality, namely, the external debt burden forcing the shouldering of more domestic debt at high interest rates, emphasises the problematic nature of the original IBRD loans, since they did not create the assets that could generate an income stream sufficient to enable the government to repay them (see Chapter 2). The government has subsequently reduced the domestic debt, from 12.5 percent of GDP in 2002 to 11.5 in 2004, and projects a further reduction to 8.3 percent in 2007 (Table 3.5). This would be accomplished by reducing security issues, lengthening the maturities, and repaying outstanding credits to the National Bank of Moldova. Domestic debt became a serious problem during the Russian financial crisis when the government was forced to borrow from the central bank in order to finance the expenditures that were not covered by revenue. In 1998, the domestic debt hit a peak of 17.2 percent of GDP.

Receipts from privatisation have not been, and will not be, adequate to reduce the domestic debt. There are few state owned assets to be privatized; and, in any case, it is not clear whether privatization would be the best policy choices. Another option, which the government has begun to pursue, is to lengthen the maturity of its domestic securities by issuing bonds with 2-3 year maturities instead of Treasury Bills, which have maturities up to one year.

In late 2004, there was an unexpected surge in demand for Government T bills, perhaps due to remittances, even though their interest yield was below the inflation rate. As long as the maturities of securities lengthen and the demand for them maintains itself, servicing the domestic debt should be manageable. The problem is that such financing is being used, in effect, to reduce the external debt instead of financing public investment; in other words, the policy of increasing indebtedness without asset creation continues in another form.

In the mid 1990s, the government had to face a significant external debt problem that was caused by a rise in the cost of energy imports from Gazprom, a privately owned Russian company. This debt had its origins in 1994 when Gazprom raised its gas prices to world levels, and began charging more for its gas supplies to Moldova Gas, which is also a private company. Because the government refused, on equity grounds, to raise user prices to households and also to some productive activities, it began to incur large losses. As a result, the government had to assume the debt owed to Gazprom (which rose to 11.2 percent of GDP in 1994). This debt increased alarmingly in 1998 and 1999. However, the government bought back this debt in 1999, paying US$ 36.4 million for US$ 140 million worth of outstanding debt stock. When this debt emerged again after 1999, the government paid US$ 50.1 million in 2004 in order to retire the new outstanding debt stock of US$ 114.5 million.

In summary, the government has managed to bring its external and domestic debts under control. It has done so at a high cost, one that could have been substantially lessened had official lenders been more forthcoming with assistance. The Bretton Woods Institutions could have easily been more generous in their dealings with Moldova. As noted in Chapter 1, they delayed approval of the Economic Growth and Poverty Reduction Strategy until late 2004, and when the endorsement came it did not allow for access to key concessionary instruments. Should full support be received, especially from the IMF, the government could seek reduction and rescheduling of the external debt owed to multilateral institutions and Paris Club bilateral creditors. Given the recent history, the mutual lack of confidence between the government and its multilateral creditors certainly cannot be attributed only to the former.

Since the government has endured much of the pain in reducing the commercial and non Paris Club bilateral components of its external debt, it should be in a stronger position to lobby for favourable terms for rescheduling the remaining part. The starting point for such negotiations is the general recognition that Moldova should have been provided with concessional lending, instead of non concessional lending, beginning with the first loans it contracted in the early 1990s. Thus, the accumulated interest rate differential between the two should immediately be forgiven. In addition to the interest rate differential between IBRD and IDA terms, the maturities of the non concessional debt should immediately be rescheduled. Houston terms for rescheduling, which are hardly generous, would involve, for example, stretching the debt over 20 years with a 10 year grace period. The result would be that the net present value of Moldova's debt should drop substantially, greatly facilitating the prospects for growth and poverty reduction.

Reaching a settlement would be in the interests of both the government of Moldova and its creditors, and serve the commitment of both to growth and poverty reduction. It would benefit the Moldovan people because the funds that have been earmarked for debt servicing could have been released to finance badly needed public investment in economic and social infrastructure and the provision of essential public services.

3.4 The Composition of Public Expenditures

As stated above, the government of Moldova has implemented a relatively tight fiscal policy, with a deficit near zero during 2001-2002. In 2003, it ran a surplus of 1.6 percent of GDP, and it is projected to run a surplus of over one percent of GDP in 2004. Taking into account expenditures for the social insurance and medical insurance funds, total public expenditures were, according to the MTEF, 33.8 percent of GDP in 2003. The ratio of current expenditures to GDP rose during 2000 2003, to a peak of 27.2 percent (Table 3.6), and is projected to rise further to 29.6 percent in 2007 (Table 3.7). Conversely, the ratio of capital expenditures to GDP is slated to decline from 5.1 percent in 2000 to three percent in 2007 (Table 3.7). This does not bode well for sustained economic growth in Moldova, because well defined public investment is a powerful stimulus to private investment. Moreover, if it is too low, private investment tends to be depressed.

Part of the problem is that one third of public capital expenditures have been financed by external grants. But Moldova has no Public Investment Programme to coordinate these investments. In order to advance national development priorities, public investment should be reliant on the mobilization of domestic revenues. This depends in turn on the mobilization of domestic savings, which remain very low in Moldova. Beyond revenue generation, there is a more general problem of the lack of accumulation of capital, both private and public. Moldova's heavy reliance on external assistance to finance public investment contributes to the lack of coherence of public investment, partly driven, as it is, by domestic priorities and partly by donor priorities. Moldova needs a consolidated and coordinated Public Investment Programme that is more ambitious, more geared to investing in growth and more focused on poverty reduction.

Table 3.6: *Composition of Public Expenditures (% of GDP)*

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

SOURCE: MTEF 2004.

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

Within current expenditures, the public sector wage bill is projected to increase only slightly, from 7.7 percent of GDP in 2000 to 8.1 percent in 2007. Between 1998 and 2002, there was a fifteen percent reduction in the number of employees, with eighty percent of this reduction comprising employees in education and health. This is surely not a pro poor approach to public sector reform. However, the Government did raise the wages of these low income employees. Nonetheless, overall wages in the public sector remain low.

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

Table 3.7: *Current and Capital Expenditures (% of GDP)*

Expenditure Category	2000	2001	2002	2003	2004 (App)	2005 (Proj)	2006 (Proj.)	2007 (Proj.)
Current Expenditure	25.1	23.8	27.1	27.2	28.1	29.9	29.7	29.6
Capital Expenditure	5.1	3.6	5.0	4.6	4.0	4.0	3.3	3.0
Total Expenditure	36.4	31.4	33.9	33.8	34.9	36.4	35.0	34.3

SOURCE: MTEF 2004.

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

An examination of trends in expenditures on social and economic services during 2000 2004 underscores the relative neglect of the economic services. Expenditures on both education and health increased during this period (Table 3.8). By contrast, expenditures on agriculture, transport and communication edged downward. Overall, the share of social services in GDP increased from 19.6 percent to 21.3 percent while the share of economic services declined from 4.3 to four percent. Economic services are programmed to decline further, to 3.2 percent in 2007, while social services will remain virtually constant at 21.4 percent.[51]

Table 3.8: *Public Expenditures by Sector (percent of GDP)*

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

SOURCE: MTEF 2004.

Given the importance of agriculture and agro industry to future growth and exports, the lack of expenditures on economic services for these sectors, particularly public investment, is not optimal. Moreover, the lack of public investment in infrastructure for transport, communication and energy indicates an erosion of the basis for long term sustainable growth. Rural and agricultural infrastructure is essential to stimulate Moldova's industrial development as well as promote its agricultural development. Even compared to neighbouring transition economies, Moldova is allocating relatively less attention to economic services and relatively more to social services. While this is due in part to the depth of the recession that the country has endured, such an allocation of public resources suggests that the full recovery from such a catastrophic decline will be more protracted than anticipated.

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

3.5 Poverty, Inequality and the Budget

Public finance, both expenditure and taxation, can be used as a powerful and effective instrument of poverty reduction in Moldova. The country has the institutions and the human capacity to use the public budget to make growth more pro poor. Among the principal constraints, however, are: 1) the low morale of civil servants, which over time should be raised by improved salaries, and 2) the need for a greater focus by government on more pro growth and pro poor expenditures and taxes.

Two concrete measures would facilitate pro poor budgeting. First, the Ministry of Finance could institutionalise a poverty impact assessment of each annual budget. At the initiative of the government, parliament might pass legislation mandating that such an assessment accompany the presentation of each year's budget. The poverty assessment could include an evaluation of the likely impact of the budget on income distribution.

Also important would be a gender impact assessment of the budget, which would be focused on, but not limited to, the impact on poor women. Such an assessment would make more transparent any necessary expenditure and taxation trade offs involved in directing benefits to men and women. One reason that discrimination against women in budgets continues is that the gender impact of expenditures and taxes is not transparent, making public debate difficult. There are standard methodologies for such assessments, which are mandated for several donors and lenders in their assistance programmes.

Chapter 4:

Poverty, Inequality and Policy in Moldova

4.1 Introduction

Poverty in Moldova shares features with other transitional economies of the region, but has specific aspects that require country-specific analysis and policies. The main findings of the analysis suggest, first, that both income-poverty and human-poverty sharply increased since 1991. With few exceptions, they still have not recovered their pre-transition levels. While most of the current official and academic literature on poverty in Moldova goes back to 1997, a complete understanding of the trends, causes and responses of the present predicament, and of the ground that needs to be recovered, requires placing the poverty problem into the proper historical context, i.e., 1989-2004.

Second, unlike in the developing countries of Latin America affected by the debt crisis of the 1980s, but similar to what observed in other members of the former Soviet Union, the trends in different indicators of well-being show a marked co-variation. This suggests that the increase in poverty is of a deep structural and multifaceted character. Third, this strong co-variation among indicators of well-being shows that poverty in Moldova is combines 1) low income and consumption levels, 2) high mortality and morbidity, 3) declining access to subsidized health and education, 4) growing social exclusion, 5) limited participation in decision-making, and 6) disempowerment of the poor. The problem cannot be solved only by policies that focus on reduction of income poverty, but requires a broader approach.

Fourth, the poverty profile that emerges from the analysis of available data and the review of existing studies points to a picture observed in several other economies in transition. Poverty is largely a rural problem, seventy percent of the total, affecting agricultural labourers and small farmers. Households in small single-industry towns were affected even more severely, though their number is comparatively small. Demographic factors, such as gender, old age and disability, were not dominant causes of poverty, though they matter for some groups, for example, families with three or more children. Also, poverty differentials by level of education are not significant except for those with higher education. This finding, typical of the economies in transition, is not characteristic of other developing countries with similar income levels per capita.

Fifth, the causes of such huge deterioration in well-being between 1991 and 2000, and of the modest improvements recorded subsequently, resulted from the collapse during 1992-1996, the subsequent crisis of 1998-99 and the marked growth rebound that began in 2001. It has frequently been ignored in the poverty literature on Moldova that the initial rise in income poverty resulted from an increase in inequality during that period (1991-1996, see Chapter 2). Likewise, future prospects for poverty alleviation would depend on the ability of policy to foster a more equitable pattern of growth.

In light of the multiplicity of the factors affecting living standards, a serious attack on poverty requires interventions on several fronts, through pro-poor growth characterized by with greater investment in agriculture (see Chapter 7), higher employment intensity of growth (discussed in Chapter 6), supportive labour market policies (again Chapter 6), and the mobilization migrant remittances (Chapter 5).

4.2 Trends in Poverty

Moldova experienced poverty before the introduction of the market reforms. Because of full-employment, an egalitarian distribution, and price stability during the socialist era, income-poverty was low and mainly affected marginal groups. Atkinson and Micklewrigth (1992) suggest that in 1989 the proportion of workers with a wage below the 'official minimum' was about fifteen percent. Closer inspection reveals that the situation was less positive than suggested by the income statistics, because the distribution of real consumption was affected by queuing and the rationing of most goods, dual distribution systems, parallel markets and regional differences in the supply of consumer goods. These factors had a marked inequality effect on the distribution of consumption poverty and family well-being, though pre-transition poverty was minor compared to the situation in the mid-1990s.

Poverty in Moldova started to rise in 1990-91, just before the official onset of the transition. Its increase over the subsequent fifteen years is indisputable, though the level and trend for 1989-96 can be estimated only approximately, through indirect methods. Despite a severe deterioration in living conditions during 1992-1996, poverty was recognized politically only in 1997 when the first random HBS was introduced.

During 1991-1996 the country was devastated by a severe depression (see Chapter 2), the collapse of Comecon which provoked a large increase in energy prices, the internal conflict of 1992, and floods in 1992 and 1994 that had a severe effect on agricultural and food processing. This period was characterized by a sharp and protracted decline in GDP per capita and a marked increase in income inequality (again, see Chapter 2). Although no precise information is available, one can tentatively estimate that as a result of the economic collapse,[52] hyperinflation and a sharp rise in inequality, the poverty headcount ratio (PHR) rose during this period, to reach sixty-five to seventy percent by 1995, and possibly even higher levels during the early years of hyperinflation. The catastrophic collapse of output was responsible for well over half of the increase in poverty over 1991-1996. During this period, however, poverty rose also because of a marked worsening of the distribution of income.[53] The Gini index of the distribution of gross earnings rose from 0.250 in 1989 to 0.392 in 1992, to stabilize at broadly that level over 1993-95. Hyperinflation, a marked shift in relative prices and the compression of public social expenditure also contributed pushing upwards poverty.

During 1997 and the first half of 1998, output recovered slightly (growth of 1.6 percent in 1997), while inequality reached a Gini coefficient of .42. Though no direct data are available, indirect estimates (based on the method in footnote one), it is likely that during these two years poverty declined, from about sixty percent to the low fifties. The modest recovery was reversed during August 1998 to the

52 A tentative way to reconstruct the poverty trend consists in making use of the relation derived from Bourguignon (2002) who showed that any percentage variation in the poverty headcount ration (DPHR/PHR) can be mathematically decomposed in the weighted algebraic sum of the percentage change in mean income (approximated by GDPc/GDPc) and the percentage change in the distribution of income (approximated by Gini/Gini). The weights (i.e the poverty-growth and poverty-inequality elasticities) can be drawn from Table 3 while the 1997poverty incidence can be used to work out retrospectively poverty incidence in 1992.1996. Valeriu Prohnitski elaborated an interesting alternative method that leads, however, to results not compatible with the observed PPMU findings for 1997-2202.

53 Though the income distribution data based on randomized surveys are available only since 1997, the data on the distribution of earnings (that over 1997-2002 tend to covariate considerably with the income and consumption inequality indexes obtained from income survey data.

end of 1999, when the economy contracted by six percent in 1998 and three percent in 1999. This coincided with the Russian financial crisis, and the ensuing one hundred percent devaluation of the rouble that affected Moldavian exports and emigration to Russia. During 1997-1998 poverty and extreme poverty rose to over seventy and sixty percent, respectively (World Bank 2004b, p.80).

After 2000, a sustained economic recovery finally began. Inequality declined somewhat between 2001 and 2002, and markedly in 2003, as Table 4.1 shows. The 2003 improvement was characterized by a sharp rise in the income share of the bottom quintile, despite the decline of agricultural output in the same year (Economic Statewatch Q2/2004), confirming the favourable effect of a broad based output expansion (6.3 percent) on income distribution and poverty. As a result of these effects, as well as price stability, the poverty headcount ratio fell, and at the end of 2002 reached forty percent, according to PPMU estimates and 48.5 percent according to those by the World Bank. In 2003 the PPMU poverty rate fell to around twenty-six percent, and extreme poverty to fifteen percent, showing a poverty alleviation elasticity of growth of over five, a value that warrants some probing even taking into account the clear improvement in inequality that took place in 2003. As consumption inequality fell by three points (from 39.5 to 36.6 over 1999-2002, see Table 4.2), some thirty percent of the poverty decline was induced by the improvements in the distribution of consumption expenditure. This estimate may in part be a statistical illusion due to the better accounting of food stocks on farms.

These preliminary conclusions about the fall in poverty incidence are cast into question by the results of the self-assessment of the poverty status carried out in August 2002. This survey indicated that sixty-eight percent of households interviewed considered themselves in poverty, a much higher rate than that estimated by the PPMU (40.4) or the World Bank (48.5). These differences can be interpreted in several ways. The first observation is that the poverty lines used by the PPMU and the World Bank are too low, and therefore underestimated the real level of poverty as perceived by households. A second explanation is that the interviewees associate the term ‘poverty’ with a ‘low income status’ that differs from the PPMU and World Bank poverty line, that focus only on severe deprivation. However, contrary to the ‘objective’ measures that showed higher poverty rates in rural areas, the subjective poverty responses were higher in urban areas (sixty six percent of the households) than in rural (fifty eight percent). This might be explained by the lack of access to land by many urban residents, or the result of higher expectations about the minimum level of consumption by urban residents.

Table 4.1: *The quintile distribution of disposable income, 1998-2003*

	1998	1999	2000	2001	2002	2003
1st quintile (Q1)	3.9	4.5	4.6	4.3	4.6	5.8
2nd quintile (Q 2)	9.7	9.8	10.4	10.4	10.4	11.2
3rd quintile (Q 3)	15.0	14.7	15.1	14.8	15.0	15.5
4th quintile (Q 4)	22.6	22.0	21.9	21.7	21.6	21.8
5th quintile (Q 5)	48.8	49.0	48.0	48.8	48.3	45.7
ratio Q5/Q1	12.1	10.9	10.4	11.3	10.5	7.9

SOURCE: Bulletin Statistic 2004, ‘Aspectele privind de trai al populatiei’, p.27, DSS. Numbers may differ from those in Chapter 2 due to differences in sources used.

Table 4.2: *Inequality for various measures of income (Gini coefficients)*

	1997	1998	1999	2000	2001	2002
Income inequality (disp. inc)	44	44	44	42	43	42
Consumption inequality		40	40	38	38	36
Wage inequality		43	44	39	39	43

SOURCE: author's compilation; Note: Income and consumption inequality (computed on the bases of HBS) are from PPMU (2003), while the wage inequality data are taken from the Transmonee database.

The poverty gap shows even bigger variations over time than the poverty and extreme poverty rate. In 1999 it reached thirty percent, very high, observed only in severely deprived developing countries, then fell to almost one third this value by 2002. Even greater improvements were observed for the extreme poverty gap, indicating major improvements among those remaining in poverty. While a poverty gap of thirty percent may increase the risk of death and higher morbidity among the poorest population groups, one of ten to fifteen is not likely to raise death rates and severe under-nutrition, though it may still reduce access to health care, school enrolment and access to other essential services.

From a programme and policy perspective, it is essential to know whether over time poverty affects different or the same people. If the latter, the solution to the poverty problem is more complex, since by definition it is structural in nature. Indeed, the 'permanently poor' may adopt unsustainable coping strategies such as the distress sale of assets (land, houses, working animals and consumer durables), the withdrawal of children from school, and socially and humanly destructive measures such as prostitution, trafficking in organs of the body, and child labour. These carry considerable risks, entrench poverty among those who adopt them, raise the probability of its intergenerational transmission, and give rise to a culture of poverty and dependence.

The panel component in the Moldavian HBS makes it possible to identify the poverty dynamics for individual households and, by aggregation, to evaluate whether poverty in Moldova is predominantly transient or permanent. During 1997-2002 eighty six percent of the population experienced poverty for at least one year. For many of them poverty was a transitory phenomenon: 15.1 percent of households were in poverty for one year, 20.7 percent for two, 24.1 for three, and 26.5 percent remained in poverty all four years. This group of persistent hard core poor consisted primarily of families with many children, with a head with less than college education, or of elderly unrelated people living together (World Bank 2004b). However, the incidence of year-to-year repeated poverty showed a decreasing trend: forty-four percent of poor over two consecutive years in 1997-98 to forty two in 2000-01, and forty in 2001-02.

The data about widespread ownership of land and dwellings, levels of education and the broad coverage of basic social services would suggest that a class of 'hardcore poor' had not yet arisen in Moldova to any great extent. Even the 26.5 percent estimated to be permanently poor during 1997-2002 may not have been be asset-poor, education-poor and health-poor, if the poverty gap is not large. Some indications to the contrary emerge. For example, in small cities and remote rural areas, home appliances and heating systems fell out of order, dwellings were not maintained, educational enrolments and health expenditures on newborns were reduced, and assets were sold. The persistence of low income and high inequality might cause long term apathy among the poor, loss of trust on the possibility of exiting 'the vicious circle of poverty'. The rise in remittances since 1999 might have reduced this fatalism and the process of poverty entrenchment.

4.3 Characteristics of Poverty

A major feature of poverty in Moldova was its concentration in rural areas and small towns, including in 2002, eighty nine percent of the poor. This concentration of poverty in rural areas and towns rose steadily, during both the collapse and recovery. In 2002, people living in small towns had a 2.2 higher risk of falling into poverty, and a 2.9 greater risk of being in extreme poverty than the residents of the large cities (Table 4.3). The poor were also disproportionately located in small towns characterised by a failed or difficult-to-restructure industry. The ratio of the poverty gap between towns and cities is even larger (five times greater). This meant that towns had proportionately more poor than the cities, and that the poor in towns are poorer than the cities.

Poverty in small towns were linked to the pattern of industrialisation during the Soviet period, in which a few medium-large industries were established in each town, which resulted a highly un-diversified structure similar to that found in Western European countries and the United States during the same period. With market liberalisation, these mono-industries showed limited ability to compete, not least because of lack of investment for restructuring. In addition, while the people in the rural areas could to some extent sustain their food consumption through subsistence agricultural, this was not possible for people in small towns.

While poverty was most acute in small towns, the majority of the poor lived in rural areas. The share of population in the countryside is close to two thirds of the total (Table 4.3), and the incidence of poverty among this group is the second highest. For people in rural areas, the relative risk of poverty and extreme poverty in relation to the cities was very high, 1.8 and 2.2 in 2002. The causes of poverty in rural areas resulted from three factors. The first was the extremely limited employment opportunities outside agriculture. The overwhelming majority of rural residents farmed the plots assigned to them by the land reform, or hired themselves out as rural labourers on larger farms. The statistics in Table 4.3 show that while the share of poor and extremely poor among the rural labourers fell, because of the decline in the rural population, the opposite was observed for farmers (see Chapter 7).

However, among the three main regions (North, South, Centre), poverty was not uniformly spread. The results show considerable differences in the incidence of poverty among districts (*judets*). There is evidence (PPMU 2002) that the poverty and extreme poverty incidence may vary considerably also between the cantons (*raions*) of the same *judets*, which would make the task of geographical targeting of public expenditure for anti-poverty interventions complex, detailed and expensive. Given this intra-regional and intra-*judet* heterogeneity, the identification of the major poverty groups at the national level is not sufficient for the design of effective poverty alleviation policies. Further effort at mapping poverty at the local level may be required.

In many countries, the poor are often found in 'incomplete' families, in families with unfavourable dependency ratios, in families headed by pensioners, or including the disabled. This is only partly true in Moldova, whose demographic features that differ markedly from those of other countries with the same income per capita. In Moldova, the bulk of poverty is not explained by high dependency ratios. Table 4.3 suggests that the incidence of poverty and extreme poverty rose steadily with the increase in the number of children, and that poverty headcount ratio is higher than the national average starting with families with two children. The incidence of poverty appears to fall steadily with the age of the person. However, some of these results are ambiguous, as they were obtained by the World Bank (2004) making use of 'per capita equivalence scales'.[54] This assumes that children, adults and elderly have the

54 We could not locate similar data from the PPMU which uses in the computation of the poverty rates the standard OECD equivalence scales same consumption needs, and that there are no economies of size in consumption. These two assumptions are not generally accepted in the poverty literature.[55]

Table 4.3. *Incidence of poverty and extreme poverty by main socio-economic characterstics*

	Poverty rate			Extreme poverty rate			Share popul.	Share of poor			Share of extremely poor		
	1997	1999	2000	1997	1999	2000	2001*	1997	1999	2000	1997	1999	2000*
National	47.4	71.2	48.5	37.5	61.3	37.8	100	100	100	100	100	100	100
1. Location													
rural	49.1	75.8	51.6	39.1	65.4	4.5	.627	.638	.668	.678	.665	.698	.682
small towns	61.0	8.3	62.5	49.9	72.0	52.4	.162	.157	.183	.200	.202	.190	.254
large cities	31.6	5.4	28.5	23.3	4.8	18.3	.210	.206	.148	.122	.133	.112	.064
2. Regions													
North		74.2			66.7		.301		.314			.328	
Centre		66.2			53.4		.569		.529			.496	
South		86.0			83.0		.130		.157			.176	
3. Hh size													
children	35.6	6.5	36.8	26.2	49.2	26.8	.401	.263	.341	.347	.235	.321	.324
one	47.9	73.0	53.0	38.0	64.5	41.9	.283	.292	.290	.300	.292	.298	.304
two	55.5	81.3	6.9	45.7	72.5	48.1	.232	.292	.266	.241	.303	.274	.244
three	61.3	87.9	75.9	51.2	75.8	65.4	.066	.105	.081	.090	.111	.081	.100
≥ four	71.7	89.7	87.5	59.9	84.6	83.3	.017	.048	.022	.031	.049	.023	.037
4. Age													
0-15	54.0	78.6	59.2	43.9	69.4	48.1	24.7	.294	27.2	.264	.301	.280	.276
16-59	45.7	69.1	46.4	36.1	59.7	36.5	61.6	.589	59.8	.616	.588	.600	.622
60 & over	41.7	67.4	42.4	31.1	54.5	29.7	13.7	.116	13.0	.120	.110	.121	.102
5. Hh head													
male	47.5	72.6	49.6	37.3	62.5	38.8	73.3	.737	.747	.703	.731	.747	.705
female	46.8	67.3	46.2	38.1	58.0	35.4	26.7	.262	.252	.297	.269	.253	0295
6. Education													
hh head													
illiterate	.509	.781	....				.010	.017	.011	....			
primary	.461	.732	.527				.108	.130	.111	.116			
secondary	.507	.743	.442				.759	.776	.793	.744			
higher	.289	.490	.244				.123	.075	.085	.058			
7. Work													
employed	47.0	71.1	49.6	37.3	61.8	39.5							
farmer	49.1	74.0	53.9	36.8	62.5	45.0	.103						
agr laborer	53.5	79.9	66.2	42.6	7.9	54.0	.251	.075	.107	.207	.073	.105	.217
n-agr labor self	43.1	65.6	4.9	34.3	56.8	3.9	.373	.318	.282	.207	.319	.290	.260
emp	34.8	51.8	33.1	29.3	44.3	24.8	.022	.321	.346	.294	.320	.346	.278
other	38.9	68.5	25.4	31.4	63.1	21.1	.020	.015	.016	.015	.016	.016	.014
unemployed	64.4	73.6	57.0	58.2	7.0	49.7	.015	.018	.020	.010	.015	.020	.011
pensioner	46.5	71.2	46.8	36.6	58.4	33.9	.231	.253	.230	.252	.251	.220	.229
8. Sector													
agriculture	51.6	78.2	59.1	4.2	68.6	48.7	.336						
industry	43.3	59.6	38.0	33.4	52.2	29.7	.069						
construction	45.6	72.7	44.6	41.0	65.0	35.9	.055						
trade	46.3	65.3	43.6	38.5	54.4	33.3	.064						
trans&com	45.9	7.0	37.8	35.0	57.8	25.6	.036						
other	24.3	53.7	32.5	19.3	44.9	24.3	.015						
state admin	36.4	67.1	27.8	27.1	55.0	21.8	.028						
education	35.6	62.5	33.8	27.8	53.1	23.7	.039						
pub.services	44.1	62.7	52.2	37.4	57.3	41.2	.051						

SOURCE: derived from WB (2004b)

NOTES: *Computed using the population shares for 2001 as those for 2002 were unavailable.

55 Furthermore the sensitivity test presented in WB (2004, p.75) is not entirely satisfactory as it fixes the total poverty rate rather than letting it change with the change in poverty scale.

Nevertheless, the evidence is strong that there was a greater incidence of poverty and extreme poverty in families with three or more children. The members of these families are poorer than the average, because either the child allowance system did not reach all households, because the allowance was insufficient to lift the family out of poverty, and because the parents would be poor even if they had no children. These families are a comparatively small proportion of the total (8.3 percent). The average number of children per family fell dramatically after independence, in line with a drop in the total fertility rate from 2.3-2.4 in 1989-1991 to 1.2 in 2002. Greater poverty incidence among large families may mean that poverty is associated with unemployment or part-time employment among women who must care of their children. This problem might be solved by child care and labour market policies that facilitate women's employment. Be as it may, the elimination of poverty in large families, an issue that should receive priority, would not solve the bulk of the poverty problem in Moldova.

Many of children face a higher than average risk of poverty due to the characteristics of the families in which they live, whatever may be the size of thee family. Children living in single-parent families accounted for about six percent of all children. The share increased due to changes in divorce and adult mortality rates and, especially, because of the migration. PPMU (2002) suggests that the share of such families among the long-term poor grew, and accounted for over one-fifth of the persistently poor in 2002. Infants in rural areas represented another group particularly exposed to the risk of poverty. Because of the greater time needed for child care, feeding and parental supervision, households with pre-school children faced a higher risk of falling into poverty compared to households with school-age children. The design of child allowances should take this into consideration.

In contrast, the incidence of poverty in families with two children might have been overestimated by the World Bank. Many of these families were in poverty, but possibly with no greater probability than the national average. It is unclear whether the main cause of this problem is the low income received by the adults, due to a low participation rate or low pay, or the demographic factor represented by two children.

Poverty among pensioners was high, but not significantly different from the national average (Table 6), while their risk of extreme poverty was a bit lower than the national average. Similar conclusions emerged from Table 6, panel 4, that indicates the risk of poverty and extreme poverty was lower among the over-sixties than on average.[56] These results are confirmed by logit regression analysis done by PPMU (2002). That the level of poverty among the pensioners in Moldova is not particularly high is due to the almost universal outreach of the state pension inherited from the socialist era, which survived the fiscal collapse of the first decade of transition. The future of such system has been questioned, and as a result the government has introduced (but implemented in a limited fashion) a compulsory pension insurance system.

This average picture could be misleading, as pensioners were a heterogeneous group. Pension levels varied considerably among recipients, with war veterans, long service and other privileged categories enjoying higher than the average, and

56 This is true a fortiori if one considers that the poverty estimates of the World Bank were obtained on the basis of 'per capita equivalence scales' while one could argue that the caloric consumption of an elderly non-active person are somewhat lower. On the other side, the WB (and PPMU) poverty line have not – or only partially - corrected for the increased health expenditure incurred by the households – and particularly by the elderly who are more disease prone than children and adults – following the cuts in public expenditure on health that intervened between 1997 and 2001 and that unloaded a considerable part of the cost of health on the families.

those on minimum and survivor pensioners receiving much less. As a whole, the pension transfers are mildly regressive. In addition, the incidence of poverty among pensioners varies between the rural and urban areas. While rural pensioners face a lower than average risk of poverty, as they often can count also on a plot of land, the opposite is true in the cities where the pensioners that take part time work were less numerous. Finally, there is evidence that the risk of poverty among pensioners rises steeply with their age as, likely, their income earning ability falls. The available data from the 2003 PPMU poverty diagnostic for 2001 suggest that the incidence of poverty among the disabled is not greater than for the general population, a rather surprising result requiring further verification. Their inability to earn income was compensated in part by a disability payment similar to the old age pension, and covered than 115 thousand people in 2002.

Table 4.4. *Average pension per month & number of pensioners by types of pensions*

Type of pension	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
	Number of pensioners					Average pension/month (current Lei)				
Old age	555.970	535186	516861	495841	472556	87.6	85.0	86.1	143.3	169.8
- minimum	21824	63331	59097	9	0	60.4	64.9	64.9	65.0	….
- privileged 2	13176	13348	12807	12	5	102.9	100.5	101.2	165.2	208.0
Disability	112374	111735	113022	115526	115220	80.6	80.3	82.1	139.6	163.1
Survivor	35963	34493	37470	36012	33515	65.4	64.4	63.1	88.3	107.3
Long service	787	803	774	778	716	126.0	127.3	142.8	171.2	225.4
Chernobil acc.	1375	1595	2049	2178	2175	393.5	396.6	577.3	576.9	559.9
Memo Item										
Poverty lines										
WB						128.9	179.2	234.8	257.3	270.7
PPMU						104.7	130.0	175.2	193.1	201.8
Average wage						250.4	304.6	407.8	555.8	691.9

SOURCE: Ministry of Labour and Social Protection (2003): Annual Social Report

International experience shows that female-headed households are frequently face a higher than average risk of poverty. Female headed household, and women more generally, face much higher risks of poverty because of a variety of discriminations affecting them in the labour market and in access to some social services such as education. However, while gender discrimination was robust in Moldova, the HBS and other data indicate that women headed households face a slightly *lower* level of poverty than male headed households. If this finding is valid, it might be explained by three factors: women's level of education was equivalent to men's (a legacy of the Soviet era), the industries that collapsed primarily hired men; and women headed households may be a proxy for households receiving remittances.

In most developing countries, the level of education is a good predictor of the risk of poverty, but was less so in the economies in transition. Until 1991 education in Moldova was provided universally, free of charge to all those until sixteen years of age. In 1999 the illiterate were only one percent of the population, those with primary education 10.8 percent, those with different types of secondary education 75.9 percent, and those with higher education 12.3 percent (Table 4.3, panel 6). While secondary education is typically a route out of poverty in a low income countries, this cannot be the case in Moldova, where the share of people with this degree level was quite high, while the demand low because high unemployment and low-paying jobs. The risks of poverty only fall only for those with higher education.

Widening access to higher education would at best create the supply side conditions for poverty reduction, for there must be jobs for the educated to take. The fundamental employment problem in Moldova, at all levels of education, is demand, not supply of qualifications. While the highly educated were less likely to be unemployed, a substantially larger number of tertiary graduates are unlikely to do more than raise the average qualifications of the unemployed and create an 'inflation of qualifications' in the labour market.

As one would expect, in Moldova the unemployed face a higher risk of poverty and extreme poverty. The unemployment data upon which Table 6 is based must be viewed as highly unreliable.[57] Where Table 6 implies an unemployment rate of less than three percent, the DSS unemployment survey found it to be over eight percent for the same year (see Chapter 6). Further, both sources did not attempt to capture 'discouraged works', those who abandon the search for work due to lack of success.

An analysis of the poverty incidence data by sector of employment (Table 6, panel 8) confirms that poverty is highest in agriculture. It also reveals that households whose head was employed in the sector and, including education, were generally better-off. Their poverty risk was fifteen percent lower than the national average, but this was not true for those employed in 'other public services'. Generally speaking, workers employed in the private sector have a somewhat higher risk of falling into poverty than those working in the public sector, primarily because the majority of private sector employees is employed in agriculture.

In principle, ownership of land, other physical and financial assets, durable goods, and access to credit should reduce poverty, as the household could use them to smooth its consumption over time. In Moldova, asset ownership was significantly correlated with poverty. Multilogit regression analysis conducted by PPMU (2003) on the 2001 HBS indicated that while ownership of farmland itself and of simple household appliances were not associated with a lower risk of poverty, the size of housing, ownership of costly appliances, and bank savings were. In other words, expensive appliances and size of land holding were a proxy for income level. Lower poverty risk was also correlated with borrowing from banks and access to electricity. From a policy perspective, the poverty-reducing impact of credit should be further investigated, to determine whether bank borrowing is cause or effect of lowering poverty risk. If it is cause, creation of programmes that facilitate access to borrowing could be pursued.

Several studies have shown that migrant remittances can have a beneficial effect on income, poverty, though they may negatively affect other aspects of well-being. Moldova illustrates well this trade-off, as it had one of the world's highest proportions of the labour force working abroad, migrant remittances on GDP and private transfers on disposable income. Migration effects are discussed in detail in the next chapter. Here it should be noted that the generally recognised underestimation of remittances at the household level and in the aggregate may lead to some overesti-

57 In 2002, for instance, the unemployed had a 25 percent higher risk than the employed of being extremely poor.

mation of poverty, because the HBS show that the ex-post impact of remittances in reducing poverty was large; as many more families would have remained below the poverty line if the possibility of migrating had not been there. As a rough estimate, migration reduced the incidence of poverty in 2002 by some twenty to twenty-five percentage points.

4.4 Changes in Inequality

Inequality in Moldova has attracted relatively little attention either at the official level or in public discussion. As noted in Chapter 2 and in this chapter, above, from 1991 to 1997, income inequality rose rapidly. The relationship between inequality and poverty can be shown quite simply for given a constant poverty line. The percentage change over time in the proportion of the population living below the poverty line, ($\Delta PHR/PHR$), can be decomposed into the percentage change in GDP per capita (*DGDPc/GDPc*), and the percentage change in income distribution (measured by an appropriate index, such as the Gini, DGini/Gini), plus an interaction term *IT*. By definition:

$$DPHR/PHR = - DGDP/c + DGini/Gini + IT$$

The headcount poverty rate (PHR) declines with rises in GDP/c, and the elasticity varies widely across countries, and even within countries over time, depending on the degree of inequality of the income distribution, the extent of its clustering around the poverty line, and the ratio of the poverty line to the average income per capita (Table 4.5). Not incorporated in the equation is the possibility that a rise in inequality, or its persistence at high levels, as in the Moldavian case, may affect the rate of growth of GDP per capita itself, thus depressing further the prospects for reducing poverty. There are several reasons for this 'growth–dampening effect'. First, when inequality increases substantially, the work incentives of the poor fall. Second, high inequality reduces access to education and health care for a large portion of the population. Third, when capital markets are imperfect and the poor cannot borrow, investment opportunities are concentrated in the hands of the rich who invest in activities with decreasing returns while the poor, who would engage in more productive activities, cannot realize their productive potential. Fourth, high inequality may reduce taxation and the access to key public services that are essential for growth and social cohesion, as has happened in Moldova. Finally, a high degree of social stratification can create political instability, undermining the effectiveness of public policy.

Part of the inequality rise of the early 1990s in Moldova was unavoidable, given the changes in economic system and output collapse, and the subsequent protracted stagnation. But part of it was dysfunctional, related to the weakness of the legal and institutional development of the first years of transition, which was unable to prevent the absolute and relative accumulation of wealth in the hands of a few. As mentioned above, these inequality changes were an important contributor to the surge in poverty rates in the first decade of transition. Policy seeking to reduce poverty must aim at reducing the level of inequality. As discussed in Chapter 3, taxation and public expenditure are powerful instruments to achieve this.

The transition to the market economy induced large shifts in the structure of household income, which affected the overall distribution of income. Indeed, the income components characterized by low inequality (social transfers and wages) fell, and those characterized by high inequality (profits, rents, entrepreneurial incomes and incomes from the sale of agricultural products) rose. The most dramatic shift was the collapse of the wage economy, with a fall in the wage share between 1991 and 1997 of twenty-seven points, and by another two points by 1999, some recovery during 2000-2002. The share of social transfers on total disposable income dropped from 19.2 in 1991 to 11.6 percentage points in 1997 (Table 4.5). In parallel, the privatization of state assets and the land, liberalisation of markets, and the spread of commercial activities permitted created opportunities for income earning, which were successfully seized by a small portion of the population. All this raised the share of informal sector incomes, mixed incomes, profits and other types of capital income. For example, the share of self-employment income doubled between 1991 and 2000. The income from property and rents probably rose as well, although it is obvious that these categories are understated in the statistics in Table 4.5. In addition, the share of transfers (of which remittances were a major component) doubled between 1991 and 2002.

Table 4.5. *Structure of household income , by main income types, 1989-2002 (percentages)*

Income type	1989	1991	1993	1995	1997	1999	2002	Gini range
Wages and salaries	66.3	57.1	46.7	59.0	36.7	33.8	36.2	.35-.45
Self employment	14.9	15.1	26.2	12.4	36.7	39.6	32.0	.45-.60
Social benefits total	11.3	19.2	8.3	7.3	11.6	10.7	13.4	.25-.30
- pensions	na	na	na	4.8	10.7	9.9	12.1	na
- child allowances	na	na	na	1.7	0.4	0.3	0.3	na
- maternity	na	na	na	na	na	na	na	na
- unemployment	na	na	0.1	0.1	0.1	0.1	0.1	na
- social assistance	na	na	na	0.7	0.4	0.4	0.9	na
Property income	na	na	na	0.1	0.2	0.1	0.1	.50-.60
Other(incl. transfers)	7.5	8.5	18.5	20.0	14.6	15.7	15.5	.45-.55
Memo item: no. of households	1325	1325	1327	1325	5876	7651	6159	

SOURCE: author's estimates on Transmonee database

Prior to the transition Moldova had an egalitarian wage scale, with a Gini coefficient for the distribution of gross earnings in 1989 a low 0.25. Wages differed little within and among sectors. Wage inequality rose sharply in 1992 reaching a Gini index of .40, and between 1992 and 1999 the distribution of wages worsened further, reaching a Gini value of .44 (to decline to .39 in 2001). The standard explanation offered for such a large shift in earnings inequality focuses on the adoption of new wage settlement rules that, unlike during the socialist era, put a premium on qualifications and skills; i.e., a relative wage argument. It emphasises also that the rising demand for new skills (computer specialists, accountants, foreign language specialists, financial analysts, bankers, etc.) was not matched by supply, leading to scarcity and rapidly rising wages (Vecernik 1994, World Bank 1994). In addition to these, overall wage dispersion in Moldova increased because of a rise in inter-industry wage inequality that was hardly justified by differences in skills and experience. Sectors in which wages rose relatively were finance, followed at considerable distance by electricity, gas and water, public administration, and industry while the sectors that suffered the largest losses were agriculture, health, education and, in recent years, trade (see Chapter 6).

Had the general level of wages fallen only moderately, it might be possible to lend some credence to the standard explanation. Real wages fell by sixty-to-seventy percent in the first half of the 1990s, and considerable imagination is required to attribute this to a relative change in the demand for skills. A much more credible explanation presents itself: the collapse of the demand for labour, with wage levels further depressed by the virtual absence of trade unions that could protect the bargaining power of workers.

4.5 Inequality and poverty alleviation

We can now consider how much faster poverty would fall if Moldavian policy makers had introduced policies to restrict the growth of inequality. This can be illustrated with a simple arithmetical exercise that calculates the impact of different growth rates and income inequality levels on the poverty incidence. Using them most recent distribution data, 2002 is taken as the base year, with the calculations generated through 2007. Three growth rates are assumed: four percent (the average rate recorded during the recovery of 2000-2002); an 'Asian Tiger' growth rate of eight percent per year; and slow growth of two percent. The exercise assumes two alternative levels of inequality of the distribution of net disposable income, the early 2000s Gini value of .42, and a lower value of .35, that is close to that observed in Poland, Hungary and Vietnam. Also, it is similar to that of relatively unequal Western market economies, the United Kingdom, the United States and Italy, and higher than that of egalitarian developed market economies, Austria, Belgium and Sweden. Among developing countries, this value is close to those in South Korea and Taiwan, where the distribution of assets and access to education have been egalitarian, credit markets efficient, and the labour force fully employed.

Table 4.6 calculates poverty incidence over the years 2003 to 2007 for various combinations of GDP growth and income inequality. The results of this calculation show that the fastest way to cut poverty in half by 2007 requires in generating a sustained and rapid growth of GDP in the range of eight percent, without a further deterioration in the distribution of income (see columns 2 and 3 of the table).[58] Though not impossible, this outcome might be difficult to achieve because of the imbalances it might generate in the balance of payments, investment financing, and institutional capacity. Similar levels of poverty, 26.8 versus 25.6 percent, would be achieved if Moldova grew at a more achievable and more egalitarian four percent a year. This would require rapid broad-based growth in rural areas and small cities that was highly employment generating, as well as in the two major urban areas of the country. Poverty incidence would fall by almost forty percent from the 2002 level (fourth column), if the four percent growth of GDP was achieved in a sufficiently equitable way, i.e. with levels of inequality similar to those of the UK and Italy. This an objective would be implicitly requested of Moldova as part of the *acquis communautaires* to be satisfied for a possible application to and eventual entry into the European Union. Under this scenario poverty incidence would fall to 30.6 percent by 2007.

Poverty incidence would remain pretty high in the low growth scenario of two percent, and even a moderate level of inequality would contribute substantially to poverty alleviation. The beneficial effects of lower inequality would be significantly amplified by robust growth, and remain modest with slow growth. Thus, both growth and inequality are essential for poverty reduction, and that any policy seriously aiming at this objective must include both mechanisms; growth alone would be insufficient; greater equality alone would also be insufficient.

58 Even more impressive results could be achieved if this 'Asian tiger' rate of growth could be combined with a decline of the Gini coefficient from 0.42 to 0.35, i.e. from rather high to medium levels of inequality.

Table 4.6 *Poverty incidence for different assumptions on growth rates and inequality levels (percentages) Initial Headcount Poverty Rate (2002) = 48.5%*

	Growth = 8% Ineq = .42	Growth = 8% Ineq = .35	Growth = 4% Ineq = .42	Growth = 4% Ineq = .35	Growth = 4% Ineq = .30	Growth = 2% High ineq = .42	Growth = 2% High ineq = .35
PAEG*	1.5	2.2	1.5	2.2	2.8	1.5	2.2
2003	42.7	40.0	45.6	44.2	43.1	47.0	46.3
2004	37.5	32.9	42.8	40.3	38.2	45.6	44.3
2005	33.0	27.1	40.3	36.8	34.0	44.3	42.3
2006	29.0	22.3	37.8	33.5	30.1	42.9	40.4
2007	25.6	18.4	35.6	30.6	26.8	41.6	38.6

SOURCE: author's calculations, using poverty alleviation elasticities of growth taken from Kakwani and Song.
NOTES: PAEG is the 'poverty alleviation elasticity of growth'. In the table, the elasticity is kept constant, though with growth the ratio (z/m) of the poverty line (kept constant) to the average income per capita should fall, leading to an increase in paeg. This effect may be negligible for growth rates of two and four percent and over a few years, but not so much in the case of a growth of 8% over 5 years. In this specific case (columns 1 and 2) – that has been neglected for simplicity – one would expect paeg to rise by about a third in relation to the value indicated in the third line of the table.

Annex 1. Statistical Sources

Most of the information used in this chapter comes from micro data on poverty incidence and utilisation of social services derived from the Household Budget Surveys conducted since 1997 by the Department of Statistics and Sociological Studies and elaborated in the form of Reports on Poverty in Moldova (2000, 2001 and 2002) by the Poverty and Policy Monitoring Unit (PPMU) of the Ministry of Economy. Several data are also drawn from the 2003 Public Expenditure Review and the 2004 Poverty Assessment of the World Bank, the UNICEF-IRC Transmonee database[59], the 2003 Statistical Yearbook, and a long series of independent studies undertaken in recent years by a few United Nations agencies, the IMF, World Bank, bilateral development agencies and several Moldovan research centres.

With a few exceptions, the statistical information available in Moldova is comparatively abundant and of adequate quality, and allows one to reconstruct relatively accurately the poverty trends and features of this country. In particular, thanks to the assistance provided by the UNDP and World Bank, the country can count on a comparatively large amount of information on poverty and inequality trends and on their immediate causes. Random surveys of relatively good quality have been taken since 1997 while smaller, non–ran-

59 The Transmonee database (see www.unicef-icdc.org/) reports standardized data for the period 1989-2003 for all countries of the former European socialist bloc. The information covered concerns (i) indicators of human well-being (mortality, mobility, education, nutrition, child abandonment, crime incidence, etc.), (ii) their determinants (income, income structure and distribution, social transfers, family formation, social expenditure and service provision, relative prices, deciles tabulations of Household Budget Surveys, and so on) and (iii) background information on the macroeconomy, population and so on. For every year and country, the database includes about 1500 data points that are provided to Unicef-ICDC on a regular basis and according to a standardized template by the Central Statistical Offices of the region.

dom and non comparable (but still useful) information exists for the prior years. The routine data compiled regularly by the Department of Sociology and Statistics are also relatively abundant and detailed and help in reconstructing the poverty picture in Moldova. The main problems affecting them derive from the division of the country, following the conflict of 1992. While some indicators refer to the whole country, others relate only to the area controlled by the Moldavian government, where the majority of the population live. Though the division of the country occurred in 1992, the population series were adjusted only in 1998.

The analysis of the policy and non-policy determinants of income-poverty and non-income poverty is, in contrast, more tentative in part because of data problems (household surveys were introduced only in 1997) are and in part because different models of poverty emphasize different aspects of the problem (e.g. individual characteristics of the households affected vs. public policies). The area where the analysis is most deficient concerns the impact of different policies (especially macroeconomic and institutional but also, if to a lesser extent, development and social protection ones)[60] on the immediate determinants of poverty rates and various social indicators. The methodologies for this kind of macro-micro analyses are not yet fully establishe d and required the ability to combine different files. Finally, reasons of space, do not allow this chapter to deal adequately with the 'perceived indicators of well-being' derived from consultations with the poor' through anthropological studies and sociological surveys. This is a major drawback as emphasized by the current 'qualitative-quantitative' debate on poverty measurement (Kanbur 2003), is a major source of intellectual and policy enrichment.

Prior to 1997, when a randomized HBS comprising about 6.000 households has been introduced and taken since then every quarter Moldova did not dispose of a regular randomized system for collecting data on household incomes and expenditures. It could count, however, on yearly surveys (affected by sampling bias) of about 1350 households that provide some information, not immediately comparable however with that generated by the new household surveys. It was impossible to measure the degree of inequality of the distribution of income or to construct a socio-economic profile of poverty on the basis of randomly selected micro-data. All this poses a serious problem as a proper evaluation of poverty trends and anti-poverty measures and objectives should use 1989/91 as a baseline and not 1997 (as currently done) as all indicators in that year were already much worse than in the immediate pre-transition period. Whenever possible, the analysis goes back to 1989/91.

The country does not have an officially sanctioned poverty line. Several national and international agencies and researchers have produce poverty data, starting from the PPMU, the World Bank, the DSS and some researchers. All these institutions and scholars recognize that poverty is a multidimensional phenomenon encompassing numerous aspects of well-being and that requires therefore a variety of gauges, income or consumption-based, assets-based, capabilities-based and so on. Among the income/consumption-poverty concepts that have been used in the comparatively large literature in this area one finds the following concepts: (i)

60 The panel component in the HBS makes it possible to analyse the evolution of household well-being and the long-term incidence of income poverty and vulnerability and to gauge the poverty impact of shocks and policy changes. However, the usefulness of these data for policy analysis would increase substantially if they could be couples with the routine data collected by various branches of the public administration (about service supply, coverage, utilisation, costs, benefits incidence and so on). Such combined data would especially be needed for the evaluation of existing or planned social protection programs.

absolute (normal and extreme) poverty lines (ANPL and AEPL), that have been built in normative, empirical or participatory manners, (ii) relative poverty lines (also in this case to denote normal or extreme poverty, RNPL, REPL that in this case were by necessity built in a normative way), and (iii) subjective poverty lines (SPL). The method of construction of these poverty lines is briefly reviewed hereafter, so as determine their applicability and usefulness in analyzing poverty changes in the Moldavian context.

There are three main producers of poverty estimates, all making use of the HBS data produced by the DSS, i.e. the Policy Poverty Monitoring Unit (PPMU) of the Ministry of the Economy, the World Bank (WB) and the Department of Statistics and Sociology (DSS). Poverty is calculated by two absolute measures, 'normal' and 'extreme'. The Department of Statistics and Sociology has developed in a normative way following Government Decision 902 of August 28, 2000, involving a broad 'minimum consumption standard' that includes all the goods and services that a normal family ought to consume to conduct a decent life. The 'absolute normal poverty line' (ANPL) is then fixed as 50 percent of such 'minimum consumption standard', after standardizing all members of the households in adult equivalent terms using the OECD equivalence scales that assigns a weight of 1 to the head of the family, 0.7 to all other adults and 0.5 to children.

In the PPMU approach the absolute extreme poverty line (AEPL) proposed is set equal to the cost of 2282 Kcal a day generated by the food products effectively consumed by the people in the second to fourth consumption deciles. The prices used to determine the Lei cost of the poverty line are an average of the unit values paid by the poor for the quantities purchased. Adjustments are made for differences in rural and urban prices. Unlike the World Bank approach, PPMU used the OECD equivalence scales in order to standardize the consumption of different family members into adult equivalent units. The ANPL assumes the presence of a non-food basket, which is determined on the basis of the effective goods consumed by the population close to the extreme poverty line.

The AEPL developed by the World Bank (2004b) corresponds to the cost per adult/day of 2100 calories (multiplied by thrity to standardize it on a monthly basis) where the foods included in this caloric basket correspond to ninety items effectively consumed by the poor i.e. people in the third to fifth deciles of the distribution of per capita consumption expenditure. This national poverty line amounted in 2002 to 171.6 Lei per person/month. No equivalent scales were used to standardize the consumption expenditure per capita into adult equivalents, while different unit values are used to take into account rural-urban price differentials.

The World Bank ANPL was obtained by adding an allowance for tobacco and drugs, clothing and footwear, health care, education, transport and communications and entertainment (but not utilities, housing and consumer durables) corresponding to some average of the effective consumption of households in the third to fifth deciles (Signoret 2004 in World Bank 2004b). For 2002, this added another 30.2 Lei per person/month to the poverty line. Also in this case, no equivalence scale was used to standardize the consumption expenditure into adult equivalent units, while the same rural-urban price adjustments were carried out.

Though relative poverty lines are notoriously of little use for tracking the evolution of material deprivation in low income societies and though they can lead to wrong policy conclusions (as in case of sharp recessions accompanied by a decline in inequality or, as happened in Moldova in 2002, in case of a rapid expansion accompanied by a deterioration in income distribution) both the World Bank and the PPMU have ventured in the development of such poverty lines that were used, *inter alia*, in official documents such as the PPMU (2003) 'Poverty in the Republic of Moldova 2000':

The 'relative poverty line' used by the PPMU was set at the level of fifty percent of the average household consumption expenditures per adult equivalent. The equivalence scales used are the same as in the case of the absolute poverty lines. In turn the 'extreme relative poverty line' is the value of forty percent of the average equalised household consumption expenditure. This line was set at the level of fifty percent of the mean household consumption expenditure per capita, in terms of adult equivalents, or 210 Lei.

In turn, the 'relative poverty line' used by the World Bank (2004b, p.51) was set at sixty percent of the median equalised per capita expenditure per year. The PPMU has also calculated a 'subjective poverty line' (SPL) following the subjective approach developed by Bernard van Praag at the University of Leiden. In this approach the households are asked where they can make ends meet easily, not so easily, with difficulty and so on. In addition, various groups of households are asked the amount of money they think is sufficient not to be in poverty. This information allowed PPMU to estimate several subjective poverty lines (see Table A4.1).[61]

This approach has a number of informational advantages, as it allows to understand the people (rather than the government's or World Bank's or that of the UN) perceptions of what it means to be poor and can therefore be relevant for the development of anti-poverty policies. Its main problem is that the perception of poverty may be influenced by several factors such as the national economic trend, expectations about the future, climatic changes, observation of 'economic distance' in relation to other households or individual emotional changes, i.e. factors that are independent from the changes in material circumstance of the people interviewed. In any case, such approach can be a good complement to the dominant ANPL or AEPL one.

While the broad trends and features of poverty in Moldova identified on the basis of the numerous poverty lines are broadly consistent and allow a relatively clear analysis, and while the literature produced in this field by the PPMU and other national and international bodies is truly impressive, the current approach to poverty measurement in Moldova is still perfectible in a few regards. In particular, it might be possible to remove a number of methodological problems concerning the determination of the level of poverty and the ranking of poverty incidence and intensity among different groups. Furthermore, the data for Moldova suffer from measurement and quality problems that may weaken some of the conclusions arrived at on the basis of the present datasets and procedures. The main problems can be summarized as follows:

Too many concepts of consumption poverty are being used in the analyses on Moldova produced by national and international institutions.[62] Table 4A.1 includes twelve poverty lines, and a few more could be listed. As noted, some of these measures (as the RNPL and REPL) area not useful in the Moldavian context and should be abandoned. Likewise the international poverty line of US$ 2.15 a person/day is not useful as it was estimated on the basis of information from about 20 developing countries that are

61 Brought to the extreme, this approach implicitly entails the development of 'individual poverty lines' as the perception of poverty and minimum consumption needed to escape it, may differ substantially from one individual to another.

62 PPMU computes and publishes also a large number of synthetic measures of inequality (decile ratios, Gini, enthropy, Atkinson, Theil, etc.) that are not used in the subsequent analysis.

Table A4.1. *Poverty lines, incidence of poverty, extreme poverty and the poverty gap.*

	1997	1998	1999	2000	2001	2002	2003
A. Poverty lines (all in Lei per capita/month in current prices)							
(i) absolute poverty line (food share in parenthesis)							
- normal poverty line PPMU	....	128.9 (78)	179.2 (78)	234.8 (78)	257.3 (78)	270.7 (78)	-
- normal poverty line WB	99.3 (86)	104.7 (84)	130.0 (83)	175.2 (84)	193.1 (85)	201.8 (85)	-
- normal poverty line DSS	-	-	-	-	....	....	....
- internat. Poverty line US$2.15 WB	85.0 (?)	91.6 (?)	127.6 (?)	167.5 (?)	183.9 (?)	193.7 (?)	-
- extreme poverty line PPMU	...	101.0 (100)	140.4 (100)	183.9 (100)	201.5 (100)	212.0 (100)	-
- extreme poverty line WB	85.5 (100)	88.4 (100)	107.8 (100)	147.5 (100)	163.4 (100)	171.6 (100)	-
(ii) relative poverty line							
- relative poverty line PPMU							-
- relative extreme pov line PPMU						210	-
- relative poverty line WB							-
(iii) subjective poverty line							
- subjective poverty line PPMU							
1 person household	-	-	-	301.2	-	-	-
3 persons household	-	-	-	279.0	-	-	-
5 persons household	-	-	-	269.3	-	-	-
B. Poverty Incidence							
- normal poverty line PPMU	...	52.0	73.0	67.8	54.6	40.4	26.0*
- normal poverty line WB	47.4	61.6	71.2	70.6	62.4	48.5	....
- normal poverty line DSS	-	-	-	-	51.2	42.2	....
- international poverty line WB	43.4	57.7	67.6	67.1	58.4	44.6	....
-extreme poverty line PPMU	....	37.4	59.7	52.2	38.0	26.2	15.0
-extreme poverty line WB	37.5	51.7	61.3	60.9	52.0	37.8	....
- relative normal pov. line PPMU	-	23*	23*	23.0*	23.8	22.9*	....
- relative extreme pov. line PPMU	-	-	-	-	13.5	-	-
- relative normal pov. line WB	....	....	....	....	....	....	....
- subjective poverty line	-	-	-	-	-	84.2	-
- self evaluation by the population	-	-	-	-	-	68.0	-
C. Poverty Gap							
- normal poverty line PPMU	....	19.5	32.3	27.0	19.3	12.4	....
- normal poverty line WB	16.5	25.1	29.7	28.9	24.0	16.5	....
- international poverty line WB	....	....	....	....	....	....	....
- extreme poverty line PPMU	....	12.4	22.7	17.6	11.6	6.6	3.1
- extreme poverty WB	12.0	19.3	23.0	22.2	18.0	11.6	....

SOURCE: World Bank (2004a, 2004b), PPMU (2003), GoRoM (2004), Notes: * author's estimate.

very different from Moldova and for this reason cannot be used as a reference for analysis in this country (Pogge and Reddy 2003). Reference to this poverty line too can be dropped.

As for the ANPL and AEPL estimated on national data, it is quite evident that the trends identified on the basis of the PPMU, World Bank and DSS approaches identify – unsurprisingly – similar trends.[63] Yet, the levels of the different estimates can differ in a non negligible way. For instance, the 2002 poverty headcount ratio estimated on the basis of the ANPL was equal to 48.5 according to the World Bank estimate and 40.4 according to PPMU. Second, while similar the WB, PPMU and DDS trends are not parallel, they tend to converge in period of crisis (e.g. 1998) and diverge in years of recovery. Third, the different equivalence scales used in the three above approaches makes that the value of the PHR changes and, even more important, that the ranking of poverty among different groups changes , as shown by the recurrent problem concerning the ranking of poverty among families headed by pensioners versus families with two children (see later). The latter group appears to be on top of the poverty list if one uses per capita equivalence scales and no economies of size in consumption, but not if one uses OECD or other equivalence scales. This is an important issue, as it can influence the priorities of the anti-poverty policies and transfer policies in particular.

This proliferation of measures is quite confusing – as the results of analyses using different standards that are not comparable. For policy purposes, there is a need to stick to single ANPL and AEPL (both set at an appropriate level see below) and to a few measures of inequality, and rather focus on the analyses of the relation between poverty, policy changes and structural factors.

In Moldova, the absolute extreme poverty lines, based on the cost of 2100 or 2278 calories, are meaningless. A food–only poverty line may make some sense in a sub-tropical country with a large and relatively young population. However, in Moldova where winter temperatures can fall as low as minus twenty degrees centigrade, and the elder constitute a high share of the population, survival requires access to a modicum of shelter, heating, electricity and life-saving drugs. While in the past utilities and drugs were provided at highly subsidized prices, this is no longer the case. In Moldova's winter, people consuming 2100 or 2278 calories per day, and nothing else, face much higher risks of death, as confirmed by the Moldavian dismal mortality statistics. Thus, 'food-only' poverty lines do not seem conceptually helpful to identify a minimum survival package.

The ANPL of PPMU and especially the World Bank are low, leading in this way to an underestimation of the number of the poor, assuming all incomes in kind are accurately accounted for, see below. The implicit food share of the World Bank's ANPL ranges between 83 and 86 (see Table A4.1), well in excess of the usual standards by which the food share never exceeds 75-80 percent of the consumption of the extreme poor (as well illustrated by the 80-80 'Lipton's rule'). In turn, the food share of PPMU's ANPL is 78 percent, still high but within the international range. The 2001 HBS indicates for instance that the food share of the poor and extreme poor is respectively 80.5 and 81.3, entailing that the food share at the level of the poverty line should be lower.

The high value of these food shares of the ANPLs estimated by the World Bank and PPMU depends on the method used for constructing them. While the food component of the poverty line is 'normative' (in the sense that the number of calories

63 This should not be surprising as the years under investigation were characterized by marked swings in output

pre-established assures proper nutrition), the non-food allowance is derived in a 'non-normative' (i.e. empirical-behavioural) way, that basically measures what people consume at around the poverty line level (actually below it, i.e. the third to the fifth deciles for the World Bank and the second to the fourth for PPMU). However, these 'effectively consumed quantities' do not necessarily guarantee adequacy in relation to a minimum normative standards. Also, the approach followed conflicts with consumer theory. In addition, in the case of ANPL developed by the World Bank, no allowance was made for expenditures on utilities and housing (that the 2001 HBS shows account for no less than for 8.5 and 8.1 percent of the total expenditure by the poor and extreme poor) thus excluding from the computation of a minimum standard an essential input for the production of a minimum of well-being. This practice is in sharp contrast with direct field observation where concern for the access to these consumption items is paramount. For instance, in an interview with this author, the mayor of Floresti (a typical de-industrializing town of 30.000 people) indicated that the 3500 poor pensioners living in his city allocated some forty percent of their meagre consumption expenditure to gas, electricity and no longer subsidized drugs. For the winter months, the extremely poor can apply for a monthly heating subsidy of 16 lei per month, but such subsidy is low in relation to the need and, as it is non-universal, it may cause self-exclusion from the benefit because of the stigma and high informational costs attached to the application. Indeed, the data in Table 11 in section 3 suggest that this kind of subsidy is allocated in a very regressive way.

Reductions in subsidized health and education imply the need to revise upwards the poverty line. The World Bank public expenditure review of 2003 shows that the overall public expenditure on health, education and social protection declined markedly over 1997-2001, following the drastic fiscal adjustment of 1998-99, both as a percentage of GDP and in real terms (Table A4.2). This sharp reduction in social spending was accompanied by growing inequality in the access to services, deterioration in their quality and the introduction of user charges in health and education. The introduction of official fees at public institutions together with a rise in informal payments, have *de facto* raised the price of health services to a much higher level than before. Table A4.2 seem to indicate that the average Moldavian citizen lost almost half of the health and education subsidies received from the government in 1997. While some of this consumption may have been simply foregone, its most essential part was absorbed into household expenditure that had to bear in this way a higher cost of the minimum consumption basket.

This means that the real value of the non-food allowance component of the poverty line should have increased in 1998-99 in relation to 1997 so as to reflect the de-subsidisation of essential public consumption on health and education, as well as utilities and transport. On the basis of the documents available, it is not clear whether this correction, which should have led to a rise in the real value of the poverty line over time, was carried out by either PPMU or the World Bank.

The poverty measurements are affected by whether all incomes recorded, and, ff not, whether the under-recording bias remains constant, declines or increases. It is well known that the ratio of average consumption expenditure per capita computed on the basis of the HBS tends to be a fraction (ranging between forty and 150 percent, with a median of around sixty) of the consumption expenditure per capita derived from the national accounts (Ravallion 2001). A second issue in this regard, well illustrated by the analysis of the Indian data, is that such ratio can change sharply over time, thus casting doubt on the consistency of the poverty trends identified. This problem is well known to DSS and PPMU, as in Moldova the cash and remittances component of national income is the lowest in Europe. The recording and imputation of agricultural incomes is therefore complex and could underestimate the effective consumption expenditure per capita. Likewise it is unclear to this author the extent to which a (growing volume) of migrant remittances enter the income and consumption accounts of the HBS. The evidence mentioned later on in this paper suggests tentatively that remittances are only partially recorded in the HBS, possibly leading in this way to an undercounting of overall household consumption.

The estimated poverty alleviation elasticity of growth seems rather high for credibility. The elasticity was tentatively estimated by PPMU at around 3, while the values estimated by the World Bank (2004b, p. 94) are about the same (though with very high variations from one year to the next). However, such value looks incompatible with the comparatively high level of income inequality prevailing in the country (Gini of 0.42-0.44) and with the ratio of the poverty line to the average income per capita of about 0.5 in 2002, as the PPMU yearly poverty line was 3248 Lei while the GDP per capita was around 6100 Lei (Ministry of Labour and Social protection, 2003).

Table A4.2. *Budget aggregates and the index of public expenditure on health, education and social protection*

Years	1996	1997	1998	1999	2000	2001	2002	2003	2004
A. Percentage of GDP									
Total Revenue	26.6	33.0	30.5	25.1	25.6	22.7	22.5	24.2	23.2
Total Expenditure	36.2	40.4	33.9	28.7	26.6	22.7	23.0	22.6	22.1
Deficit/surplus	-9.6	-7.5	-3.3	-3.2	-1.0	0.0	-0.5	1.6	1.1
Social Expenditure	19.9	22.0	16.2	11.8	11.8	10.8	12.4	12.3	11.4
-Education	10.3	10.0	7.0	4.7	4.5	4.8	5.5	5.5	5.3
-Health	6.7	6.0	4.3	2.9	2.9	2.8	3.5	3.4	2.6
-Culture, sport, youth	0.8	0.9	0.9	0.5	0.5	0.4	0.6	0.6	0.6
-Social protection*	2.1	5.1	4.0	3.8	3.8	2.6	2.9	2.7	2.9
-Social protection**	na	8.4	8.4	6.1	6.2	5.7	na	na	na
B. Index of expenditure in constant prices (1997=100)									
Social Expenditure	na	100	77.5	57.2	57.2	57.0	na	na	na
-Education	na	100	69.7	50.3	47.7	54.7	na	na	na
-Health	na	100	67.6	45.1	48.8	52.2	na	na	na
-Culture, sport, youth	na	na	na	na	na	na	na	na	na
-Social protection*	na	na	na	na	na	na	na	na	na
-Social protection**	na	na	na	na	na	na	na	na	na

SOURCE: elaboration on World Bank (2003) and budget data provided by the Ministry of Finance provided UNDP-Kishinew (e-m by Liudmila Barcari). * includes only the transfers from the state budget to the social insurance fund, ** includes the outlays of the social security fund financed with payroll taxes and not included in the state budget.

Indeed, according to Table A4.3 that reproduces the estimates of Kakwani and Song (2003) based on a large sample of 'growth-poverty episodes' for countries with different levels of inequality, the Moldavian poverty alleviation elasticity of growth should be in the 1.4-1.6 range. The reasons of the discrepancy between the PPMU and the estimates in Table A4.3 ought to be clarified. The discrepancy may be due to recent improvements in collecting information on food consumption and food inventories in the HBS, that have caused an increase in rural incomes faster than what it would have been the case with no changes in methodology. A second explanation is that the distribution of consumption expenditure is not smooth and shows considerable bunching (a hump) around the poverty line, so that even comparatively modest variations in consumption expenditure per capita move many people in and out of poverty.

While the latter explanation may account for the high poverty-growth elasticity observed over the last few years in relation to changes in consumption expenditures within its specific 1997-2002 range of variation, it is unlikely that such high elasticity will hold for wider ranges of the distribution. This means that it would be unreasonable to assume the same poverty –growth elasticity for projecting the poverty impact of future growth.

Table A4.3. *Poverty Elasticities*

z/m	Poverty-growth elasticity				Poverty- inequality elasticity			
	Gini coefficients							
	0.3	0.4	0.5	0.6	0.3	0.4	0.5	0.6
0.33	-3.9	-2.1	-1.3	-0.8	5.2	3.3	2.4	2.0
0.50	-2.8	-1.6	-1.0	-0.7	2.5	1.7	1.3	1.2
0.67	-2.0	-1.2	-0.8	-0.5	1.2	0.9	0.8	0.8
1.00	-1.2	-0.8	-0.5	-0.4	0.2	0.2	0.3	0.4

SOURCE: Kakwani and Song (2003) *The left panel is the elasticity between GDP growth and poverty, the right panel the poverty- inequality elasticities under different assumptions about the Gini coefficient (shown by column) and the ratio of the poverty line (z) to average income or consumption per capita m (again, by by column)

Annex 2. Analytical Framework for Calculating Poverty Reduction

We consider the specific factors explaining the rise of income inequality in Moldova by using the Kakwani decomposition (1980) that shows that at any point in time, the Gini coefficient (G_t) can be written as follows:

$$G_t = \Sigma\, s_{it}\, C_{it}$$

Where C_{it} is the concentration coefficient of the i-th income component (wages, or entrepreneurial incomes, or capital income or transfers),[64] at time t, and s_i its share in total income. Changes over time in Gini coefficient can be decomposed as:

$$DG = G_{t+n} - G_t = SDs_iC_i + SDC_i\, s_i + SDs_iDC_i$$

Where the Ds_i and DC_i refer to changes over the period t - t+n in the shares of the various income components and their concentration coefficients. This decomposition requires data for the initial and final year, the shares of each type of income, and their concentration coefficients.

64 The concentration coefficient C_{it} is similar to the Gini index except that the ranking of individuals is by the total income and not the i-th income components. As a result C_{it} can ranks between 1 and –1, instead of 0 and 1 as the Gini coefficient.

Chapter 5:

Migration, Employment and Poverty Reduction

5.1 Migration from Moldova

There are many estimations of the number of migrants from Moldova, and substantial differences between official statistics and unofficial estimates from a variety of sources. The official data on legal or regular emigration (*Statistical Yearbooks*, 2003/4) suggest yearly outflows between 1992 and 2003 ranging between five and nine thousand. Capturing illegal or irregular migration is considerably more difficult. In 2000 the Department of Statistics and Sociology estimated that were 234,000 Moldavians working abroad legally and illegally (Sleptova 2003). An estimate very close to this was obtained by the Labour Force Survey of 2003. In 2004 an independent survey conducted by the Moldova Microfinance Alliance estimated that between 265 and 285 thousand Moldovans went in search of work abroad (Ghencea, B & I Gudumac 2004). The media has reported as many as one million Moldovan citizens working abroad.

The most recent estimate comes from a survey of over 3,700 families undertaken in late 2004 and sponsored by the International Organisation for Migration, the IMF and the European Union. The resulting Moldova Remittances Study (MRS) estimated 398,000 Moldovans working abroad coming from approximately 315,000 households. If the number of people who were in Moldova, but have been abroad and reside temporarily (the exact phrase is 'or a certain time') in the country, then the migrant contingent rises to approximately 567,000. Just over twenty percent of Moldovan households had one or more members aboard with the vast majority of these, almost eighty percent, having one.

The following description of Moldova's migrants comes draws heavily on MRS. Moldovan migrants are generally young with over seventy percent under 40 years old and nearly forty percent under 30. There is a significant gender difference with female migrants much more likely to be in the 31-40 year old category than the 21-30 year old category (35 percent versus 28 percent of female migrants). The percentage for men is the reverse (28 percent in the 31-40 range versus 38 percent in the 21-30).

Table 5.1: *Age distribution and gender (percentages)*

	Under 20 years	21 – 30 years	31 – 40 years	41 – 50 years	over 51 years	Total
Male	5.5	38.3	28.3	22.5	5.5	100.0
Female	4.1	27.9	35.1	29.1	4.0	100.0
Total	5.0	34.6	30.7	24.8	4.9	100.0

SOURCE: Moldova Remittance Study (January 2005)

Although we do not have adequate information on the poverty status of migrants the MRS reveals that the amount of money required to become a migrant is not large although it varies significantly with the destination country. More than half claim that migration expenses are less than US$100 with a quarter claiming that they are less than fifty. The majority of the migrants spending the small amount of funds migrate to CIS countries. Migrants to the EU will spend considerably more, for example more that US$2000 for Italy or Spain and over US$440 for Turkey.

Migrants tended to be generally well-educated. Only ten percent had no educational qualifications, and over forty one percent have reached secondary education qualifications. A further twenty eight percent have post high-school qualification while twenty percent have higher education qualifications. There is also a strong relationship between destination and education with migrants to the EU having higher levels of qualification than those to the CIS or other transition countries. For example about half of migrants to Spain or Greece have higher qualifications compared to only eight percent of migrants to the Ukraine or nearly twelve percent of migrants to Russia (MRS).

The majority of migrants from Moldova, over fifty eight percent, go to Russia (MRS) and less than thirty two percent go to EU member states. Of these countries, Italy is by far the most popular destination accounting for over eighteen percent of migrants. Female migrants are more likely to go to Mediterranean countries than to northern Europe or members of the CIS (MRS). This pattern is not surprising given the tradition from the Soviet period when Moldovans sought seasonal work in agriculture and construction in other parts of the Soviet Union, particularly in Russia and Ukraine. Today most reportedly work there as labourers in the oil, manufacturing, and construction industry; others work as drivers, cleaners and small-scale retailers (Dudwick and Sethi). Although the number of respondents is small, just over half of the migrants appear to be employed in the construction industry. No other category comes close to this proportion (MRS).

Table 5.2: *Main countries of destination*

	of the families with migrants	migrants
Spain	1.4	1.5
Italy	20.2	18.9
Russia	56.4	58.2
Turkey	1.3	1.3
Romania	1.5	1.9
Portugal	4.7	5.0
Cyprus	0.5	0.5
Germany	1.2	1.0
Greece	3.2	2.7
The Czech Republic	1.1	0.8
Belgium	0.6	0.5
Israel	1.7	1.4
Ukraine	1.7	2.2
France	1.0	0.9
Other countries	3.5	3.0
Total	100.0	100.0
EU	33.9	31.8
CIS	58.1	60.4

SOURCE: Moldova Remittance Study (January 2005)

Table 5. 3: *Main countries of destination by gender*

Country	Male	Female	Gap
Cyprus	15.60	84.40	68.80
Greece	29.60	70.40	40.80
Turkey	32.20	67.80	35.60
Italy	36.50	63.50	27.00
Spain	41.40	58.60	17.20
Romania	46.70	53.30	6.60
France	50.80	49.20	-1.60
The Czech Republic	51.70	48.30	-3.40
Israel	56.30	43.70	-12.60
Ukraine	63.20	36.80	-26.40
Belgium	63.90	36.10	-27.80
Portugal	67.90	32.10	-35.80
Russia	74.30	25.70	-48.60
Germany	78.20	21.80	-56.40

SOURCE: Moldova Remittance Study (January 2005)

Table 5.4: *Spheres of activity of the Moldovan migrants abroad:*

	The percentage of the total number of the interviewed migrants (214 people)
Agricultural works	6.9
Constructions, reparations	51.3
Employees at factories, plants, firms	7.2
Employees at private people	10.9
Housekeeping, social care	7.8
Commerce	7.3
Services	7.3
Something else	0.9
No answer	0.4

SOURCE: Moldova Remittance Study (January 2005)

Just over twenty-eight percent worked on an employment contract leaving over seventy percent outside the regular system. Very few had assistance from the government or migrated through official /regular channels. When asked who had helped them or organised their departure for working abroad, respondents revealed that over forty six percent had no help at all. Fewer than thirty percent were helped by friends, neighbours and acquaintances and approximately twelve percent were helped by family. Only 4.3 percent and 3.8 percent were helped by tourist agencies and employment agencies respectively. The high proportion of migrants who leave without any help is explained by the fact that most of these were going to Russia. Over eighty one percent of migrants to Russia (over fifty eight percent of total migrants from Moldova) went without any support. The vast majority of migrants also found a job within one month (over eighty two percent) with half finding work when they arrived. Only a very small percentage paid something to obtain a job (less than six percent).

In terms of the way of departure, the majority of migrants left using an identify card (fifty four percent). This roughly corresponds with the number of migrants working in the CIS. Just over thirteen percent used a work visa while just over fourteen percent used a tourist visa. Only a small number used a false visa or were illegally transported by interlopers (just over five percent in each category) although these figures may obviously be under represented.

While obtaining adequate information about migrants is problematic, the situation is mirrored when trying to identify information about remittances. In a similar way there are official statistics that do not capture flows outside formal channels and many unofficial estimates. Again the media presents very high numbers in this respect. Moldova is not alone with this problem and the quality of data on remittances is generally quite poor (Kapur 2004). Over half of respondents to the MRS send money home at least once a quarter with about 25 percent sending it home on a regular basis. The MRS team estimate that over half a billion dollars was transferred in remittances over the last twelve months (October 2004).

Table 5.5: *Reason for Migration (of total respondents)*

Tourist visa	14.3
Work visa	13.4
Official trip from the working place	1.0
Sport delegation	0.8
With the identity card	54.3
With foreign citizenship	2.4
Cultural exchange (dance, theatre, orchestra troupe etc.)	0.4
Business relationship	0.2
Marriage	0.7
Something else	0.7
With false visa	1.3
Illegally transported by the interlopers	5.2
No answer	5.1
Total	**100.0**

SOURCE: Moldova Remittance Study (January 2005)

It should also be noted that Migrant families also send money to Migrants although the amounts are very small (MRS). Just over one third of Moldovan migrants also sent home goods in addition to money, mostly clothes, food products and household assets (MRS). Only a third of transfers are made through formal channels (bank transfers, rapid transfer and the post office) on a regular basis although more than half have used them at least once.

Table 5.6: *Methods used by the migrants for sending money home*

	They used it at least one time	They used it more often
Bank transfers	25.7	13.0
Rapid transfers	28.8	19.5
Post offices	4.4	1.9
Train conductors	12.7	7.1
Bus, mini-bus conductors	11.4	6.8
He brought it personally	38.9	17.3
Through relatives, friends, acquaintances	29.1	11.7
In parcels with the other things you receive	8.7	1.3
Something else	9.4	0.9
No answer		20.6

SOURCE: Moldova Remittance Study (January 2005)

In terms of using the remittances received over seventy percent say they used funds to buy food and clothes while over sixty percent used funds to pay for household utilities. In terms of using the funds accumulated abroad, over forty five percent of respondents reported that their priority is current consumption (food, clothing etc). Only a small percentage prioritised business investment.

Table 5.7: *Planned use of money earned abroad 'in the next 12 months'*

	First Priority percent	Second priority percent
The debt repayment	11.8	5.1
Current consumption (food, clothing, current household expenditures, services and utilities)	45.4	21.7
Special consumption (education, health, household durables, lending the money etc.)	10.6	24.6
Household investment (to buy a car, house/ apartment, house/apartment renovation, weddings , funerals , bank deposits)	15.5	22.8
Business Investment (to buy land, agricultural machinery, mini-bus, cattle/fowl/Sheep)	1.5	4.8
Something else	0.7	0.2
No answer	9.8	2.4
The number of people who answered the question	95.3	81.7

SOURCE: Moldova Remittance Study (January 2005)

It is also important to recognise the diversity of remittances (COMPAS) in the sense that the label remittances relates to a variety of different transfers that will have different impacts. For example, the impact of intra-family transfers may be different from transfers controlled by the migrant to collective transfers.

5.2 Migration, Growth, Employment and Poverty Reduction

Migration and Poverty

Given the difficulties with obtaining adequate information about migration levels, migrants and remittances, accurately identifying their impact on growth, employment and poverty reduction is not surprisingly problematic. It should also be noted that the impacts that fall into the categories of positive or negative may not be substitutes. For example, it is impossible to say that the brain drain or reduction in human capital can be countered by increased financial flows from remittances: They are not substitutes (Kapur 2004). This section sets out what we believe to be the various impacts of migration on growth, employment and poverty reduction. Some of the impacts are direct, for example increased consumption for poor households from remittances. Others are less direct, present consumption from previous investment or increased knowledge from the experience abroad leading to higher earning potential. Many of the issues have been raised in other chapter and these are referred to in this section in order to get a better overview of the positive and negative impacts of migration.

As noted in Chapter 2 the recovery and growth of the economy after 1999 was driven primarily by the inflow of remittances which fostered growth through relieving the import constraint. In addition, it was noted that remittances have reduced the government's dependence on conditionality-based borrowing, thus potentially allowing for flexibility in macro policy. However, the inflow of remittances has the effect of appreciating the exchange rate, as occurred during 2003 and 2004, making exports less competitive, while the higher interest rate would discourage investment by Moldovan companies, and have little impact on foreign domestic investment. Though there is no research on the strength of these negative effects, their impact may have been quite strong in the late 1990s and early 2000s.

Remittances can have a direct impact on poverty reduction though increasing levels of consumption. The draft study revealed the importance of remittances to the welfare of those left behind and families with migrants are generally better off than those without. Table 5.8 below illustrates the before and after migration perception of households with migrants.

Table 5.8: *Household Perception of Effect of Migration*

		Very good	Good (adequate)	Difficult	Very difficult	No answer
Food	Before the migration	1.6	57.1	34.3	5.6	1.4
	After migration	7.4	71.6	18.5	1.0	1.5
Dwelling	Before the migration	1.6	52.1	38.2	6.3	1.9
	After migration	4.7	70.4	21.5	1.6	1.8
Clothes	Before the migration	1.1	46.9	45.0	5.3	1.7
	After migration	4.5	68.1	24.3	1.4	1.7
Health	Before the migration	1.6	50.7	38.3	7.6	1.8
	After migration	2.8	57.6	33.2	4.7	1.7
Education	Before the migration	1.9	47.4	35.5	4.6	10.6
	After migration	3.3	60.1	20.8	1.8	14.0
Entertainment	Before the migration	1.0	31.8	46.7	12.9	7.5
	After migration	2.3	47.3	35.6	7.1	7.7

SOURCE: Moldova Remittance Study (January 2005)

In terms of poverty reduction the major decline in the "very difficult" category and the significant decline in the "difficult" category across all basic needs illustrate the contribution of remittances to household welfare among households with migrants abroad. Several studies have shown that migrant remittances can have a beneficial effect on income–poverty, though they may also affect negatively other aspects of well-being. Moldova illustrates well this trade-off, as it has one of the highest proportions of her labour force working abroad, migrant remittances on GDP and private transfers on disposable income. If properly accounted, all these three ratios are likely to near thirty percent of the total.

In accounting terms, the HBS includes questions also on 'private transfers' without distinguishing whether these originate from abroad or within the country. In addition, the relation between remittances and poverty cannot be studied thoroughly as only part of them are accounted in the HBS, in which they represent 5.5 percent of total household income against the seventeen percent of GDP estimated on the basis of the national accounts.

Three factors may explain this discrepancy. To start with, remittances used for the construction of houses may not be considered as discretionary income and not be declared in the survey. Second, especially in the countryside, lax security and fear of theft may induce households living in isolated areas to 'hide' the remittances received for fear that this information may leak out and induce some robber to steal these moneys. Third, the HBS undersamples the families of emigrants. As the 'hump theory of migration' suggests, migration is costly and only those with resources or access to family or informal credit are able to finance their migration.[65] This mean that the most likely to migrate are neither the rich, who are not impelled to move by material deprivation, nor the poor who are credit-constrained, but a middle class of fairly young people with medium-high levels of skills and schooling. This high-remittances group is however under-represented in the HBS. This last argument may not hold as we know that most migrants work in Russia and only need very small funds to get there. Of course they also earn considerably less.

The situation seems to be one in which the underestimation of remittances in HBS both at the household level and in the aggregate possibly leads to some overestimation of poverty. In spite of this, the HBS show that the ex-post impact of remittances in reducing poverty is very large, as many more families would have remained below the poverty line if the possibility of migrating had not been there. A rough estimate is that migration reduced the incidence of poverty in 2002 by some twenty-twenty five points, and that these sharp gains in income-poverty were accompanied however by a worsening in social-poverty.

Remittances have the possibility of increasing future consumption through income generating investments. As already noted the vast majority of respondents intend to use the assets accumulated from migration primarily for consumption. Business investment seems a priority for very few. The secondary impact of investment on income poverty reduction through future consumption therefore seems limited in Moldova. Like in many other high migration countries, one of the greatest challenges for government policy makers is to change this situation and to facilitate the channelling of resources to sustainable income and employment generating activities.

65 5000 Euros per migrant is the most common estimate of the investment required for the illicit acquisition of visas and working permits, travel costs and the connection to networks in the country of destination.

Migration and the Labour Market

The dynamics of the educational sector and the migrations process have seriously impacted on the human capital formation in Moldova. Only one in every five people in Moldova goes for university education. But more important is the fact that enrolment of children from the poorest households even at the upper secondary level has declined in recent times and it is only fifty percent, compared to seventy-one for the richest quintile. At the university level, the situation is even worse. The enrolment rate for the poorest women and men has consistently declined over time to about four percent in the mid-2000s. For the richest households, the enrolment not only improved, but at thirty-four percent was more than four times than that of the poorest quintile. Human capital formation in Moldova had a definite bias towards the rich. Various social illnesses, some of which are by-products of poverty, alcoholism, drug dependency, and high criminality rate, depleted the quality of human capital as well.

The migration from Moldova also impacted on the formation of human capital in that country. For a country of 4.4 million people, an estimated 600,000 people, almost fourteen percent of the population and twenty three percent of the workforce, worked abroad in 2003.[66] Over one half of the expatriate workers are under age thirty, and eighty eight percent under forty five, implying that workers in the prime age group were leaving the country. In the five years, 2000-2004, thirty six thousand doctors left the healthcare system, and twenty-eight thousand teachers left the education system. About seven percent of the expatriate labour has a university education, and one third of the workers abroad had secondary vocational education, compared to just twenty-five percent of the workers at home. Nearly three-quarters of those working abroad had previous experience in medicine, education, agriculture, construction and small business management (Dudwich & Sethi 2004). By any standard, these represent a serious brain drain. It had immediate impact on societal health, quality of education and economic growth. Migration of unskilled workers, mainly from rural areas, led to higher than normal dependency ratio and to several family problems with children left by their parents, to grow up with no care and no adequate education.

On the other hand, consumption may benefit the supply of human capital especially where remittances are used for education. Other countries have benefited from new skills of returnees though there is little evidence of this in Moldova, that is not to say that it is not happening (i.e., just because it is not captured by surveys)

One of the greatest challenges faced in the transition has been to adapt professional education towards to new economy and the new types of job that are available. Moldova is no different form other FSU countries and faces the challenge of re-organising its Vocational Education and Training (VET) system in terms of facilities, curricula and the subjects it teaches. Migration can lead to shortages of workers, especially in specific sectors where the skills are required abroad. It is widely reported that shortages of skilled and non-skilled workers in the agriculture sector are largely the result of migration, both international and internal, especially among the young. It may be that rural agricultural workers are migrating internally to fill the jobs left by urban workers who have migrated abroad. Domestic migration data also needs to be developed. The census probably has many of the answers but is not yet available.

While there are reports of large increases in salaries being made to attract construction workers back to Moldova, there is little evidence of large increases in salaries

66 The estimates of migration range from 230,000 (LFS 2002) to one million (MISS).

in the construction and agricultural sectors. Official data suggest that the average nominal monthly salary has increased by 305 percent between 1997 and 2003 while in the agricultural and construction sector nominal monthly salaries have increased by 270 percent and 265 percent respectively.

The Social Impact of Migration

An outrageous aspect of migration was human trafficking, which was quite wide spread in Moldova. There were three major features of Moldovan human trafficking. First, there was the misleading of innocent people with the false promise of employment abroad. Moldovans spent an average of US$126 to obtain access to employment in CIS countries, 1,987 for Western Europe and 2,470 for the Middle East. Only two-fifths of the migrants depended on their own resources. Of the rest thirty percent borrowed from relatives, thirty percent from moneylenders (at *monthly* interest rates of ten to fifteen percent in foreign currency), and almost twenty percent from Savings and Credit Associations (at interest rates of twenty to twenty).[67] In addition, people often would sell assets (Munteanu 2002).

Second, in many cases, people who were trafficked became bonded labour in the host country. This happened when people could not find work abroad, or their documents were lost, stolen, or seized by the employers, or who could not pay off debts related to their migration. The last phenomenon was often related to trafficking of the poorest. They would arrange that traffickers pay money in advance to their families, with the understanding that the sum would be repaid by the trafficked persons from their earnings.

Third, a significant portion of female migrants, most often those under 25, entered the sex trade, though estimates vary widely, from 10,000 to 100,000 (US Embassy in Sweden 2002). While some women knowingly become involved into prostitution abroad or were aware of the risk, others are lured abroad with false job promises and then coerced into prostitution. There were several root causes for the ready supply of Moldovan women to the sex industry. These included structural reasons such as poverty, social exclusion (in case of Roma population), and insecurities of the youth that pushed young people abroad in search for better opportunities. A survey of Moldovans between sixteen and thirty years found that almost all of them wanted to go abroad if they could find an opportunity. Domestic violence also instigated women to leave the country.

Trafficking of people fragmented communities and families, depleted human capital, deprived households of expected remittances, and caused child neglect. Migrants working illegally in host countries were subject to exploitation and abuse from smugglers, employers and local authorities alike. As countries tightened immigration restrictions, they drove greater numbers of people into illegal migration. Even when illegal migrants could remain working in the host country, they would become part of an underclass without legal rights or recourse. Finally, illegal migration contributed to the expansion of global crime networks. Benefiting from the mismatch between legal opportunities and actual demand for migration, criminal organizations dealing in arms, drugs, and prostitution diversified into migrant smuggling. They benefited from the steady demand from migrants, coupled with lax prosecution and enforcement. The victims of this traffic become vulnerable to violence, isolation, and diseases such as STDs and HIV/AIDS. The end result is serious human deprivation.

67 Moneylenders charged monthly interest rates of ten to fifteen percent. The Savings and Credit Associations were even more expensive, twenty to twenty-five percent.

Migration also adversely affected children. When children of migrants remain at home under the care of relatives or neighbours, they fall risk to leaving school early, moving away from home, and ending up as street children, and this process characterised Moldova. Children themselves became subject to human trafficking. According to the data from the Ministry of Interior, Moldova became a major source in supplying underage girls to Russia for sexual exploitation, with an estimated 5,000 trafficked there annually. Children from care institutions, forced to leave at sixteen with few job skills or support network, were particularly at risk, and there were allegations implicating an orphanage director in selling girls to traffickers (Dudwick & Ethi 2004).

5.3 Possible Future Patterns of Migration

Both qualitative and quantitative research reveals similar motivations for becoming a migrant. The MRS reveals that the main motivation is for current consumption with nearly forty four percent of respondents citing this reason as the main factor. Debt repayment and household investments were the second and third main factors. Combined these three factors were the major motivations for over eighty four percent of respondents. A very small number of migrants (less than one percent) identified business investment as the major factor for migration. This corresponds to actual use of remittances and resources accumulated by migrants described above.

Table 5.9: *Factors that determine departure*

	First	Second
Debt repayment	21.2	6.5
Current consumption (food, clothes, commodities, household assets, etc)	43.9	32.6
Special consumption (education , health, household durables, lending money, etc)	11.3	21.4
Household investments (car, house/apartment, renovation, weddings, funerals etc)	19.0	28.6
Business investments (land purchase, agricultural machinery, mini-bus, animals etc.)	0.9	3.9
Something else	1.7	0.2
No answer	1.5	0.5
The total number of people who answered the questions	99.5	93.7

SOURCE: Moldova Remittance Study (January 2005)

The qualitative survey undertaken revealed similar results where the key factors for the departure included (a) insufficient money for the bare necessities or "financial problems"; (b) lack of a place for living or to improve the living conditions; (c) lack of a job/ well-paid job; (d) the necessity to pay the studies of one of the family members, and; (e) the opportunity for leaving, the fact that someone is waiting for them in the host country, the possibility to leave legally etc. On the supply side there is no reason to suggest that these factors or motivations will change. As noted in earlier chapters, significant levels of growth and some time is going to be required to bring average living standards to those achieved by the time of independence.

Two possible future scenarios were raised by a number of informants. First there is anecdotal evidence that people may stay in host countries and bring their families to them thereby drying up the flows of remittances. This is certainly a scenario that is commonly described by close observers of the situation in Moldova. The evidence from the MRS does not comply with this fear, indicating that only a small percentage of migrants intend to stay in the host countries with the vast majority wanting the return to Moldova once enough money had been saved or remitted. The MRS study revealed that most Moldovan migrants (over sixty seven percent) intend to return to Moldova after making enough money abroad. While in a static sense this would lead to a fall in migration in a dynamic way it may not as returning migrants may simply be replaced by new migrants. Nearly sixty percent of respondents stated that they or a member of their family intended to migrate in the near future. Of these over half intended to migrate to Russia. Finally, the basic question concerning the intention to settle in the destination country for good revealed that only 11.4 percent said they would. Additional findings from the Public Opinion Barometer (August 2000 through November 2003) conducted by the Moldovan Institute of Public Policy (IPP) confirms the tendency suggesting that about eighty percent of the population wants to leave the country on a permanent or temporary basis. For the young the figure is higher with almost ninety percent of young people between ages of eighteen-twenty wanting to leave the Republic of Moldova for a period. Other findings seem to confirm the scenario: the Barometer found that, if there were a possibility, about thirty seven percent would want to leave the country forever. Only nine percent of young people want to stay in the country.

A second fear is that the demand for migrants may fall over time either through labour market changes in host countries or through increasing difficulties for migrants in terms of policing. The latter would obviously affect irregular migrants. While most concerns relate to the EU with most migrants going to CIS countries and Russia in particular, Moldova's relationships with these countries may be as important. This illustrates the problem of data. While CIS may be responsible for absorbing the most construction and agricultural workers, the EU migrants may be responsible for the majority of remittances or skill used by returned migrants. It is therefore very difficult to generalise without adequate data, disaggregated by country of destination. Only then can the pros and cons of changing contexts be analysed and different scenarios developed by government as the basis on which to make policy.

Moldova has agreements with Ukraine, Belarus and the Russian Federation but also two agreements within the framework of the CIS. The first from 1995 provides a degree of protection for migrant workers and their families. The second, more recent agreement (2002) relates to cooperation on fighting illegal migration (IPP 2005). Immigration cards were introduced in Russia in early 2003 to better control migration. Although these measures will allow migrants to work legally, it is reported that a large number have not chosen to register (Dudwick and Sethi).

In 2003 the EU introduced the European Neighbourhood Policy (ENP) to enhance relations with some of its neighbours (Ukraine, Moldova, Belarus and the Southern Mediterranean countries). Moldova has now developed an action plan the framework of the ENP which includes the objective of ensuring the efficient management of migratory flows, including initiating the process towards conclusion of a readmission agreement between the European Community and Moldova. Moldova's relationship with the EU will change when its neighbour Romania gains membership, likely to be in 2007. Although Moldovans require passports to enter Romania, unlike EU countries and other EU-accession countries, Romania does not require visa from Moldovans. At the same time Moldovans may acquire Romanian citizenship if they had grandparents who lived on Romanian soil before 1918, when Moldova became part of Romania. Martin (2004) reports the estimate that at least 500,000 Moldovans had acquired Romanian citizenship, making them dual nationals[69]. In addition, he reports estimates that two million Moldovans, almost half the population, could obtain Romanian passports (allowing them to spend up to 3 months in the EU without a visa); that 140,000 Moldavian citizens also have Russian citizenship in 2003; 60,000 to have Israeli citizenship, and; 20,000 to 30,000 Ukrainian citizenship. Studies of the EU labour Market suggest that demand for migrant labour will not decrease in the near future and in fact is likely to rise, although more so for skilled rather than unskilled labour. (Doudeijns and Dumont, 2003)

Moldova is faced with a number of possible scenarios and it may not be able to choose the one it would like. It is clear that the status quo cannot continue. The social costs of trafficking and associated negative aspects of irregular migration are not palatable for society. A reduction in migration may slow the economy even if it improves family cohesiveness and addresses shortages in some parts of the labour market but is unlikely to occur while Moldova still faces serious domestic social and economic problems and while demand is still strong. The likely scenario is one of maintaining high levels of migration but move to improved management and more regular flows. Some negative aspects may remain but policy interventions can be designed.

5.4 Policy and Possible Future Directions

It is clear that a policy framework needs to build on the positive aspects described above and reduce the negative impact of migration. But there will be tradeoffs and a balance will need to be achieved. Difficult decisions will need to be made and in some cases, such as the complex issue of the negative social effects of migration, the impact is going to be difficult to quantify. What is needed is a wide-ranging consultative process of the type that should have been undertaken during the preparation of the PRSP to determine what kind of society is needed and what direction Moldova is going in. Future policy directions need to be based around a vision of the role of migration in Moldovan society. Will Moldova be a society dependent (and therefore vulnerable) on migration and remittances, be willing to put up with some of the downsides of migration (such as on social poverty) in return for the possibly of a quicker return to pre-transition living standards. There also needs to be recognition that while there are policies that may have an important impact on growth, employment and poverty reduction there are limitations of government action not only in the sense of influencing individuals in a society where government is not that trusted but also where exogenously determined policies have a great influence on outcomes. A realistic sense of what can be achieved needs to be ensured.

The Migration Policy Concept of the Republic of Moldova was adopted by Parliament in October 2002. In December of the same year, Parliament also passed the Law on Migration (IPP 2005) which included the establishment of a new organisation responsible for migration management. The Migration Department it is being supported by the donor community to improve migration management, develop and strengthen strategies and policies and to develop appropriate agreements with destination countries. Although the basic institutions are in place but much needs to be done.

69 Moldova officially allowed its citizens to hold dual nationality in 2003

Given the importance of migration and remittances it is surprising that the PRSP has so little to say about the subject. It does, however, identify three broad directions for the future, all of which are important, if a little vague in terms of content, and deserve the financial and technical support of the international community.

First, the government could bring legislation on migration in accordance with the international standards. Concrete actions to implement those conventions already ratified by Moldova are needed. In addition, efforts could be made to move towards regular migration and the signing of more bilateral agreements with host countries is required. In addition more flexible Memoranda of Understanding may be used for seasonal workers (Martin 2004). The move towards regularising migration has the advantages already noted in the chapter in terms of the significant social costs of migration and trafficking, but also in terms of enabling more effective management and the subsequent alleviation of other costs. As part of this, strengthening migration management is critical and especially ensuring that adequate legislative environment covering the participating of private sector organisations (such as recruitment and tourist agencies) involved in the migration process is in place and implemented.

The second and third PRSP actions are closely linked and relate to making a comprehensive study on population migration and its consequences, and the creation of an informational system and the improvement of the management of migration processes, respectively. There is need for better information on migration for more effective policy making. Not only should there be consolidation and reconciliation of the information already available but also better coordination and cooperation among stakeholders involved in information collection and analysis, including international organisations. At this stage the collection and analysis of migration information is of vital importance as the impact of migration on planning will be important. An example would be the delivery of health services and education in rural areas where migration has had a major impact. It should also be noted that since many of the factors that influence migration flows are exogenously determined it is important that the government has the tools, capacities and information to adapt policies within a potentially changing environment.

There are other policy measures that can be used to increase the benefits of migration and remittances in terms of growth, employment and poverty reduction. First, policies related to the volume, characteristics and utilization of remittances. Second, efforts can be made to affect the volume of remittances. Government efforts to oblige migrants to remit a certain percentage of income home would be unrealistic even if regular migration increased. The design of private sector investment instruments that are attractive to migrants is a better approach. For example, encouraging commercial banks to offer foreign currency accounts and transactions or encouraging competition in the banking sector to reduce the costs of remitting funds. Ensuring a well-regulated and effective financial sector including for non-banking financial institutions such as micro-finance mechanisms is key. A specific option may be the development of a foreign currency bond that ensures the anonymity of the investor and would be more attractive to migrants who are concerned about the tax or other implications of remitting funds (Moreno-Fontes Chammartin, G. and F. Cantu-Bazaldua 2005). The government can also play a role in ensuring that information on financial services are available to migrants and are reliable.

In addition to the macroeconomic impact of remittances, the utilization for remitted funds for productive purposes is important for growth, employment n poverty reduction. Many of the actions described elsewhere in this report with regard to the appropriate macro-economic framework, especially investment patterns, and policies for employment promotion and income generation are as important for migrants as non-migrants. Putting these policies in place, especially those related to the agricultural sector, is the priority for encouraging increased investment of migrant remittances. In addition to these specific instruments can be designed to attract migrant funds for investment or to ensure the more efficient use of investment resources. The provision of information on likely sector growth and potential returns from investment is an example of the former, while training specifically aimed at migrants is a case of the latter. What is important is that these innovations are part of a well managed strategy that includes piloting, learning through effective and evaluation of the interventions and revision of the schemes in light of lessons learned. Since the ability of government to influence the investment choices of individuals through such schemes may be limited, what is not needed is an *ad hoc* series of interventions.

Chapter 6:

Employment, Productivity and Proverty

6.1 Employment and Poverty

For the majority of poor people, the only viable escape route out of poverty in the long term is through employment. Economic growth is essential for reducing poverty in a sustained manner, and does so through generating employment that provides livelihoods above the poverty line. When growth creates ample opportunities of employment and the poor are able to grasp those opportunities, then poverty declines in a sustainable manner. This is as true in Moldova as elsewhere. However, merely creating jobs may not be sufficient. The main problem in Moldova is that well-paid jobs are not being created in sufficient numbers to rapidly lift the working population out of poverty.

Of the people who were in poverty in 2002, twenty percent were outside the labour force, and only two percent were unemployed, implying that about seventy-five percent had work of some sort (Table 6.1). The problem was that their work did not pay sufficiently to escape poverty. This need not imply that working brought no benefits. Those with a formal sector job had a lower rate of poverty (thirty seven percent) compared to the unemployed (sixty percent), and compared to those outside the workforce (forty six percent). The last group received pension support from the government. So, a job helped to attenuate the burden of poverty, but for many workers it was not sufficient to move them and their households out of poverty.

The challenge for Moldova is the creation of employment opportunities associated with increased productivity so that the employed population can obtain incomes sufficient to escape poverty. At the same time, ways must be found to equip the poor with the requisite skills and assets so that they are able to avail of the opportunities for productive employment as and when they arise. This chapter analyses the nature and extent of this challenge.

After 1999, the rate of unemployment fell from eleven to seven percent, and the absolute number of unemployed people also declined. Unemployment had risen in the wake of the Russian crisis, from 167 thousand in 1998 to 187 thousand in 1999. Then it declined to 110 thousand by 2002, an impressive forty percent decline in a span of just three years (Table 6.2). An unemployment rate of seven to eight percent is not high by the standards of either the developed countries of Europe or other transition economies.

A closer look reveals a less positive picture. The fall in unemployment did not reflect a corresponding rise in employment, since the number of employed people remained approximately constant at about 1.5 million from 1999 to 2002.[69] This reflected in part a steady decline in the working age population, primarily a result of out-migration (see Chapter 5), and partly a reflection of an increase in the numbers of people becoming economically inactive.[70] Thus, the main reason why unemployment has fallen is that many Moldovans have either chosen to migrate abroad, or have become economically inactive.

69 In 2003, total employment dropped to 1.35 million, with the fall concentrated in agriculture.

70 The activity rate declined steadily from 61.3 percent in 1999 to 51.6 percent in 2003. While both the size of the labour force and the number of employed persons declined in absolute terms, the number of inactive persons increased from 1.06 million in 1999 to 1.38 million in 2003.

Another problem is that the average number of hours worked per week is very low, about thirty hours for the economy as a whole. This reflects substantial 'hidden' underemployment. There have been signs that the extent of involuntary underemployment (manifested in short working time) may be declining: the length of the working week rose from 26.6 hours in 1999 to thirty hours in 2002, although this is still below the normal level in Western Europe. Open unemployment is more serious in urban areas, but underemployment is the greater problem in rural areas. Statistics for 2002 show that unemployment was 12.1 percent in urban areas, and three percent in rural areas. By contrast, the average number of hours worked per week was only twenty four in agriculture, compared to thirty for the economy as a whole. The problem of finding gainful employment remains pervasive throughout the country, although its manifestation differs in urban and rural areas.

Measured unemployment is more of a problem for men than women. In 2002, 8.1 percent of the male labour force was unemployed, compared to 5.5 percent of the female labour force. The unemployment rate declined for both men and women at about the same rate. As a result, the rate for men has remained higher than for women since 1999, and the relative gap has not changed.

It was noted above that the decline in the rate of unemployment was not the result of employment growth, either for men or women. After 1999, the employment rate (the employed as a percentage of the working age population) remained almost constant at just over forty two percent for men, and forty percent for women. A somewhat longer time perspective reveals that the recent stagnation in employment was part of a trend throughout the transition in Moldova. In 1996, total employment was 1.66 million workers. This declined to 1.5 million in 1999 following the Russian crisis, and did not recover thereafter, even though aggregate output expanded substantially during 2000-2004.

Table 6.1: *Poverty by Work Status, 2002*

Employment Status	Poverty rate (%)	% working age population
Formal sector	37.4	25.0
Informal (non-agri)	47.3	5.0
Informal (agri)	40.2	8.0
Multiple jobs	25.0	3.0
Household self-employment	46.9	27.0
Other unpaid employment	63.8	10.0
Unemployed	59.9	2.0
Out of labour force	46.5	20.0
Total	45.2	100.0

SOURCE: World Bank (2004)

Table 6.2: *Employment and Unemployment, 1997-2003*

	1996	1997	1998	1999	2000	2001	2002	2003
Absolute number (thousands)								
Population	3599	3654	3652	3646	3639	3631	3623	3612
Labour force	1686	1671	1809	1682	1655	1617	1615	1474
Employment	1660	1646	1642	1495	1515	1499	1505	1356
Unemployment			167	187	140	118	110	118
Percentage of labour force								
Employment	98.5	98.5	90.9	88.9	91.6	92.8	93.0	92.0
Unemployment	n.a.	n.a.	9.1	11.1	8.4	7.2	7.0	8.0

SOURCE: DSS 2003

NOTES: From 1998, the ILO definition of unemployment has been added to employment figures to obtain labour force estimates. Thus, statistics for the proportion of employment before and after 1998 are not comparable.

6.2 Employment, Wages and Productivity

Employment and Wages

To understand the employment problem in Moldova, it is necessary to analyse the structure of employment, its distribution across economic sectors, and the change in that distribution over time. In 1996, the service sector was the leading employer of the labour force, accounting for a share of forty five percent of the total (Table 6.3). Agriculture followed closely behind, with a forty three percent share, and industry came a distant third, with a share of about twelve percent. As the Russian crisis deepened, agriculture became the leading employer, absorbing many workers laid off from the other two sectors. This trend continued until 2002, when agriculture employed half the labour force, and service's share fell to forty percent. In 2003, however, the share of agriculture fell sharply to forty three percent, making services once again the largest employer, with forty five percent, as in 1996. During these years, the share of industry changed very little, fluctuating between ten and twelve percent.

The long-term decline in the number of employed was shared across all three sectors (Table 6.4). In 2003, the level of employment stood at eighteen percent below the 1996 level: eighteen percent below for agriculture, sixteen below for industry and nineteen for services. After the Russian crisis, employment recovered in both agriculture and industry, but not in services. This may indicate that the services category included many jobs taken only when no viable alternative presented itself. Industrial employment was seven percent higher in 2002 than in 1999 (Table 6.5). Since industry was the smallest of the three sectors, the effect of this mild increase on overall employment was minimal. More significant was the tendency for employment to rise slightly in agriculture.

However, the picture changed significantly in 2003. Agricultural employment dropped precipitously, by more than twenty percent compared to the level in the previous year. Changes in the other two sectors were relatively minor, with the result that overall employment declined by almost ten percent. Over the whole post-crisis period from 1999 to 2003, overall employment declined largely due to a fall in agricultural employment (Table 6.5).

While employment has either stagnated or declined in most sectors, output and value-added have increased substantially. After 1996, GDP grew at 1.8 cent per annum, while employment declined at the annual rate of 2.9 percent. The difference between positive GDP growth and negative employment growth is even greater during the post-crisis recovery period. Between 1999 and 2003, overall GDP grew at four percent per annum, while employment declined by 2.4 percent (Tables 6.5 and 6.6).

Among the three broad sectors of the economy, the differential between output and employment was the greatest in industry, where nearly an eight percent growth of value added after 1999 was accompanied by a meagre 0.6 percent growth in employment. In the service sector, value-added increased at four percent per annum along with stagnation of employment (only a 0.2 percent rate of growth). The contrast was even greater for transport: twelve percent annual expansion of value-added in contrast to negative employment growth (of almost minus one percent) (see Tables 6.5 and 6.6).

The divergent movement in employment and output growth in other sectors manifested itself in agriculture as well, but with a difference. Between 1999 and 2002, value-added in agriculture grew at the rapid rate of 4.3 percent per annum, whereas employment increased very slowly, at 0.7 percent. This was similar to the output-employment growth relationship in the other two sectors. However, the relationship changed dramatically in 2003, when measured value-added in agriculture fell by nine percent compared to the previous year, and employment dropped by a disastrous twenty two percent. This simultaneous fall in production and employment raises a question of causality: whether employment fell because of a depression in output, or whether a drop in the rural labour force due to out-migration engendered an output collapse. It would appear that so many agricultural workers migrated from Moldova that a labour shortage might have become a critical bottleneck for some activities, thereby constraining the expansion of output (see Chapter 5).[71]

The employment-production relationship has implications for the growth of productivity and labour income. The failure of employment to keep pace with production meant that labour productivity increased, quite sharply in some cases. Over the period 1996 to 2003, productivity of labour grew at 4.8 percent per annum for all sectors (Table 6.7). The most rapid growth occurred in services (6.9 percent per annum), especially in trade-related services (11.5 percent). Industry had the slowest growth, at 2.2 percent. Agriculture had 3.9 percent growth.[72] Considering only the recovery period from 1999, the overall picture remains the same although the relative positions of the sectors change quite a bit. For the economy as a whole, labour productivity grew at the rate of 6.7 percent per annum. The highest rate of growth of productivity was observed in agriculture and industry (both just over seven percent per annum). Productivity in services grew at the rate of 4.2 percent. Within services, transport emerged as the leading sector, with a growth rate of 12.9 percent, whereas productivity in trade declined.

Along with the slow growth of employment and rising productivity went an increase in real wages beginning in the mid-1990s. This trend was reversed during the Russian crisis, to rise again thereafter. The apparently high rate of increase from 1996 to 2003 (almost eight percent per annum (Table 6.8)) and during the recovery period after 1998 (14.7 percent) must be placed in the context of the catastrophic collapse in the 1990s. To such depths had real wages fallen, due to output decline and inflation, which their low levels undoubtedly undermined productivity.

The rise in real wages during 1996-2003 occurred at similar rates across all the major sectors of the economy: 5.4 percent per annum in agriculture, 6.3 percent in industry, and 5.8 in services (Table 6.9). Some variation is observed, however, among the sub-sectors within services. In transport and construction, real wages grew at ten and eight percent, respectively. The lowest rates of increase were in trade and the public sector (health, education, and public administration).

Given the decline in the real value of money and the social wage during the first half of the 1990s, it is quite possible that the living standards of workers dropped to such a low level that worker productivity was undermined due to ill-health and malnutrition. Thus, that real wages seemed to have outpaced the growth of labour productivity could reflect a process of adjustment toward a more sustainable 'efficiency wage' level. While the average real wage for the economy as a whole increased at the rate of 7.7 percent from 1996 to 2003, labour productivity grew at the rate of only 4.8 percent (Tables 6.7 and 6.8). Looking separately at the sectors of production, both agriculture and industry saw real wages grow faster than productivity. Only in services did the opposite

71 The hypothesis of excessive migration out of agriculture seems eminently plausible in view of the significantly lower levels of productivity and wages that prevail in agriculture compared to other sectors. See the discussion below.

72 However, if the special case of 2003 is excluded, then up to the year 2002 productivity grew in agriculture only at the rate of 1.8 percent, by far the lowest among all the sectors.

happen. However, during the recovery period since 1999, all three sectors saw real wages growing faster than productivity (Tables 6.7 and 6.8).

Agricultural real wages were the lowest among all sectors, and the gap with wages in other sectors widened slightly over time. In 1996, the real wage in agriculture was two-thirds of the national average; by 2003, it had fallen to below sixty percent (Table 6.9). Within the service sector, the lowest wages were in health and education. The highest real wages; namely, those in the financial services sector, were five times above those in agriculture. These inter-sectoral variations in real wages reflect corresponding differences in labour productivity. Agriculture had the lowest level of labour productivity among all the major sectors of the economy, and the gap with the national average widened over time (Table 6.9).

Changes in the structure of employment in an economy tend to have different impacts on men and women, as a result of the discrimination against the latter that relegates (if not segregates) them to low-paying jobs. As in other countries, women in Moldova dominate in health and social work, education, and hotels and restaurants. Surprisingly, they also dominate in finance, which pays the highest monthly salaries among sectors but represents a very small proportion of total women's employment; namely, less than two percent. Hotels and restaurants employ a similarly small percentage of all female workers. Health, social work and education, on the other hand, account for over forty percent of women workers although they are among the lowest paid sectors in the country.

The average monthly wage in 2003 was 891 Leu. Approximately fifty seven percent of women worked in sectors with wages below this average (see Table 6.10); while for men the percentage was forty seven. The anti-discrimination legislation of Moldova is quite strong on paper, and if effectively implemented, would reduce the earnings gap between men and women. However, enforcement is not effective, perpetuating the inequality despite enlightened legislation. A new draft Law on Gender Equality has been prepared and may be approved in 2005. While this would extend the prohibition against discrimination, it would not address the implementation and enforcement problem. As important as formal legislation is, there is still a 'culture of sexism' in Moldova. Many men, as well as some women, are notably insensitive to discrimination against women. As long as this continues, substantially reducing discrimination against women in the labour market will be very difficult.

Legislation against pay discrimination, for example, is easily evaded within a discriminatory culture that relegates women to low-paid jobs. Enforcing equal pay within occupations and skill categories has limited impact on salary differentials if women are segregated into the lowest positions. Strong leadership by the government is necessary to overcome such discrimination. The public sector should set the example for the private sector. Moldovan women perform an enormous amount of unpaid work within the family, and play a leading role in many community organisations. At the same time, they are absent from most decision-making, partly because of the lack of coherent and supportive state policies and partly because of a patriarchal mentality that still adversely influences the entire society, including women themselves.

Productivity and Efficiency

Similar to trends for trends for wages, labour productivity was the highest in industry, followed by services, with agriculture a distant third. In 2003, labour productivity in agriculture was one-third of that in industry and two-thirds of that in the service sector. Correspondingly, agricultural wages were forty percent of industrial wages and sixty percent of wages in services. Within services, labour productivity was the lowest in public administration and the highest in financial services, the same pattern exhibited for real wages (Table 6.11). Given the well-known problems of measuring productivity in services, especially in the public sector where workers typically do not produce a marketed output, these comparative figures must be interpreted cautiously. The need for caution is suggested by the calculation that the service sector had the most consistent and fastest growth of productivity compared to both agriculture and industry, but this difference was not reflected in the relative growth of real wages. Between 1996 and 2003, measured labour productivity grew in services almost three times faster than in industry, and yet average real wages in services grew at a slower pace (5.8 percent per annum in services compared to 6.3 percent for industry).

The preceding analysis suggests that the Moldovan economy failed to raise the level of employment sufficiently to achieve poverty reduction, even when output recovered. Official unemployment figures do not reflect this failure, because of massive out-migration and a growing proportion of economically inactive people. The stagnation of employment levels and the existence of severe underemployment bear adequate testimony to this failure.

To some extent, the failure of employment to recover fully, even during a period of output recovery, should be expected in a transition economy. As in all transition countries, enterprises in Moldova carried more workers before the transition began than would be justified under market criteria. As market forces impinged on enterprises, they began to shed this excess labour. As a result, employment growth lagged behind output growth for some time. However, it appears that the Moldovan economy has completed this process. Employment fell in agriculture, and this decline was not matched by employment expansion elsewhere in the economy. As a result, the pressure to migrate abroad continued, keeping the measured rate of unemployment down, but at considerable social cost (see Chapters 4 and 5).

Stagnant or falling employment coincided with rising labour productivity and increased real wages in all sectors of the economy. Workers who managed to retain or find employment gained from these trends, though the vast majority of them remained at extremely low, if not poverty-assuring, wage levels. Combined with government policy to protect the pensioners, the rise in real wages helped reduce poverty in some years (see Chapter 4). If employment does not recover robustly in the future, it is likely that real wages will cease to rise, and productivity gains will accrue to the owners of capital. However, if wages rise, the number of poverty-level households supported by wage labour will decline. Thus, for the majority of poor households to benefit from the growth process, it is essential to substantially raise the overall level of employment.

The Moldovan transition to a market-based economy is far from complete. This is highlighted by the fact that the level of output remains below the pre-transition level. Since enterprises have probably shed most of the excess labour inherited from central planning, employment increases depend now on the differential between the growth rates of output and productivity. Analysis of enterprise level data reveals a positive relationship between labour productivity and employment creation in Moldova, not the contrary. Enterprises with higher labour productivity have been the ones that have created more jobs (Rutkowski 2004). But only a small number of enterprises have such an achievement. These have usually been newly emerging enterprises in the private sector, rather than privatised enterprises. These new enterprises are typically small and non-agricultural. Poverty reduction requires that this productivity-driven employment generation spread more broadly across sectors and enterprises.

Table 6.3: *Employment by Economic Sectors, 1996-2003*

	1996	1997	1998	1999	2000	2001	2002	2003
Agriculture	42.8	41.6	45.7	48.9	50.6	51.0	49.6	43.0
Industry	11.7	11.6	11.1	10.7	10.6	11.0	11.4	12.1
Services	45.4	46.8	43.2	40.4	38.8	38.0	39.0	44.9
Construction	3.3	3.2	3.5	2.9	2.9	2.9	3.1	3.9
Trade	16.3	16.8	12.7	10.0	10.8	10.9	11.6	13.0
Transport	4.0	4.4	4.7	4.7	4.2	4.3	4.1	5.0
Public admin	16.8	17.6	17.5	17.8	16.5	16.1	16.1	18.0
Others	5.0	4.9	4.8	5.0	4.4	3.9	4.1	5.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: This table, Tables 6.4-6.9 and Table 6.11 rely on data, or calculations based on data, from the DSS.

Table 6.4: *Index of Employment by Economic Sectors, 1996-2003*

	1996	1997	1998	1999	2000	2001	2002	2003
Agriculture	100.0	96.2	105.5	102.8	107.7	107.5	105.1	82.0
Industry	100.0	97.9	93.3	82.1	82.6	84.6	87.7	84.1
Services	100.0	102.3	94.2	80.0	78.0	75.6	77.9	80.8
Construction	100.0	94.5	105.5	80.0	80.0	78.2	83.6	96.4
Trade	100.0	101.8	76.8	55.4	60.1	60.5	64.6	64.9
Transport	100.0	109.1	116.7	106.1	97.0	97.0	93.9	103.0
Public admin	100.0	103.9	103.2	95.3	89.6	86.4	87.1	87.5
Others	100.0	97.6	95.2	89.2	80.7	69.9	73.5	81.9
Total	100.0	99.2	98.9	90.0	91.3	90.3	90.7	81.7

Table 6.5: *Index of Employment during the Recovery Phase, 1999-2003*

	1999	2000	2001	2002	2003	Rate of growth
Agriculture	100.0	104.8	104.5	102.2	79.8	-5.5
Industry	100.0	100.6	103.1	106.9	102.5	0.6
Services	100.0	97.5	94.5	97.3	101.0	0.3
Construction	100.0	100.0	97.7	104.5	120.5	4.8
Trade	100.0	108.7	109.3	116.7	117.3	4.1
Transport	100.0	91.4	91.4	88.6	97.1	-0.7
Public admin	100.0	94.0	90.6	91.4	91.7	-2.1
Others	100.0	90.5	78.4	82.4	91.9	-2.1
Total	100.0	101.4	100.3	100.7	90.8	-2.4

Table 6.6: *Index of Sectoral GDP at 1996 Prices, 1999-2003*

	1999	2000	2001	2002	2003	Rate of growth
Agriculture	100.0	101.9	109.2	115.2	105.2	1.3
Industry	100.0	110.3	117.8	118.1	134.4	7.7
Services	100.0	95.0	99.1	109.3	118.8	4.4
Construction	100.0	69.7	86.7	91.6	112.5	3.0
Trade	100.0	76.4	77.6	80.1	88.1	-3.1
Transport	100.0	121.4	132.4	144.9	157.6	12.1
Public admin	100.0	100.3	99.6	116.6	118.0	4.2
Others	100.0	114.9	121.6	137.5	155.5	11.7
Total	100.0	100.3	106.1	113.0	117.4	4.1

Table 6.7: *Labour Productivity by Sectors and Annual Growth Rates, 1996-2003 (1996 = 100)*

	1997	1998	1999	2000	2001	2002	2003	Rate of growth
Agriculture	116.5	99.8	98.8	96.1	103.2	111.4	130.3	3.9
Industry	91.1	81.0	88.7	97.3	101.3	98.0	116.4	2.2
Services	99.0	106.8	135.2	131.7	141.7	151.8	159.1	6.9
Construction	88.9	67.9	93.1	64.9	82.6	81.6	87.0	-2.0
Trade	92.6	143.3	285.0	200.5	202.3	195.7	213.9	11.4
Transport	96.0	82.4	88.2	117.1	127.7	144.2	143.1	5.3
Public admin	106.3	100.1	86.4	92.2	95.0	110.2	111.1	1.5
Others	101.5	108.3	139.3	176.7	216.1	232.4	235.7	13.0
Total	102.3	96.5	107.5	106.4	113.7	120.6	139.1	4.8

Table 6.8: *Real Wages by Sectors, 1996-2003 (1996 = 100):*

	1997	1998	1999	2000	2001	2002	2003	Rate of growth
Agriculture	99	96	84	94	107	127	144	5.3
Industry	111	120	106	107	117	136	154	6.3
Manufacturing	111	117	104	109	119	136	152	6.2
Mining/quarry	104	103	90	85	103	129	135	4.4
Utilities	112	130	109	97	108	132	159	6.9
Services	102	106	88	86	106	130	148	5.8
Construction	118	121	102	99	114	133	170	7.8
Trade	104	102	89	85	91	119	135	4.4
Transport	112	121	105	112	138	161	198	10.3
Finance	109	138	147	158	139	149	152	6.1
Real estate	103	112	105	102	122	142	162	7.1
Health/educ	97	95	72	69	86	113	133	4.1
Public admin	99	109	88	80	104	132	133	4.2
Others	99	112	83	80	96	118	141	5.0
Total	105	110	97	99	120	146	168	7.7

Table 6.9: *Relative Real Wages by Sectors, 1996-2003*
(1996 prices, weighted sectoral average = 100)

	1996	1997	1998	1999	2000	2001	2002	2003
Agriculture	65.2	61.5	56.3	56.6	61.9	57.9	57.0	56.0
Industry	155.6	165.4	169.3	169.7	167.8	151.9	145.0	142.5
Manufacturing	150.8	160.3	159.3	161.2	166.6	149.3	140.7	136.4
Mining/quarry	164.7	163.1	153.7	151.8	142.0	140.9	145.9	132.3
Utilities	181.3	194.5	213.6	203.4	176.9	163.3	164.3	172.0
Services	113.7	110.3	109.0	102.9	98.6	100.1	101.7	100.3
Construction	132.6	149.0	144.5	139.3	132.7	125.4	121.3	133.9
Trade	111.8	110.7	103.4	102.0	95.6	84.5	91.2	89.7
Transport	138.0	147.6	150.5	148.8	156.0	158.1	152.7	163.0
Finance	362.6	375.4	453.1	547.2	578.1	418.4	371.1	327.2
Real estate	132.1	129.8	134.1	142.6	136.1	133.7	128.8	127.3
Health/educ	85.0	78.8	73.1	62.5	59.5	60.4	65.9	67.3
Public admin	158.3	149.0	156.5	143.6	127.3	136.3	143.2	125.7
Others	89.8	84.7	90.6	76.9	72.7	71.8	73.1	75.4

Table 6.10: *Wages and Employment by Sector and Gender, 2003*

Sector	Average Monthly Wage (Lei)	Women as % of total workers by sector	% of women workers by sector
Financial Activities	2926	63	1.4
Transport and Communications	1454	31	7.3
Industry	1271	47	18.8
Construction	1194	17	2.4
Real estate activities	1133	44	3.9
Public Administration	1050	37	8.5
Hotels and Restaurants	827	76	1.0
Trade	795	54	5.2
Other public	671	56	2.8
Education	610	75	18.7
Health and Social Work	579	80	9.5
Agriculture and Forestry	499	43	20.6
Average	891	Total	100%

SOURCE: DSS (2003a).

Table 6.11: *Relative Labour Productivity by Sectors, 1996-2003 (Weighted sectoral average = 100)*

	1996	1997	1998	1999	2000	2001	2002	2003
Agriculture	73.3	83.4	75.8	67.37	66.2	66.5	67.7	68.7
Industry	224.4	199.7	188.2	185.12	205.2	199.9	182.4	187.7
Services	93.0	90.0	102.9	116.97	115.2	115.9	117.1	106.4
Construction	131.7	114.4	92.7	114.05	80.3	95.7	89.1	82.4
Trade	63.2	57.2	93.9	167.58	119.2	112.4	102.6	97.2
Transport	161.4	151.4	137.7	132.33	177.7	181.2	193.0	166.0
Public admin	86.9	90.3	90.2	69.79	75.3	72.6	79.4	69.4
Others	130.9	129.9	146.9	169.57	217.6	248.9	252.3	221.9

6.3 Generating Wage Employment

Moldova has experienced a slow rate of growth of new enterprises, even by the standards of other transition countries, and this rate has slowed down in the first half of the 2000s. As should be expected, the rate of growth dropped sharply after the Russian crisis, but it did not recover thereafter. In 1997, new enterprises grew at ten to fourteen percent, depending on the legal status of the firm; in 2002, the rate fell to five to seven percent (Table 6.12). These rates can be contrasted with average rates of sixteen to eighteen percent in the transition economies of Central Europe (Eurostat 2000).

The rate of firm closure in Moldova has been one of the lowest among European and Central Asian transition economies. The sluggishness in the growth of new enterprises, rather than the closure of existing enterprises, has contributed more to the stagnation in employment. However, enterprise-level data for 2001 show that expanding enterprises created jobs at a slower rate than the contracting firms lost them (Table 6.13). While average employment increased by thirteen percent in the expanding firms, it declined by sixteen percent in the contracting ones, and the contracting firms outnumbered the expanding ones by a ratio of four to three.

The preponderance of contracting enterprises over expanding ones means that in the formal sector job destruction outpaced job creation. In 2001, expanding enterprises added 6.7 percent to total employment, while the contracting ones subtracted 11.2 percent. The net result was that employment shrank by 4.5 percent. The relative preponderance of contracting firms is not unique to Moldova. The imbalance, however, has been much greater, because of a low proportion of expanding enterprises. For example, while the proportion of contracting enterprises in 2001 was virtually the same in Moldova as in Lithuania, the proportion of expanding enterprises was only thirty percent in Moldova compared to thirty seven percent in Lithuania. As in the case of enterprise turnover, so for enterprise size: it is not so much the severity of job destruction as the sluggishness of new job creation that has proved the main drag on employment in Moldova.

The transition to a market-based economy throughout Central and Eastern Europe resulted in devastating job destruction, in notable contrast to transition in Vietnam and China. This difficult transition led to loss of output on the one hand and continued hardship of the working class on the other. The extent of job destruction in Moldova was typical of European transition economies. Atypical was the slow rate of new job growth, either in the form of the creation of new firms or the expansion of existing ones.

Identifying the major impediments to employment growth is essential to designing effective employment policies. Rutkowski (2004) explored alternative hypotheses to explain the slow rate of job creation in Moldova. In particular, he assessed the importance of so-called 'labour market rigidities',[73] or the costs of hiring and firing workers, which orthodox analysts argue has been responsible for the relatively slow pace of job creation in Western Europe. He found that since the rate of job destruction in Moldova was no less than in other transition economies, there is no reason to believe that the costs of hiring and firing posed a serious problem. The Moldovan labour codes appear to make dismissals difficult, by requiring, for example, the approval of trade unions. Surveys of employer opinions also indicated that they consider the procedural and monetary costs of dismissals an important factor in reducing incentives to create new jobs (ProEra 2002). However, the high rate of job destruction suggests that the provisions of the Labour Code are honoured more in the breach than in implementation. For example, the requirement that employers consult with workers' representatives on dismissals has had little practical consequence because of the weakness of the trade union movement.

73 This concept suffers from a one-sided interpretation in practice, in which virtually all 'rigidities' are those labour practices and regulations that are in the interests of employees, and not 'rigidities' arising from inefficient management.

In addition to labour market 'rigidities', Rutkowski also examined the importance of other factors, such as access to credit, export orientation, ownership structure, capital density, and investment. He found no systematic relationship between these factors and an enterprise's ability to create new jobs. While allowing for the possibility that any relationship may be hidden by limitations of the data, he accepted the hypothesis that the main bottleneck in the creation of new jobs lies in an unfavourable regulatory environment resulting in highs costs of 'doing business'. This conclusion accords well with the prevailing perception of private employers in Moldova about the problems of 'governance' in business regulations.

The argument that the regulatory environment has not been friendly to business in Moldova, while true, may not be decisive, however. The important question is the relative significance of its impact. Rutkowski's own cross-country evidence suggests that while the costs of 'doing business' in Moldova are far higher than in Western Europe, they are not out of line with those in other transition economies. The cost of 'doing business' cannot, therefore, be the major explanation of Moldova's massive failure to create new employment compared with other transition economies.

One problem with Rutkowski's otherwise useful analysis is that he ignores the importance of the demand side in explaining the slow rate of employment creation in Moldova. Supply-side factors, such as production and distribution costs, have played a part and reducing these costs could form an integral part of any comprehensive employment policy. But Moldova's failure relative to other transition economies cannot be fully understood without underscoring demand-side factors. Domestic demand contracted severely in Moldova, due to a massive collapse in the real incomes of its people, and recovery has been slow since then (see Chapter 2). Foreign demand also collapsed in the wake of the disintegration of the Soviet trading system, and has not yet been regenerated by tapping into new export markets. In the face of severe demand constraints, it is not surprising that new enterprises found it difficult to emerge and the existing ones found it difficult to expand. This demand constraint must be addressed as a priority if the rate of new job creation is to exceed the high rate of job destruction.

Since job creation rates have varied among different types of firms, it is important to identify which were more likely to create employment. The evidence for 2001 indicates that, first, each of the three major sectors of the economy; agriculture, industry and services, created fewer jobs than it destroyed (Table 6.14. The problem was most severe in agriculture, and only moderate in services. Though services performed relatively well on net employment losses, in most other transition economies, by contrast, this sector absorbed the workers displaced elsewhere in the process of restructuring. However, this did not happen in Moldova.

It would appear that the form of ownership affected job losses and creation. We consider three types of ownership: state, collectives, and private.[74] In both state and collective enterprises, the rate of job destruction exceeded the rate of job creation. Only the private enterprises were net creators of jobs, but this category accounted for less than ten percent of the workforce outside agriculture in the early years of the 2000s. It is not unexpected that new enterprises would be the greater net creators of employment, since the statistics include only the successful ones, not those that failed to establish themselves.

74 We use the Moldovan statistical categories: collectives were formerly state-owned enterprises that had been either fully or partially privatized; while 'private' refers to new enterprises.

It also appears that enterprise size affected employment creation. Large and medium size enterprises showed negative net job creation, while small and micro-enterprises, and especially the latter, generated more jobs than they destroyed. These smaller enterprises accounted for about sixteen percent of the work force in the non-agricultural sector. However, their employment creating record is due to the fact that they hardly existed before 1990. Thus, while their record on employment was encouraging, it is not strictly comparable to the record of state enterprises or collectives, which did exist before the transition and took the brunt of adjustment.

Rutkowski repeats the ubiquitous view that small enterprises face discrimination in most developing economies in both public policy and private markets. There is no systematic evidence to support this allegation; on the contrary, there have been notable examples of public policy seeking to foster small enterprises—but with mixed success (Katarak 2002). A study of Bulgaria found that the rapid growth of small enterprises resulted more from filling the gap left by state enterprises than from any disciplining process of competition.[75] More generally, cross country evidence suggests that although public policy is important, it is much less important than the structural characteristics of an economy on the medium and long term potential for small enterprises to become viable (Weeks 2003). Public policy in Moldova should seek to foster employment in all ways that are efficient, effective and sustainable. A major part of this effort would be a vigorous public investment programme that reduces the operating costs of enterprises regardless of their size of ownership.

Table 6.12: *Enterprise* Openings and Closures, 1997-2002*

Enterprise category	1997	1998	1999	2000	2001	2002
Openings						
Individual owners	14.3	11.2	4.1	3.4	3.6	4.8
Incorporated	10.3	9.3	8.1	8.1	7.8	7.4
Closures						
Individual owners	1.6	1.6	0.8	2.4	2.8	2.5
Incorporated	1.6	1.1	0.8	2.4	0.7	0.5
Turnover						
Individual owners	15.9	12.8	4.9	5.8	6.4	7.3
Incorporated	11.9	10.3	8.9	10.5	8.4	7.9

SOURCE: Rutkowski 2004
NOTES: The term 'natural persons' and 'legal persons' are used in the source.

Table 6.13: *Expanding and Contracting Enterprises, 2001*

Enterprise category	Share in enterprises (%)	Share in employment (%)	Average enterprise size (persons)	Change in employment (persons)
Contracting	42.0	61.7	84.7	-16.1
Stable	28.5	6.6	13.4	0.0
Expanding	29.5	31.7	61.9	13.0

SOURCE: Rutkowski 2004

75 In the conclusion of the study, the author writes, "It was the initial 'push effect' of the launch of system reform, and the initial liberalization of the legal framework, that had the most marked impact on the numbers of new start-ups, though this must be viewed in the context of the "hidden privatization" made possible as a result of the disorder following the withdrawal of the state from control of the economy." (Kassayie 2002, p. 179)

Table 6.14: *Job Creation and Job Destruction by Types of Enterprise, 2001*

Sector	Gross job creation	Gross job destruction	Net job creation	Employment share (%)
All ownership units				
State	3.0	8.4	-5.4	30.0
Collective	7.0	13.2	-6.2	60.9
Private	16.5	8.6	8.0	9.1
Non-agricultural sector				
State	2.6	7.0	-4.5	42.1
Collective	8.9	11.6	-2.7	46.4
Private	11.6	7.5	4.1	11.4
Enterprise size				
Micro (1-10)	37.3	9.5	27.9	3.4
Small (11-50)	13.5	12.6	0.8	12.9
Medium (51-250)	6.8	15.4	-8.6	34.0
Large (250+)	2.8	9.0	-6.2	49.7
Sector				
Agriculture	3.8	14.0	-10.2	34.0
Manufacturing	7.4	11.9	-4.5	33.3
Services	9.0	9.2	-0.2	32.8

SOURCE: Rutkowski (2004).

6.4 Labour Market Policies

Mindful of the need for new and more productive employment creation, the government of Moldova has pursued active labour market policies. Parliament approved a new version of the Labour Code in 2003, and other laws on employment, remuneration, and the settling of labour disputes were also introduced. Article 43 of the Constitution of the Republic of Moldova ensures the right to work and to labour protection for every Moldovan citizen. In order to improve the labour market and reduce the level of unemployment, the government adopted the Strategy on Labour Force Employment in the Republic of Moldova for 2002-2008. This strategy was meant to fulfil four overarching objectives: improving the skills of the labour force; developing entrepreneurial capacity; increasing the 'flexibility' of workers and enterprises; and providing equal opportunities.

The Strategy was to be implemented in two phases, with the first phase in 2002-2004 and the second in 2005-2008. In December 2004, the Ministry of Economy provided the first assessment of the progress made in implementing the first phase of the strategy. This evaluation indicated that while progress had been made, the record on reducing unemployment and poverty was disappointing.

Previously, the National Programme for Employment, which had been initiated by the Ministry of Labour and Social Protection in 1994, had included labour market analysis and forecasting, special measures for job creation, employment opportunities for young people, and training and re-training for the unemployed. The National Employment Agency and its territorial bodies were assigned with the task of supplying information on existing vacancies and short-listing applicants by matching job offers to the qualification, aptitudes and interests of applicants. The services provided by the agency also included guidance on occupational choice, support to new enterprises, promotion of labour mobility, and training. However, these efforts produced little success in fostering job creation. According to the Ministry of Economy, only about five percent of Moldovan businesses took advantage of government incentives, such as reduced income taxes or social contributions, and those that did were enterprises that generated mostly low-paid jobs.

The agency's training programmes have also had a limited impact. The government usually contracted out training courses to private institutions and financed the costs from the Employment Fund, which has been part of the government's Social Fund. The training was intended to be based on existing and projected demand for different types of labour. In practice, however, there was considerable mismatch between supply and demand. To correct this, the National Employment Agency changed the programme to establish a more demand led system and create labour supply more adapted to enterprise needs. Evidence indicates that the National Employment Agency and its regional offices have made progress in ensuring that the unemployed benefit from job search and guidance services at an early stage.

In order to develop and facilitate youth employment, the Government adopted the National Programme for Prevention and Reduction of Youth Unemployment. With the financial support of the World Bank, the National Net for Youth Employment was established, with four regional centres and eleven resource centres. These resource centres provide consulting services, professional training, and cultural activities. During 2002-2003, more than fifty thousand people took advantage of the consulting services and nearly eighty percent of them were sixteen-twenty nine years of age.

In order to foster entrepreneurship and facilitate access to funding for new and existing small and medium enterprises, the government adopted the State Programme of Small Business Support for 2002-2005. The Programme led to the following reforms:

1. Simplification of the registration procedure for enterprises;
2. Streamlining of the list of activities subject to licensing;
3. Reduction of the tax burden for small and medium enterprises;[76] and
4. Establishment of a Fund for Entrepreneurship Support and Small Business Development;[77]
5. Adoption of the Law on Micro-Finance Organisations in order to facilitate access by small and medium enterprises to non-bank micro-finance services.

The 'Entrepreneurial Patent' has been an additional public measure designed to encourage entrepreneurship in specified activities. It has involved a simplified registration and taxation system for obtaining a patent. These patents can be obtained by nationals or foreigners from local tax authorities or, in certain cases, from local

76 According to the new version of Article 49 (Tax Code, Title II) a small and medium enterprise could be exempted from income tax for the first 3 years ("tax holidays") if its staff is fewer than 20 persons and its annual turnover no more than leu3 million.

77 In 2004, one million Leu were transferred to the Fund from the state budget and used for guaranteeing credits received by SMEs from commercial banks.

administrations. In 2003-2004, this program reached more than eighty thousand people, of who twenty four percent were in Chisinau.

There is lack of information, even understanding, on the part of workers and employers about the nature of the labour market. One consequence is that the system of wage setting does not encourage workers to acquire new skills or facilitate their movement between jobs. Many workers have only a narrow range of technical skills, often specific to industries in decline. The National Employment Strategy is trying to address this problem by enlisting the help of employers in the design and delivery of training and requiring them to share the costs and responsibilities.

The inefficiency of the labour market in Moldova in allocating workers among jobs should not be interpreted as market 'inflexibility' in the orthodox sense of the term. Whatever may be the problems with the labour market, it is not 'inflexible' with regard to wage 'adjustment'. As shown in this chapter and Chapter 2, real wages collapsed in the first half of the 1990s, indicating, if anything, excessive downward wage 'flexibility'. However, this real wage flexibility was not matched by employment flexibility: the wage collapse was associated with a simultaneous collapse of employment. That is, falling wages did nothing to boost employment, contrary to the predictions of an orthodox model of labour markets. The simultaneous collapse of wages and employment in the 1990s reflects, in part, the weak bargaining power of workers, which has resulted from at least three factors: 1) the absence of an independent trade union movement at the beginning of the transition 2) rapidly growing unemployment and 3) ineffective regulation of employers by the public sector.

A poverty reducing employment strategy in Moldova needs the active support of trade unions in all sectors, especially in agriculture. Because labour markets are ineffective and inefficient, it is through trade unions that productivity increases can be translated into real wage increases, working conditions can be improved and job security fostered. On-the-job harassment of workers, especially women, can also be reduced. A policy of actively strengthening trade unions is especially important, because Moldova has never had an independent workers' movement, much less one with the ability to protect workers' rights in an effective manner. Research covering almost twenty countries, including transition economies, has shown '[c]ompanies that score high in terms of the human development enterprise index tend to do better in terms of economic and employment performance' (Standing 1997a).[78]

The Ministry of Labour and Social Welfare is committed to the protection of working conditions and workers' right to organise, but lacks sufficient funding to enforce the country's progressive labour legislation. Adequate funding for the ministry would be an essential element, perhaps a necessary condition, for the growth of employment providing earnings that would lift wage earner households out of poverty.

6.5 Conclusions

Moldova's employment problem does not arise principally from defects in the labour market, such as so-called 'rigidities', but from a broader problem of incomplete and painfully slow transition of its economy. Growth is not only not rapid enough but also not broad-based enough. Moreover, many poor workers do not possess the skills, resources or assets needed to take advantage of economic opportunities if they become available. Hence, an effective employment strategy needs to be comprehensive, covering a

78 The index includes twenty-four indicators of enterprise characteristics, including labour turnover and working conditions. It is explained in detail in Standing 1997b.

range of policy actions at the macro, sectoral and micro levels (see Chapters 2 and 3). Macroeconomic reforms are needed to spark more rapid growth, sectoral reforms are needed to make growth more broad-based, and microeconomic reforms are needed to enhance workers' access to expanding economic opportunities.

The most important constraints on employment growth in Moldova are related to insufficient demand and the lack of productive public and private investment in particular. While changes in the regulation of enterprises and labour markets can contribute to employment creation, the fundamental starting point is designing a more growth-oriented macroeconomic framework. This framework would have several components: expansionary fiscal policy focused on public investment, monetary policy geared to fostering low real interest rates, and a modestly undervalued exchange rate designed to boost exports.

The composition of fiscal expansion is as important as its aggregate demand effect. While there is excess capacity in the private sector, much of it is in enterprises whose expansion and rejuvenation are unlikely to occur. So, stimulus of demand, by itself, is not likely to increase capacity utilization. New productive capacity needs to be created. Hence, public investment in economic and social infrastructure, which would lower the costs of private-sector investment, is a necessary condition for sustainable employment growth at wages high enough to reduce poverty.

Making regulation of the private sector more transparent, changing aspects of labour market governance, and reducing bureaucracy and corruption can complement a pro-growth, employment-fostering macroeconomic framework. However, without a conducive macroeconomic framework, such institutional reforms are likely to have only a modest impact on growth.

At the sectoral level, special attention should be given to improving productivity and incomes in agriculture. When the Moldovan economy collapsed in the early stage of transition, people fell back on agriculture in order to eke out a living. But the precipitous decline in agricultural production undercut the sector's prospects for generating poverty-reducing employment. Hence, an agriculture-*led* growth strategy in Moldova would quickly exhaust its poverty reducing potential. Productivity and real wages are lower in agriculture than in industry and services. Based on the current open trade regime, the development of a vibrant agricultural sector that is competitive in both domestic and external markets implies that fewer agricultural workers will be needed in the long run. Already, many workers have migrated out of the sector in search of higher incomes, either in Moldova's larger cities or abroad.

It is a strategic priority to revive growth in the agricultural sector. Chapter 6 provides several recommendations on how to achieve this objective. Development is not possible in Moldova as long as agriculture is a moribund sector. But agriculture cannot grow and develop on its own. Moreover, it has absorbed too much surplus labour. Employment also needs to be created elsewhere in the economy. In this respect, agro-industry provides a critical engine of job creation. The relative absence of linkage effects from agriculture to manufacturing has resulted, in fact, in deep recession in small towns, which suffer from the highest incidence of poverty in the country (see Chapter 4). Hence, building up the agro-industrial sector will be critical not only for creating broad-based productive employment in Moldova but also for contributing to commercializing agriculture and making it more productive and competitive. Public investment should be directed towards agro-industry and private credit from the commercial banking system should also be encouraged to flow to this sector.

The acceleration of growth throughout the economy and the stimulation of sectoral growth in both agriculture and agro-industry will generate more decent-paying employment. Based on this increased demand, the supply-side interventions of the government to improve workers' skills and mobility, develop entrepreneurship and innovation, and enhance equal opportunity, such as for women and youth, will become much more successful. An integral component of a comprehensive programme to improve the supply of skilled workers is to ensure that the educational system offers broad-based access to general secondary, specialized secondary and higher education. Poorer household in Moldova have been losing opportunities for such educational attainment because inequality in access has intensified, especially for higher education.

In the short to medium term, agriculture has to be one of major sources of growth in the Moldovan economy. But this growth will depend not only on raising labour productivity in agriculture but also on expanding the agro-industrial sector so that it can re-absorb the workers who had to resort to agricultural livelihoods because of the collapse of industry during the transition. Agro-industry can provide workers with the remunerative employment that is not possible on a widespread basis in agriculture itself.

Chapter 7:

Agro-Industrial Growth and Sustainaible Proverty Reduction

7.1 Agriculture's Role in Moldova's Growth Strategy

Agricultural development is critical to Moldova's future because it would increase rural incomes and job opportunities, and contribute to reducing migration. It represents an important medium-term vehicle for assuring the recovery of the Moldova economy and laying the necessary basis for the eventual re-industrialisation of the country. However, developing the agro-industrial sector should go hand in hand with the revival of the agricultural sector. Without forging strong links to agro-processing, agriculture will be unable grow either rapidly or in a sustainable manner.

The agro-industrial sector of Moldova is still recovering from the effects of the 1998 Russian crisis. This sector was important during the Soviet era, reflecting Moldova's absolute and relative advantages compared to other republics of the former Soviet Union. As the economy collapsed after independence, a large part of the agro-industrial sector also collapsed. The remaining part has restructured and modernized, and is seeking to compete in export markets and with imports.

While agriculture may have growth potential, there are structural bottlenecks in the sector, and between producers and processing companies in particular, that require policy action in order to make rapid and sustainable growth possible. The principal problems are underdeveloped markets for inputs, output and finance. Also, weak or absent are supportive institutions, such as output marketing and input purchasing cooperatives (so-called 'single-purpose cooperatives'), which can increase the bargaining power of small farmers. Confidence in the public administration and in commercial companies is low, and enforcement of legislation is lacking, in particular when lack of enforcement adversely affects small producers. Finally, most of the agricultural sector has suffered from years of insufficient investment. As a result, rural roads, market infrastructure, irrigation systems, and communication networks have deteriorated, undermining the sustainable recovery of the sector.

7.2 Agriculture on the Eve of Independence

During the 1980s, agriculture accounted for over thirty percent of Moldova's GDP and provided employment for thirty five to forty percent of the labour force.[79] Agro-processing contributed an additional ten to fifteen percentage points of GDP, to make agricultural-based activities total about forty percent of GDP. Agro-processing also employed another eight to ten percent of the labour force. The share of the rural population declined

79 The data presented in section 6.1 are based on two sources: Annual Statistical Books issued by the Department of Statistics and Sociology (DSS) of the Republic of Moldova and the World Bank Statistical Handbook 1993 – States of the Former USSR, Washington, D.C., September 1993.

during the 1980s, but remained quite high compared to other Soviet republics. In 1990, this share was fifty three percent, compared to the FSU average of thirty four percent. Because non-agricultural jobs grew slowly and agricultural salaries were similar to those in other sectors, the rural labour force showed little job mobility.

The importance of agriculture in Moldova's economy derived in part from the country's natural resource base and fertile soils. Rich black soils cover about eighty percent of the total land area. Agriculture's importance also resulted from political factors that assigned Moldova primarily an agricultural role within the Soviet division of labour. There were no production or trade decisions made within this division solely, or even primarily, on economic and natural endowment grounds (see Chapter 1).

The crop sub-sector accounted for over sixty percent of gross agricultural output (GAO) in the 1980s. Moldova was the source of thirty percent of the USSR's tobacco, twenty percent of its grapes and wines, thirteen percent of its fruits, and ten percent of its vegetables. These comprised the so-called high value agricultural (HVA) products (Economist Intelligence Unit 2003). Moldova recorded some of the highest crop yields in the FSU. For example, the 1985 yields of Moldovan HVA crops were higher than the *current* yields in Romania or Bulgaria (USAID 2004). While labour productivity in Moldova ranked below that in the Baltic republics and other European republics, it was significantly above that in the Transcaucasian and Central Asian republics, whose agricultural employment shares were similar to Moldova. The most remunerative crops were tobacco, vegetables, fruits, and grapes, followed by potatoes, sugar beet, and (in much smaller amounts) sunflower and grains. Moldova's crop diversity is a distinct advantage and remains relevant to its current policy options and economic opportunities.

Agricultural production in Moldova, as in the rest of Soviet Union, was organized in two major types of centrally controlled large-scale socialized farms, the collective *kolkhozes* and state-owned *sovkhozes*. The system was complemented by inter-farm enterprises; large cooperatives, jointly owned by several farms, that comprised large livestock and feed complexes. During the 1980s, these enterprises provided about eighty percent of the country's pork and ninety percent of its eggs and poultry. Overall, they accounted for about fifteen percent of gross agricultural output. However, since inter-farm enterprises were not self-sufficient in feed, Moldova had to rely on imports of over one million tons of grain per year from other FSU republics.

In addition to the state farm sector, rural private household plots and garden plots of urban households accounted for an important share of agricultural production. The average size of these plots was small, averaging three-tenths of a hectare. They relied on part-time family labour and produced primarily for subsistence, although part of the output found its way to markets in nearby towns or Chisinau. While holding only seven percent of total agricultural land, private households produced up to eighteen percent of agricultural output. This can be explained partly by these households' specialization in high-value commodities, their access to subsidized inputs from the large farms, and price differentials between private markets and the administrative system.

For the state sector, the government gave highest priority to meeting production targets set by the central plan. Centrally controlled farms had mechanisms to control costs or surpluses (profits) because: (i) their inputs were delivered at non-negotiable prices; (ii) their capital investments were set by the production plan; (iii) their credit was supplied by the government without regard to repayment capacity; and (iv) sales were guaranteed at prices to cover production costs. Profitability at the farm level was sustained through subsidies. The share of agricultural subsidies in total government expenditures in Moldova grew from sixteen percent in 1980 to thirty five percent in 1990. However, by 1992, the first full year of Moldova's independence, agricultural subsidies dropped to 3.4 percent of government expenditures.

The state farms provided a range of social services in villages and small towns, which were absorbed into operating costs. It was the state's responsibility to ensure that these farms remained viable. This objective was accomplished through a wide range of financial instruments, which enabled the farm enterprises to fulfil their mission of both producing food for the cities and providing social services for their workforce. Under this system, the rural population was supported at a standard of living above poverty. The average wage in agriculture was similar to the economy-wide average, and rural households had the additional benefit of being able to cultivate individual plots, which met most of their food needs and provided some cash from sales.

7.3 Post-Independence Agrarian Reform and Economic Performance

Restructuring of Ownership

The restructuring of collective and state farms proceeded unevenly after independence. The first phase began in 1991 with the formal distribution of the household plots. In 1992, the Land Code and the Law on Peasant Farms were adopted, initiating large-scale land redistribution. Land and other collective and state farm assets were distributed among households as paper shares, which could be exchanged for land or non-land assets. However, the large wave of households clamouring to leave collective and state farms and privatize their land prompted opposition to land reform. This led to the November 1994 law, 'Suspension of Some Articles of the Land Code', which halted the process of privatisation. However, in November 1995 the Constitutional Court of Moldova declared the limitations on leaving collective and state farms to be unconstitutional, and the process of privatization began anew in 1996.

By October 1996, some ninety thousand private farmers, individually or in groups, worked one hundred and thirty thousand hectares, five percent of Moldova's arable land. The remaining farm population remained in collective farms that had been nominally restructured, or in new farm associations and production cooperatives that had been created from the collective farms. These new institutions, 'corporate farms', essentially functioned as slightly smaller *kolkhozes*. The National Land Program (NLP) of 1998, supported by external funding agencies, accelerated the process of land reform. In 1999, a law on farm debt provided additional incentives for dissolving collectives by arranging debt restructuring and consolidation. At the end of 2000, nearly 1.7 million hectares and the majority of state farm assets were transferred from over one thousand bankrupt *kolkhozes* and *sovkhozes* to about one million former farm employees. Orchards and vineyards were also distributed to households according to the latter's size. The result was to fragment a large share of land holdings into over three million small privatised parcels.

On average, each owner received three parcels of land, with an average parcel being one-half hectare. The program included the establishment of a register of land titles, and an extensive education campaign for farmers on their legal rights and market opportunities. Some of the new landowners chose to farm the land with family labour. Others leased their land and other assets to the newly created corporate farms, which had been formed out of the collective farms, and either worked on them as members or employees or received lease payments. Thus, the privatization process led to a dual agrarian structure polarized between one part based on a myriad of small-scale farms of one to five hectares and another part based on a few large corporate farms, such as limited liability companies, joint stock companies, production cooperatives, or farm associations.

The gender aspects of the land reform have been poorly documented. Rural women made up a majority of the land proprietors because men worked in constructions, technical services and commerce, losing their right under the land legislation to obtain land. However, despite this apparent advantage, women did not end up playing a leading role in the land reform. There appeared to be few female managers of cooperatives or large farms although definitive statistics on this issue are lacking. As in other sectors, gender-focused statistics for agriculture are an urgent priority in order to fully understand the role of women.

Privatization and farm restructuring, completed in early 2001, were the major components of the first stage of land reform. Stage two, the post-privatization program, began immediately afterwards and continues with the support of international donors. The post-privatization program has focused on facilitating the adjustment of private farms to a 'market environment' through: (i) developing market infrastructure, including marketing, input and credit supply; (ii) improving the legal and regulatory framework; and (iii) facilitating access to information and technical advice.

Despite these measures, agricultural markets and related services remain weakly developed in Moldova. In the aftermath of the redistributive land reform, many of the more than one million beneficiaries did not have the necessary skills for efficient agricultural operations, especially because a large proportion of the recipients were pensioners at the time of privatization. It was expected that the emergence of agricultural markets would transfer land from less efficient to more efficient producers. Greater land consolidation and concentration were the ultimate objective. Such a trend was expected, in turn, to lead to a more competitive agricultural sector.

The latest data of the Cadastre Agency indicate that 53.6 percent of total agricultural land is utilized by relatively large-scale corporate farms, mainly limited liability companies, with a much smaller share utilized by production cooperatives and joint stock companies that also operate on the basis of leasing land and assets from small landowners. The corporate farms are often headed by former managers or agricultural specialists of the collective enterprises.

Table 7.1 *Private Land Tenure in Moldova as of January 1, 2004*

Form of enterprise	Number of units	Land used (ha)	% of land used	Average Farm size (ha)
Limited liability companies	1188	639,000	42.5	538
Production cooperatives	111	105,700	7.0	952
Joint stock companies	95	47,100	3.1	496
Kolkhozes	4	13,700	0.9	3425
Peasant farms	555,000	698,200	46.4	1.26

SOURCE: Cadastre Agency, Land Balance Data - 2004

In a relatively short period, 2001 to 2004, a rapid process of land consolidation and farm restructuring took place through lease arrangements between individual landowners and large corporate farms. Individual ownership of land was not directly affected. However, next to these corporate farms, the small scale sector, composed of 555,000 peasant farms (registered and unregistered), suffered from a very small size of land holdings. The average holding was 1.26 hectares, often further subdivided into tiny fragmented land plots. This small farm sector cultivated 46.4 percent of the agricultural land. Some of these small farmers have tried to cope with the market environment by forming partnerships among themselves but this phenomenon has been limited.[80]

Compared to large-scale units, small farms appear to have higher productivity, measured by value added per unit of land. This can be explained largely by the production structure of the small scale sector, which grows most of the high value crops, such as fruits, grapes, vegetables and potatoes. A recent IFAD study (2003) highlighted the other typical advantage of small-scale growers; namely, that they have a competitive edge over larger operators because of their lower costs. However, the Moldovan agricultural sector has yet to achieve the necessary conditions for international competitiveness. The development of various factors, such as agricultural services and markets for inputs, outputs and credit as well as supportive government policies, will have an important impact on this prospect.

The government has viewed fragmented landownership and the predominance of small farm size as a bottleneck for agro-industrial development. Hence, it has launched several policy proposals aimed at land consolidation and the creation of production cooperatives. These initiatives have encountered both domestic and international opposition because they are seen as a step towards reversing some of the main outcomes of the redistributive land reform of the late 1990s.

The government proposals have encouraged the creation of 'consolidated enterprises', which would function essentially as production cooperatives. The government's reasons for undertaking land consolidation have been based on the following assumptions: (i) land fragmentation is excessively high in Moldova; (ii) small scale agriculture is inefficient and uncompetitive; (iii) consolidated agricultural enterprises, because they represent the optimal size, will be able to produce a high-quality and competitive output; and (iv) the envisaged consolidated enterprises will create new jobs, increase labour productivity and reduce migration from rural areas.

Some of these assumptions have been called into question. First, although the statistics on land distribution mentioned earlier should be treated with caution, they do suggest that small farms are economically efficient. Second, the concept of 'optimal size' is problematic. Even for the same product, the desirable size can vary in accordance with different soil characteristics and production techniques. Third, land consolidation has already taken place through lease markets, and is likely to continue. Such market forces cannot be stopped but rather can be directed into more socially desirable directions. Finally, the principal explanation for the lack of efficiency in agriculture may not be small farm size, but the underdevelopment of markets for both inputs and outputs.

A recent study attempting to gauge farmers' attitudes toward the government's proposed form of land consolidation found that seventy six percent of landowners (or leaseholders) and eighty two percent of lessees would not agree to transfer their land to a 'consolidated en-

80 The category of peasant farms (or 'the individual sector', as it is called) also includes about 340 farms whose size is over 50 hectares.

terprise' (CISR 2003). Typical reasons given for not wanting to do this were: 'won't be able to pass my land over to my heirs', 'the collective farm will not be more efficient and the employees will be irresponsible', 'can sell my land anytime now', or 'am satisfied with my land lease contract'.

As this report was being finalized, the government proposal for forming 'consolidated enterprises' was dropped. But the debate on how to improve the agrarian structure, in order to promote both efficiency and equity, continues in Moldova. One way out of this impasse is to encourage small-scale farmers to join 'single-purpose cooperatives' for buying inputs or marketing outputs. This would lead to greater consolidation of land holdings and higher levels of productivity without pushing some farmers off the land and impoverishing them. However, while most individual farmers are not required to pay value added taxes because their turnover is below 200,000 leu per year, they would have to pay such taxes if they joined cooperatives. In order to rectify this situation and actively encourage farmers to form such associations, the government should provide them with tax breaks.

Agricultural Performance

As a result of the structural changes and general economic collapse, agriculture contracted dramatically during the 1990s. In 2003, agricultural production was only at forty five percent of its 1990 level (see Figure 7.1). Livestock production proved much more vulnerable to structural changes than crop production. Over thirteen years, it decreased by nearly two-thirds. As a result, the share of livestock in total agricultural value added decreased to thirty percent from the forty percent that was typical during the Soviet period. However, in 2001, after the second phase of redistributive land reform, there was strong growth of six percent, followed by three percent in 2002. This growth might have continued into 2003 but a severe summer drought destroyed the wheat harvest, which normally accounts for fifteen percent of agricultural value added. As a result, growth was a negative fourteen percent. A simulation that nets out the negative effect of the drought on agricultural output indicates that the growth rate of gross agricultural output for that year could have been 2.2 percent.

During the period of transition, dramatic changes in the structure of agricultural production accompanied contraction. Demonetization, demand contraction and the risk-avoiding behaviour of small farmers prompted increases in the land under low-value staple crops, such as wheat, corn and sunflower, and the concomitant reduction of the area under high-value crops (see Figure 7.2). By 2003, grains and sunflower occupied about seventy five percent of cultivated area, whereas in the past they occupied fifty to fifty five percent.

The largest contraction in the crop subsector was in such high-value products as tobacco, fruits (except grapes) and vegetables. As a result, the share of high value crops in total value added declined from sixty six percent in the pre-transition period to thirty percent in 2000-2003 (see Figure 7.3).[81] Because potatoes are grown mainly for subsistence, their production remained constant over the years and thus their relative share in GAO increased.

Large declines in yields characterised the 1990s (see Figure 7.4). The yield declines were higher for the machinery-intensive crops, and lower for staples (wheat, corn, sunflower and potatoes). The low and declining yields of fruits and vegetables[82] were the result not only of insufficient and

81 The so-called High Value Agriculture sector comprises tobacco, vegetables and fruits (including berries and grapes).

82 The year 2003 was an exception in this respect: the registered yields were higher due to excellent climatic conditions for fruits and vegetables.

inadequate inputs. There were two other important constraints: the lack of re-planting of ageing orchards and vineyards, and the lack of rehabilitation and modernization of irrigation systems, particularly small-scale systems adjusted to the needs of the recently emerged private farmers. The Ministry of Agriculture reported that only half of existing vineyards and orchards were productive in 2004.

Also, only 10,000 hectares, or five percent of the previously irrigated land, was still irrigated in 2003. Water use for irrigation had dropped in 2003 to only ten percent of its level in the mid 1990s. Repairing the old irrigation system is not likely to be advisable since it was highly energy intensive and has been largely destroyed in any case. Most grain production could be supported by a rain-fed system. But irrigation is certainly of great importance to the productivity of high value agricultural crops. A 2002 IFAD study estimated that net farm income could be boosted by as much as US$ 700 per hectare on the basis of irrigating high value crops. Irrigation is such a high priority for agricultural development that the government should offer tax incentives or preferential credit to help farmers purchase irrigation equipment. Small-scale irrigation systems could be run efficiently by farmer organizations, such as Water Use Associations.

Along with the negative trends and constraints of the 1990s, there were some positive developments. According to the High Value Agriculture Study (CNFA, 2004), commercial producers of high value products that used advanced production technologies, including irrigation, registered significantly higher yields for some crops than the average in Romania, Bulgaria and Hungary. This suggests that Moldovan producers have the potential to achieve international competitiveness.

The livestock sub-sector shrank sharply over the transition period due to removal of the high subsidies it had received during the Soviet period, and, even more, due to the catastrophic decline in urban incomes (which lowered demand for meat products). The sector was devastated by the combination of price and trade liberalisation. Now, the livestock herds are concentrated on small farms (which account for over ninety percent of all animals). These farms rely on livestock for family consumption needs as well as for earning income from market sales. Cattle, which generally require long-term investments, registered the greatest decline among livestock, from over twenty percent of total livestock during 1985-1990 to only seven percent now. Lack of genetic resources, which would enable livestock production to be competitive in price and quality,[83] limited cattle selection, and inadequate breeding technology continue to be major impediments to livestock development.

7.4 The Underdevelopment of Agricultural Markets

The underdevelopment of markets for fertilizers, seeds, machinery and credit is a serious problem for Moldovan farmers. Their access to inputs has radically declined during the transition to a market-based economy and new input markets have yet to take the place of state provision. Because of the dramatic reduction of livestock, organize fertilizer is scarce. The use of chemical fertilizers, which was extensive in the Soviet period, dropped in 1999 to one-tenth of its 1990 level. This represents a severe constraint, in particular, on the growth of high value agricultural crops. While seeds have become more available in Moldova, their quality remains variable because of difficulties in importing sufficient quantities of certified seeds.

83 As of July 2003, the number of pedigree cattle was seven to ten times lower than the normative requirements. See Agricultura Moldovei, 2/2004.

There has been a rapid deterioration in the existing stock of farm machinery. The number of tractors has declined, for example, by over twenty percent and another ten percent of tractors are used exclusively for transport. The stock of tractors is now quite old: half of them have been in use for over fifteen years.

Small agricultural producers have virtually no access to commercial lending. Since land prices remain low and other farm assets are scarce, farmers possess little collateral for borrowing. The main lenders to agriculture are Moldova Agroindbank and Victoria Bank, which together account for about half of all lending. However, loans still account for only a small fraction of gross agricultural output.

With the support of external donors, Savings and Credit Associations have arisen to offer micro-credit to farmers. However, total volume is small and directed mostly to financing working capital. While such credit is indeed important, loans for long-term productive investment in agriculture are in short supply. The same shortage of credit applies to rural non-farm enterprises, which are very weakly developed in rural areas. The lack of credit is a major constraint to both agricultural and non-agricultural development. This is a constraint that public policy can do a great deal to remove by providing various incentives to financial institutions to offer more loans for such development. Helping direct such loans to private investment in agriculture and agro-industry would complement the spearheading role of public investment in these sectors.

7.5 Rural Labour Markets

As shown in Chapter 4, poverty in Moldova's rural areas is most serious amongst those who have little land. However, poverty is most prevalent in small towns, where people have few employment opportunities and no land. In 2002, the Poverty and Policy Monitoring Unit (PPMU) of the Ministry of Economy reported that agricultural workers were the poorest group of the rural population (66.2 percent of them were poor and fifty four percent extremely poor), and peasant farmers were the next poorest (53.9 percent were poor and 45 percent extremely poor).

More recent data, for 2003, indicate slightly reduced levels of poverty among farm households. The data show that access to land contributed to lowering the poverty headcount. On average, 46.9 percent of farmers were poor and 32.6 percent extremely poor. But those with less than two hectares of land had a higher poverty incidence. So, consolidating land holdings is essential for agricultural development and poverty reduction. However, since most agricultural workers, who tend to be the poorest group, are not employed on small farms, reducing rural poverty requires a broad-based growth strategy that benefits both large and small production units. But this does not imply that land should become more concentrated, i.e., consolidated under the control of large corporate farms that wield excessive market power.

In the first half of the 2000s, over half of the country's population lived in rural areas, with agriculture being the main source of their employment. While the share of agriculture in GDP declined during the 1990s, its share in total employment grew slightly (see Figure 7.5). This implies that during the economic collapse after 1991, agriculture absorbed some, although certainly not most ,of the labour shed by other sectors. The falling share of agriculture in GDP implies that the inflow of labour into farming did not spur agricultural growth, but in most cases was absorbed in subsistence production that reduced average sector-wide productivity.

Low agricultural returns and lack of jobs outside agriculture stimulated labour migration, in many cases to other countries (see Chapter 5). Non-farm employment has remained insufficient to reduce underemployment in rural areas, in spite of various projects supported by external donors and lenders. This strengthens the case for focusing on increasing agricultural incomes, through augmented output and higher prices. This could be fortified through links with an expanding agro-processing industry. Agricultural prosperity will be the necessary foundation for the growth of the non-farm economy.

Estimates indicate that hundreds of thousands Moldovans work abroad, the majority of them originating from villages and small towns (see Chapter 5). According to DSS data, this out-migration has contributed to the feminization of the rural labour force since most migrants have been men. It is clear that skilled labour has become increasingly scarce in the countryside since the late 1990s. The loss of such a large proportion of the working age population imposes serious constraints on agricultural development. This implies that the development of human resources in rural areas is still essential. But the problem is much larger than this. Consolidation of land holdings will help spur development. Strengthening links with agro-industry will also improve productivity. Special measures to channel remittances from rural workers labouring abroad into productive investment in agricultural development could also contribute.

7.6 Agro-Industrial Growth

There are many constraints impeding agricultural development in Moldova. They arise, in part, from the underdeveloped markets for agricultural services, final products, finance and labour. Another major problem is the lack of long-term investment, both domestic and foreign, that could enhance agricultural productivity and foster internationally competitive agro-food products. These investments are needed at the production level; in replanting orchards and vineyards, restoring irrigation, and developing processing facilities. During 2000-2004, agriculture attracted not more than US$ six to ten million annually for investment in fixed assets ,only about five percent of all such investment. In contrast, the investment needed to revitalize high value added crops is estimated to be about US$ two billion (USAID 2004).

Linking agricultural to agro-processing can help stimulate growth and increased investment. The agro-processing industry accounted for sixty percent of gross industrial output in 2003. Since 2000, this industry has registered impressive annual growth rates of fifteen to eighteen percent. The wine industry dominates this industry, with a forty percent share in its output, followed by fruits and vegetables (eight percent), dairy products (seven percent), oils (six percent), and tobacco (five percent). Almost all agro-processing enterprises were private in 2005, with only tobacco and some wineries still state-owned.

Moldovan agriculture and agro-industry continue to have strong export potential. Processed and unprocessed agricultural products accounted for about sixty percent of Moldovan exports (Table 7.2). In spite of the economic collapse of the

Table 7.2. *Agro-Food and Primary Agricultural Exports (1995-2003) (US$ millions & percentage)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Agric, non-processed	144	128	151	106	97	89	98	122	120
Agric, processed	393	457	487	354	200	202	260	285	343
Total Agric	538	585	638	460	297	291	358	406	463
Total Exports	746	795	874	632	463	472	570	666	790
Agric /Total, percent	72	74	73	73	64	62	63	61	59

early 1990s, Moldova remained a net agricultural exporter, but still specializing in wines and other alcoholic drinks, tobacco products, and fruits and vegetables.

Export volumes fell drastically over the course of the 1990s. In 2004, Moldova exported only ten percent of the fresh produce that it had supplied to the USSR in 1985 (USAID 2004). Russia and, to a lesser extent, other CIS countries continued to absorb over seventy percent of Moldovan agro-food exports, while the CEE countries absorbed ten to fifteen percent and the European Union absorbed about ten percent. Despite the 1998 Russian financial crisis, which exposed the vulnerability of concentrating on a single market, Moldova has not altered its trade patterns. Several factors have continued to determine the destinations of Moldovan agro-food exports: (i) the large size of the CIS market and the growing demand for Moldovan products in this market; (ii) the familiar and positive consumer image of Moldovan products, particularly wines, fruits and vegetables; (iii) easier access to CIS markets through free trade agreements and common standards for produce; and (iv) a familiar business environment, which facilitates establishing partnerships and trading relations.

Agro-industry is the fastest growing economic sector in Moldova. In 2003, the manufacturing sector as a whole grew at a rate of 13.7 percent, with food and beverages representing around seventy percent of its value added. In 2004, it is expected that food and beverages output would increase at a rate of 16.7 percent (Center for Economic Policies 2004).

There are clear signs of modernization in various sub-sectors, such as fruit and vegetables, sunflower oil processing and the wine industry. However, there are also negative trends, as in the sugar beet industry, where there is substantial over-capacity coupled with a decreasing domestic supply of raw materials. Since technology is out-dated in these Soviet-made sugar-mills, productivity is low. Therefore, even with the temporary protection provided by parliament, the sugar-processing sector may not survive, especially given the over-production in the European Union and the subsidies that it gives to its own producers. A pervasive problem throughout Moldova is the monopoly power of processing companies. They can make large profits by being able to pay farmers low prices for their output.

Sustainable broad-based economic growth and poverty reduction in the Republic of Moldova depend on revitalizing agriculture and strengthening its linkages to agro-industry. The high productivity of agriculture registered in the pre-transition period testifies to the sector's long-term potential. But in order to achieve this potential, developing well-functioning agricultural markets and services is a key requirement.

7.7 Policy Recommendations

A strategy for agro-industrial growth and sustainable poverty reduction in Moldova would need to have several components. Public investment will play a central role, especially in rebuilding agriculture's comparative advantage in high value crops and linking their production to the agro-processing sector. Public policy has to resolve the polarizing impact of Moldova's dual agrarian structure, which is dominated by a few large, and mostly inefficient, corporate farms and a myriad of small under-resourced subsistence farms. Particularly for poverty reduction purposes, public support needs to be geared to small farmers, whose tiny fragmented plots cannot produce enough commercially viable commodities. Small farmers need to be grouped into larger associations and the monopoly power of corporate farms and agro-processors needs to be reduced. The government of Moldova has limited capacities and resources. Thus, it needs to focus them where they are of most strategic importance. Following are a few recommendations that we believe are strategically crucial.

1. The government of Moldova should focus its policies on helping agriculture regain its position of comparative advantage in high value crops and facilitating its linkages to the agro-industrial sector. This can lead to the improvement of product quality and productivity and the transfer of advanced technologies down to the farm level. Such efforts would help expand exports to both traditional (CIS) markets and new (European) markets. A central ingredient of this policy focus is public investment in roads, irrigation infrastructure, rural markets and communication networks, which would 'crowd in', or stimulate, the broad-based private investment that the sector sorely lacks.

2. The development of agro-industry is central to the revitalization of the agricultural sector, particularly in ensuring the latter's linkages to export markets. A growing agro-processing sector will also create alternative employment opportunities that will relieve agriculture of the heavy burden of continuing to absorb excess, unproductive labor. The institutional and policy environment should encourage new entry into agro-industry, institute straightforward and transparent import/export procedures, and actively reduce its current monopoly powers.

3. Agricultural producers, particularly small ones, need training and extension services in order to produce more and higher-quality commodities. This could be facilitated by their major clients, agro-processors and exporters, who are familiar with the requirements of their target markets. The government can use fiscal measures to stimulate the establishment of mutually beneficial out-grower schemes that can promote improved product quality and increase farmers' income.

4. Developing physical marketing infrastructure (collection, grading, sorting, processing, storing, packaging and transporting commodities) could significantly strengthen and diversify the supply of output to markets and boost farm-gate prices. Facilitating and stimulating private investment, both local and foreign, in such infrastructure should be a key feature of Moldova's agricultural development strategy

5. The weak 'bargaining position' of the multitude of small peasant farmers (who possess very limited 'market power') can be overcome by promoting single-purpose cooperatives and associations, which focus exclusively on input purchase and/or output marketing. This is not a recommendation for full-scale production cooperatives. Tax policies and legislation that encourage the formation of such organizations can make an important contribution to accelerating their emergence.

6. The main current bottleneck for agricultural producers in Moldova is the underdevelopment of markets (such as the seed, fertilizer, agricultural machinery, labor, finance and output markets) and their corresponding institutions (such as banks, microfinance organizations and other financial institutions). Since these various markets are interlocking, an integrated policy response towards developing them is needed.

7. The Government of Moldova has limited financial resources to address the host of problems and bottlenecks hindering agriculture and agro-industry. However, it can also create a legal, regulatory and policy environment that could encourage the private sector to make greater investments in these sectors. This should be a priority of public policy. An example would be guarantees or other incentives given to the commercial banking system in order to induce it to lend more to agriculture and agro-industry.

Figure 7.1: *Evolution of Gross Agricultural Output (1990)*

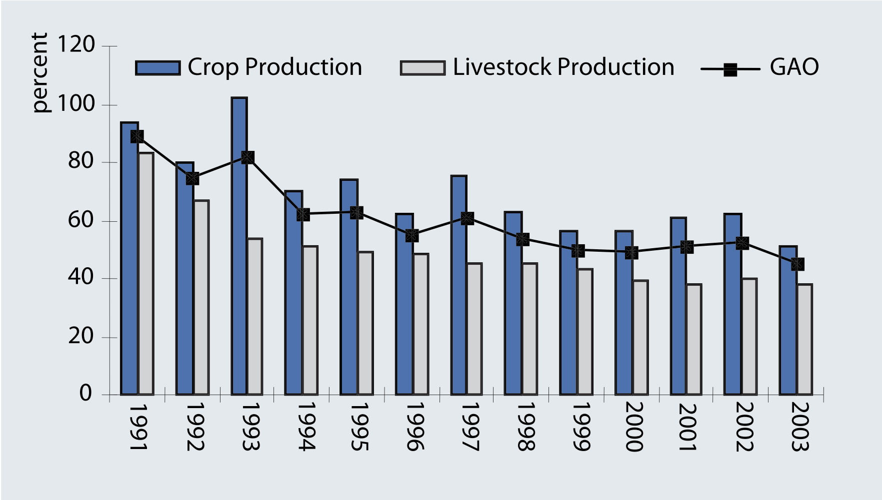


Figure 7.2: *Production Structure by Value: Crops and Livestock (Avg. 2000-2003)*

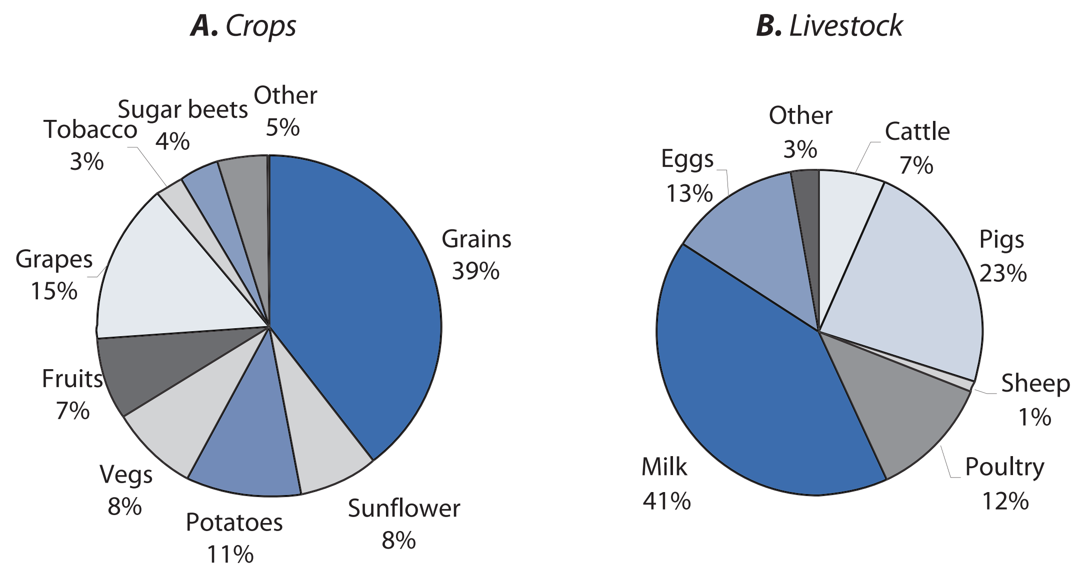


Figure 7.3: *Crop Production Structure by Area (2000-2003)*

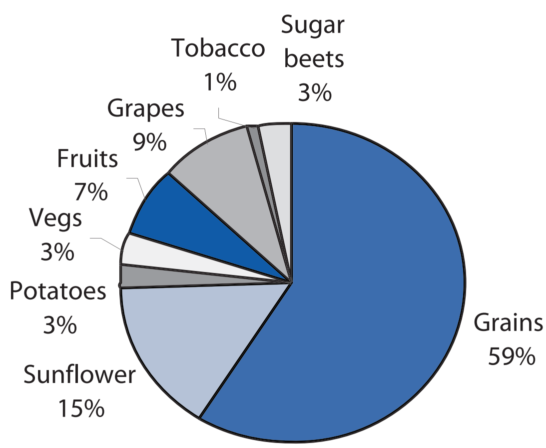


Figure 7.4: *Comparative Yields (1985-1990; 2000-2002 and 2003)*

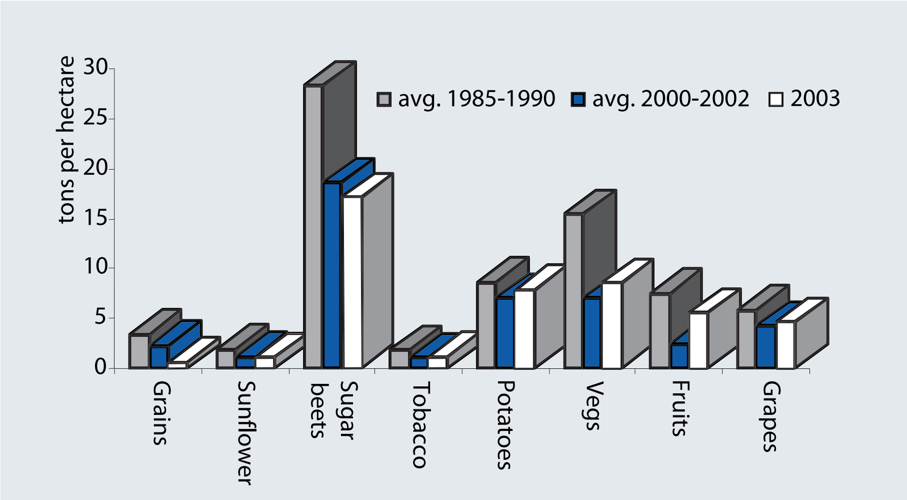
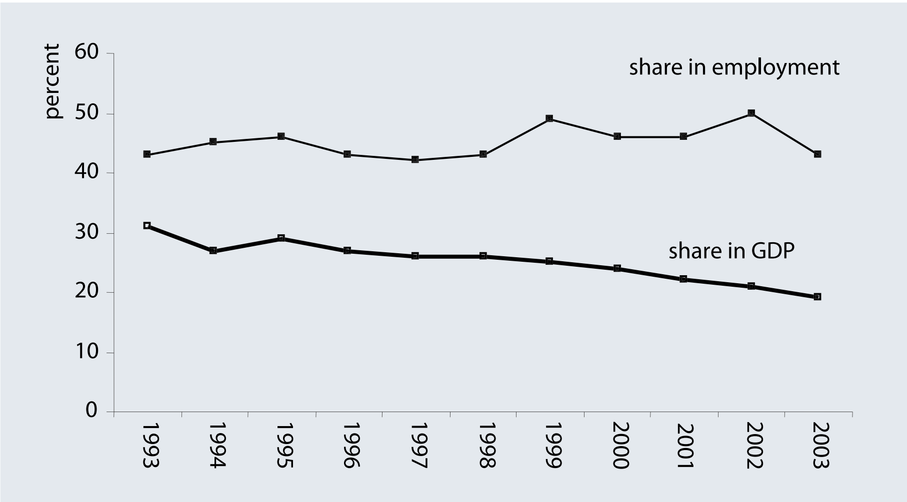


Figure 7.5: *Share of Agriculture in GDP and Employment, 1993-2003*



Chapter 8:

Social policies for Human Developmet

8.1 Introduction

Human poverty results from inadequate access to health services, safe water, basic sanitation, and educational facilities. Income may be an important means to enhance such access, but not a sufficient one. People may not have access to these services, because they do not exist, or they may be discriminated against because of race, religion, ethnicity, caste and colour. Under such circumstances, public provision of basic social services becomes critically important.

As discussed in Chapters 1 and 2, following the collapse of the Soviet Union, Moldova passed through a deep and prolonged depression. The Russian financial crisis, which struck in August 1998, brought another major blow. As a result, human development outcomes regressed, social safety nets broke down, and institutions collapsed. To a great extent, migration emerged as perhaps the major 'safety net' of households. These crises were partly due to transition itself, partly to adverse effects of policies, and partly to external factors. Beginning in 2000, Moldova reversed these disastrous trends, but the poverty situation remains serious.

It is important to stress the obvious principle that the purpose of social provision is to achieve a healthy, educated population. In pursuing this objective, the social provision system should ensure access by the poor. Social provision is not an anti-poverty programme; by its nature it is universal. We use 'universal' to mean that all members of society have access to it. To our knowledge, no government argues that part of the population should be excluded.

Across countries, the attempt to achieve universality is carried out through various concrete mechanisms, with varying degrees of success. What might be called the 'polar positions' are, on the one hand, universal provision by the public sector, without charge for all major social services; and, on the other, private provision through making social services marketed commodities. Universality through markets suffers from two major economic problems, well recognised in the literature. First, while markets may be open in principle to all members of society, the income and wealth distribution of the society will exclude a portion, perhaps large, from effective access. Second, in an argument made famous by Nobel Prize winner Kenneth Arrow, there is asymmetrical information. The buyers of health care, for example, are unable in practice to acquire even a fraction of the knowledge of the commodity that the provider has. Therefore, they lack the information to make a rational choice.

As a result of these and other, non-economic considerations, in every country there is a mixture of private and public provision, and within the public sector a range of delivery mechanisms. One delivery mechanism is *income testing* (in some countries called 'means testing'), in which those members of society with incomes below a specified level receive a specific service without charge or via a reduced charge, while those above the income level pay considerably more. The same delivery mechanism is used in many countries for benefits such as child allowances. It should be noted that income testing need not divide households between poor and non-poor, except tautologically. There is no reason, for example, that each income tested service or benefit need use the same income level.

We recommend against excessive use of income testing as a delivery mechanism in Moldova. This not based on principle, but practical and technical considerations. First, for the income testing mechanism to be effective, it must be possible a) to establish the relevant income level below which special measures, such as reduced charges, will begin; b) to measure individual or household income with appropriate accuracy, and c) to achieve the measurement at an acceptable administrative cost. The identification of a non-arbitrary income for a benefit or service is itself problematical, though the wide practice of doing so lends it a superficial credibility.

Much more problematical in any country is the measurement of household incomes, because of the differences in household compositions, and prices between regions and rural and urban areas, to name but two difficulties. The particular circumstances of Moldova make the measurement task difficult to the point of futile. The first of these problems, which Moldova shares with many other developing countries, is that the structure of employment does not lend itself to administrative verification of income levels of households. In developed countries, this verification is made by inspecting the applicant's employment records, or if employed, registration with unemployment centres. In Moldova, only about thirty percent of the economically active population is employed in the so-called formal sector, which would have the information necessary to estimate earnings.[84]

Second, a large proportion of households receive remittances from family members working abroad, about twenty percent, and sixty-five percent of those making remittances did so by means that would not appear in official statistics.[85] Even if it were the case that the overwhelming proportion of remittances entered the country through formal channels, it would not follow that these could be traced to specific households. These two characteristics of household income sources imply that estimating income would either have to rely on the reporting of the household itself, or on direct investigation of households, which could potentially be quite intrusive, as well as subject to corruption at the local level.

Perhaps more fundamental than measurement itself, is the implicit assumption in income testing that incomes remain stable over time. If a large portion of the population is clustered close to the poverty line, as is the case for Moldova (see Chapter 4), then there will be a tendency for many households to move above and below the line over the economic cycle. This creates two problems: first, even if technically feasible in light of the discussion above, the administrative task of identifying the poor becomes so expensive as to be unmanageable, because households that are defined as poor in one period are not in another. Second, as a result of the first, the entire purpose of the income testing exercise is rendered invalid if the 'poor' are not a stable administrative or practical category. Attempts to deliver benefits by income testing will result in an arbitrary delivery system with 'leakages' to the non-poor. In such circumstances, income testing fails its own test: were the identification of the poor administratively possible at a point in time, the identification is not valid over time. This represents an extreme example

84 The statistic rises to thirty-seven percent if those in unpaid employment are excluded from the economically active. See Chapter 6, Table 6.1.

85 This does not imply that sixty-five percent of the value of remittances were sent by such methods; the value may have been a larger or smaller proportion (see Chapter 5, section 1).

of the 'borderline problem', in which benefit delivery on the basis of income testing systematically fails.

The practical difficulties with income testing in Moldova do not negate that fiscal resource constraints limit the extent to which the government can finance social programmes. Therefore, some mechanism is required to establish expenditure priorities. An alternative to income testing is 'universal provisional within categorical targeting', defined as directing benefits to groups of the population that can be administratively identified (categorical targeting), without dividing the group between beneficiaries and non-beneficiaries (universal provision). Examples of this approach are universal old age pensions and child allowances. The great advantage of this approach is its administrative feasibility, and the population categories can be chosen to maximise the poverty-reducing effect.

An argument against this approach is that some benefits accrue to those who do not need them (so-called leakages), and as a result of making payments to the non-poor, the level of benefits to the poor is reduced. Considering first the trade off in level of benefits, for any level of benefit, the universal programme is likely to have lower unit costs (the benefit plus the administrative cost) than the income tested programme. This is for the obvious reason that the universal programme would not need a bureaucracy to verify and police qualification for benefits. Therefore, under a universal programme each benefit unit accruing to the non-poor does not represent a full unit that would accrue to the poor if a shift to income testing occurred. Second, for formal sector employees and employers, progressive taxation can be used to cancel out the 'leakage' to the non-poor.[86]

Further, it appears from the experience of developed countries that income testing can undermine the political sustainability of social programmes because those excluded from benefits have no direct material incentive to support increased funding for such programmes. Targeting easily identifiable groups with universal programmes has the political advantage of giving the non-poor an incentive to support poverty-reducing programmes.[87] It also avoids the potential social stigma of dividing the population between the poor and the non-poor.

On the basis of this discussion of the characteristics of Moldova and their implications for the access mechanisms for social services and benefits, we suggest that the government follow a strategy that would be both feasible and effective:

1. the basis of access would be targeting clearly identifiable groups with programmes of universal access (universal access within categorical targeting);
2. the system of universal access programmes would be augmented by income tested programmes for specific and narrowly defined benefits, such as subsidies for tertiary education; and
3. these programmes be funded in part through programme specific taxes (such as mandatory pensions contributions), and partly through progressive income taxation.

86 Effective collection of income taxes is largely limited to the formal sector for the same reason that it is in this sector that incomes can be most easily verified: the government can enforce accounting regulations that require formal sector employers, including the public sector, to keep records of income payments. Placing the burden of income taxation on formal sector employees and employers is pro-poor. As shown in Chapter 6, the poverty rate in the formal sector in 2002 was thirty-seven percent, compared to forty-seven percent in the informal sector, and forty-five percent for the entire labour force (see Table 6.1).

87 The social security retirement pension system of the United States, created by act of Congress in 1935, was designed by the Roosevelt Administration to be universal for the explicit purpose of ensuring its long term political sustainability (see Shieber & Shoven 1999, Chapter 3).

8.2 The Human Development Collapse of the 1990s

Declines in Health and Demographic Changes

Moldova entered its transition with high human development indicators. In 1990, the life expectancy was about 69 years, and there was one doctor for every 250 people (UNDP 1993). Adult literacy was almost total, with high participation and completion rates at all levels of education. But by mid-1990s, many of these achievements eroded. During the first half of the 1990s, the health of Moldovans seriously deteriorated, because of eroding standards of living, poor access to health care, and its declining quality. Life expectancy declined to 65 years, infant and maternal mortality rates increased. Sexually transmitted diseases took on near epidemic proportions, and half the population did not receive treatment for these diseases. Only after 2000 did improvements in some indicators occur.

The decline in life expectancy resulted in a shift in the sex ratio of those of reproductive age, due to higher mortality among men. This shift was increased by the higher rate of emigration by men. These factors caused a drop in birth rates to such an extent that the rate of natural increase of the resident population declined. The large drop in birth rates implied an increase in the number of one-child families. In 2002 fifty-two percent of the births recorded were the first by the parents. The decline in birth rates was accompanied by an increase in the proportion of births to unmarried mothers, increasing the number of children at risk of abandonment, institutionalization and poverty. These risks were exacerbated by the growing mortality rates among men aged 30-49.

The increase in mortality rates during the transition represented a reversal from the previous decade. The mortality rate for males aged 40-45, 45-50 and 50-55 increased by about twenty-five, forty-five and forty-five percent, respectively from 1990 to 1995, then improved in 1996 and 1997. However, the Russian crisis of 1998 brought another increase, of about five to ten percent. Thus, the rise in male mortality rates clearly correlates with the collapse of the Moldavian economy during the 1990s. In 2002 the mortality rates of men forty to fifty-five remained ten to twenty percent higher than in the pre-transition years. A similar trend could be observed for the over sixty group, for both men and women, whose death rates rose by some twenty-five to thirty percent during the first five years of transition, to recover thereafter, and increase again after 1999 to a level twenty percent higher than prior to the transition.[88]

The rise in male mortality rates resulted primarily from stress-related afflictions: heart ailments, circulatory diseases, alcoholism, suicide, and even homicide. Dealing with these requires not only better medical care, but a pro-poor policy programme to reduce unemployment, uncertainty and social marginalisation. Evidence from other countries in transition, for example, Russia and Latvia, shows that those most affected by stress related afflictions were urban men, possibly unemployed, with lower levels of education (Shkolnikov and Cornia 2000), and men from minority or migrant backgrounds and incomplete families. Other causes of the increase in male mortality, which also affect women to some degree, were strokes, cancer and diabetes, even among people under forty. Mortality from chronic liver diseases and cirrhosis exceeded the average for the European Union by a factor of six (DFID 2003).

Data on disease incidence confirm the mortality data. While respiratory diseases,

88 These statistics are from DFID (2003), and the Ministry of Health.

digestive diseases and tumours showed stagnant or slightly declining trends, infectious diseases and cardiovascular problems showed a sharp upward trend (Table 8.2). The increase in infectious diseases resulted from mutually offsetting tendencies. As a result of diphtheria outbreaks in 1994 and 1995, the immunisation programme in Moldova was strengthened with the help of external donors, and the vaccination coverage reached over ninety-five percent. Consequently, the incidence of several infectious diseases, for example, diphtheria, measles and viral hepatitis, decreased after the mid-1990s (DFID March 2003). The incidence of sexually transmitted diseases peaked in 1996 after a twenty-fold rise compared to the 1980s, and decreased subsequently. In contrast, the incidence of tuberculosis, HIV/AIDS and drug addiction rose, especially among marginal groups.

The decline in service availability in rural areas, the nation-wide fall in expenditure on drugs and other medical supplies, the transfer of formal and informal health costs to households, and the decline in family incomes lead to a fall in the use of health facilities. This is confirmed by the decline in inpatient and outpatients contacts per thousand people, and the duration of hospitalisation and occupancy rate in acute wards (DFID 2003). This decline was partially reversed after 2001, but household budget survey evidence (HBS) shows that the recovery in contacts was mainly by better off households (World Bank 2004, Figure 5). Thus, being poor means a dramatically lower access to health facilities (PPMU 2002). For example, the duration of hospitalisation of the poor was less than a tenth that of the non-poor. Exclusion from health care services was more pronounced in rural areas, for larger households, and for households whose head had lower educational achievements. Especially acute is the problem of elderly people with chronic diseases and low pensions.

A poverty-reduction strategy needs to increase the health expenditure, which the government did in 2002 and 2003, when the share of GDP allocated to public expenditure on health rose from 2.9 to 3.4. However, public resources for health were not used in the most rational way. Hospitals took over forty percent of the public health budget, though some operated at less than potential capacity. Improved priorities in public health resources across levels of care and parts of the country could allow gains in effectiveness. Some essential health activities have improved, as shown by the high coverage of hospital-based deliveries and vaccination programs. To a limited degree, these measures preserved a decent health status among children during the transition. As a result, the infant mortality rate fluctuated around twenty per thousand between 1990 and 2000, and showed clear improvement in 2001 and 2002.

Community health care institutions were funded from the local budgets, using taxes levied at the local level, while hospitals, preventive medicine, teaching institutions and health administration were funded from the central government budget. This financing was severely affected by the collapse of 1991-95 and August 1998. As a result, by 2002, real public health expenditure per capita fell to US$ twelve per capita, fifty-two percent of its 1997 level, and less than twenty percent of its pre-transition level. Budgetary cuts led to the introduction of user fees and to the *de facto* transfer of the cost of drugs to households. Patients' payments for hospital services equalled almost twenty percent of total health spending in 2002 (DFID 2003). Estimates by the World Bank indicate that private payments rose from twenty-seven percent of total health expenditure in 1997 to almost half in 2001-2002 (World Bank 2004a).

The health financing reform introduced in January 2004, from funding with general revenue to health insurance, may represent an additional constraint to the access by the poor, most of whom are not employed in enterprises from which the compulsory premiums could be collected. While the state will contribute the health insurance premium for children and the elderly, so far no solution has been found on how to ensure the access to health care by the poor working in the informal sector and small scale agriculture (World Bank 2004).

The fall in health indicators reflected a simultaneous decline in nutrition. In the early 2000s, one in every nine children under five, and about eight percent of children under twelve, were stunted, exhibiting manifestations of chronic malnutrition. There were widespread deficiencies in micronutrients and calcium intake. About twenty-eight percent of children under five and twenty percent of women of reproductive age suffered from iron deficiency anaemia. Diets were not only poor, but unbalanced, leading to excessive calorie intake resulting in obesity, with about half of adults overweight (World Bank 2004).

Health conditions varied across regions and socio-economic classes. For example, while the infant mortality rate in Taraclia Judet was about fifteen per thousand live births, the figure for Tighina was twenty-two (World Bank 2003). The incidence of infectious and parasitic diseases was six per 100,000 people in Tighina, but four times higher in Orhei.

Table 8.1: *Health Indicators for Moldova, 200-2004*

Indicators	2000	2001	2002	2003	2004e
Male life expectancy at birth (years)	63.9	64.5	64.4	na	na
Female life expectancy at birth (years)	71.2	71.7	71.7	na	na
Mortality rate (per 1,000 inhabitants)	11.3	11.0	11.6	11.9	11.4
Morbidity rate (per 1,000 inhabitants)	357.6	338.3	352.3	na	na
Infant mortality rate (per 1,000 live births)	18.3	16.3	14.7	14.3	12.3
Child mortality rate (per 1,000 live births)	23.3	20.3	18.2	17.8	na
Maternal mortality rate (per 100,000 live births)	27.1	43.9	28.0	21.9	na
TB incidence (per 100,000 inhabitants)	68.5	89.4	97.3	na	na
TB-related mortality (per 100,000 inhabitants)	16.9	15.0	15.8	na	na
HIV/AIDS morbidity rate (per 100,000 inhabitants)	0.1	0.2	0.5	1.2	na
HIV carriers (per 100, 000 inhabitants)	4	6	5	5	
No. of new HIV/SIDA cases	176	234	206	na	na

SOURCE: DSS, Ministry of Health (quoted in EGPRSP).
na – not available.

Table 8.2: *Number of new cases per year of major groups of diseases (per 1000 inhabitants)*

	1995	1996	1997	1998	1999	2000	2001	2002
Infectious	35.3	43.1	49.1	43.9	38.0	36.7	35.9	37.8
Respiratory	171.0	118.1	144.9	135.3	131.1	130.7	107.4	111.9
Tumours	3.5	3.8	3.9	3.9	3.4	3.6	3.0	3.2
Digestive	22.6	20.8	21.9	21.5	16.9	15.9	20.9	19.4
Cardiovascular	7.0	6.9	8.0	8.9	7.6	10.0	13.0	12.5

SOURCE: Statistical Yearbook of the Republic of Moldova, 2003

Inequality in Education

Despite the economic hardships of the transition, Moldova maintained high educational participation and attainment, particularly compared to other countries at similar income levels. However, education became less accessible to the poor. Far from being a source of opportunity, the education system became a vehicle for the enhancement of inequality. Superficially, the population of Moldova appeared well-educated during the transition. Less than two percent of the adult population reported that they were unable to read or write. On average Moldovans between eighteen and thirty had completed twelve years of education and ten percent of Moldovans older than eighteen completed university education. However, persistent and widening disparities in educational attainments characterised the transition. For example, the average resident of Chisinau and Balti completed two more years of formal schooling than the average rural resident, and the non-poor about one year more than the poor. The gross enrolment rates at the university level in 1997-98 were twenty-seven percent in large cities and seven in rural areas. In 2001-02, the comparable figures were thirty-seven and ten percent, respectively. Table 8.4 presents the disparities in terms of poverty status, where the same point is can be made. However, educational attainment and enrolment ratios for girls and women were higher than boys and men at all levels of education (Chacin & Nayar 2004).

The most strikingly anti-poor development in education during the transition was the slump in the kindergarten attendance (Table 8.4). The developmental and psychosocial benefits of pre-school education have long been recognized. However, enrolment rates for the three through six year olds fell from sixty-one to thirty-two percent from 1989 to 2000. Despite recovery, in 2002 the enrolment rate was still below its pre-transition level. This slump in enrolment took place despite a sharp contraction in birth rates that reduced the number of children of pre-school age. Considerable damage might result in child socialization, peer interaction and school preparedness. These are life skills in which the family can be of limited relevance, particularly in one-child families, single parent families, and for children of poor families whose parents have less time to stimulate their intellectual development.

The fall in enrolments resulted from a variety of factors. Shortage of funding resulted in closures of kindergartens managed by state enterprises. In the mid-2000s, almost one hundred percent of pre-school institutions were still run by state institutions (DSS 2003). While the new policy on pre-school education aimed at transferring these services to municipal authorities, decentralization suffered from administrative and financial problems, and several local authorities were forced to close their kindergartens due to lack of funds. Cost-cutting diluted the quality of the services that were provided. There is evidence that the contraction in the supply of kindergarten places was particularly marked in urban areas. Demand factors seem to have dominated the contraction in kindergarten enrolment rates, as suggested by the decline in occupancy rates during the 1990s, when the demand fell more quickly than supply (Table 8.4), especially in rural areas. Confronted with a mounting financial crisis, municipalities introduced or raised fees for school meals, uniforms, heating and bus services that represented a substantial share of the declining average wage (DSS 2003). The conclusion that demand factors tended to dominate, especially for poor households and in rural areas, implies that public policy ought to reduce drastically the private costs for attending kindergarten.

Trends in basic education, i.e. primary education, for children seven to ten, and lower secondary education, eleven to fifteen, suggests that public policy managed to broadly sustain at high levels enrolments in primary and lower secondary education during the difficult initial years of transition (1991-95), and in the aftermath of the 1998 crisis. These were years during which indicators of poverty and social marginalisation showed marked deteriorations. Indeed, except for a five point decline between 2000 and 2002 (Table 8.5), over the entire transition period the primary enrolment rate oscillated around ninety-five percent despite strains on family incomes and massive cuts in public expenditure per capita, that declined by 2001 to only fifty-five percent of its 1997 level, and twenty percent of its pre-transition level. In turn, enrolments in lower secondary education remained in the low ninety percentages throughout the entire period.

To a considerable extent, the success achieved in sustaining enrolment rates in basic education was due to policy changes introduced in the educational sector. Though the share of GDP assigned to public education declined sharply after the pre-transition years, it remained at a level higher than most countries with similar GDP per capita (5.5% of GDP in 2002). Second, the principle of free provision of basic compulsory education was not abandoned for pupils six through fifteen, or for non-compulsory education. However, tuition fees were introduced for children of better off families attending non-compulsory classes. While private expenditure on education rose, free education for most households avoided a collapse in enrolments among the children of the poor, which occurred in other economies in transition that introduced fees in secondary education. Third, the large expenditure cuts were translated into an almost complete cancellation of capital investment in education, a policy facilitated by the fall of the cohorts of new students, reduction in the number of teachers,[89] and reductions in the real wages of teachers and other school employees. While this policy contributed to deterioration in the quality of education, its impact on enrolments was less severe than had the cuts been a proportional reduction in the number of teachers. Fourth, educational reforms allowed private schools to open, the reform of the pre-reform curricula, and the reallocation of students from professional to grammar and vocational schools. While the latter policy may have primarily benefited the children of the middle class, it contributed to a recovery of upper secondary enrolments.

In contrast, the enrolment rate in non-compulsory upper secondary education, pupils fifteen to eighteen, declined steadily until 2000, though recovering rapidly during 2001-2004 (Table 8.5). This recovery resulted from two mutually offsetting tendencies. The enrolment decline was marked among the pupils of vocational schools, whose number fell from fifty-nine to twenty-three thousand from 1990 to 2002, then stabilized during 2003-2004. It is likely that the decline affected the children of low and middle income groups, especially from rural areas,[90] who disproportionately attend these schools. In contrast, after a thirty-five percent fall between 1989 and 1995, the number of students enrolled in secondary education that leads to university rose steadily to exceed its pre-transition levels.

While the deteriorating quality of educational institutions played a role, the drop in enrolment rates in upper secondary education can be attributed to three demand factors. First, the sharp fall in real household income for many families disproportionately raised the opportunity cost of the time of adolescents. The

89 For instance, the number of students enrolled in basic education fell from about 650,000 in 1989-91 to 518,000 in 2002.

90 The World Bank (2004) indicates that seventy-five percent of the youth not enrolled in upper secondary education in 2001-2 came from the rural areas.

'opportunity cost' of the child and adolescent's time grows with the decline of family income, particularly for families in which the child or adolescent can find employment in on the family farm or in family businesses. In rural areas, part of this decline and the increase in drop-out rates seems to be explained by the redistribution of land to farmers and the proliferation of small family shops. Second, private expenditure on education increased considerably. In 2002, school fees were paid by fifteen percent of the students enrolled in vocational education (DSS 2003). These two factors proved particularly devastating for the families of the bottom deciles, especially those with two or more children in school-going age. In 2002 expenditure on education was almost nine percent of the total consumption of the poorest households, and only four percent for the richest twenty percent (World Bank 2004). Third, the perceived loss of relevance of vocational education contributed to the decline in enrolments, as wages for this type of skill diminished. The government addressed this problem through educational reforms, but increasing the relevance of education remained a problem, particularly for adolescents in rural areas and in small cities suffering from a rapid industrial decline.

There was a decline in the total number of university enrolments from 1989 to 1994, but subsequently the number rose, even in the aftermath of the 1998 crisis. By 2002 enrolments had doubled compared to the pre-transition level. Almost half the increase was in private universities, affordable only to well off families. Tuition fees were introduced in public universities, and the proportion of students paying them rose from twenty-seven to sixty-six percent between 1997 and 2002 (DSS 2003). The fees do not seem to have discouraged enrolments, suggesting to the emergence of a social class with sufficient income to pay for university.

In contrast, enrolment in short-term colleges, offering non-academic tertiary qualifications to the graduates of vocational schools, declined abruptly both in the first part of the transition, and even more so from 1997 to 2002 (Table 8.5). The decline in enrolment was primarily due to demand factors. The proportion of students paying fees in colleges rose from sixteen percent in 1997 to twenty-seven percent in 2002, with the effect of excluding potential low-middle income applicants. The low labour market returns to this type of training was an additional factor in the drop in college enrolment rates.

The quality of education seems to have deteriorated, which is closely associated to the remuneration of teachers. In 1995 the average wage in education was 83.4 percent of the national average, and declined to 60.7 by 2000, then recovered slightly to 67.0 in 2002. Of the major sectors of employment, only agriculture had lower wages than education. Wages and salaries in the health sector were approximately the same level as education. This resulted in the resignation of some of the best and younger teachers, greater absenteeism due to second jobs, and low morale. Few long–term statistics are available for the pre-transition period on student performance, so it is impossible to quantify the deterioration in school performance. Recent data suggests that the educational reforms introduced after 1996 improved the literacy and numeracy scores of pupils in basic education (World Bank 2004), thought the performance of Moldavan pupils in relation to other countries remains low.

In the past, education was freely provided by the state and the income bias in education was limited. During the transition the decline in public expenditure per capita, the introduction of school fees for non-compulsory education and the transfer of part of the costs of compulsory education to households has firmly established an income bias. In 2002, private expenditures on education accounted for about two percent of GDP, compared to zero during the pre-transition years (World Bank 2004). About half of this expenditure was incurred for the nominally free basic education, reflecting costs borne by households for contributions to parents-teachers associations, school supplies, school meals, textbooks and optional activities. Another forty percent of private expenditure on education was on upper secondary and tertiary education.

It is necessary to introduce measures that reduce the private cost of primary and secondary education. First, this involves an integrated set of policies that achieve an increase in the quality of public education, such that the skills acquired at the secondary level give access to wages above the poverty level. This would induce families to keep their children in school, rather than taking them out of school and putting them to work at poverty wages. This increase in quality can only be achieved through allocating more funds to public education. Second, the incidence of general upper secondary and tertiary education could be made more progressive by eliminating formal and informal fees, through public funding of all compulsory school activities. Third, public revenue to improve quality and eliminate charges paid by households would come from a more progressive tax structure. Fourth, expansionary monetary and fiscal policy are required that stimulates growth, in part through public investment in labour-using infrastructure projects.

In conclusion, primary and secondary education would be more pro-poor by integrating it into a growth strategy of expansionary macro policies, progressive taxation, and public investment. For the foreseeable future, even a progressive tax structure generating a tax share in GDP of about twenty-five percent, would make universal access to tertiary education based on ability possible only for a small portion of the population. Therefore, there is no alternative to income-tested scholarships to give access to university for low-income households. Such a programme would suffer from arbitrariness in selection due to the practical problems of income testing discussed at the start of this chapter. Its pro-poor impact would also be reduced by what can be called the 'pre-selection problem'. Student performance in secondary school is strongly affected by family income, which implies that those low-income applicants to university that demonstrate high academic performance will not tend to come from the poorest households. No developed country can claim a tertiary education system which does not discriminate against the poor, though some come considerably closer than others. Given Moldova's low per capita income, limited public resources, and the coping strategies of households (see the chapter on migration), substantially reducing the bias against the poor in tertiary education is a task for the future.

Table 8.3: *Net Enrolment Rates by Levels of Education, Moldova, 1997-2002, Percentages*

Level	1997	1998	1999	2000	2001	2002
Preschool	39.2	38.4	34.3	70.0	74.0	77.0
Primary	na	na	94.0	93.5	92.4	92.7
Lower Secondary	na	na	87.0	87.0	86.8	83.9
Upper Secondary	na	na	29.0	31.5	34.5	38.8
Higher	18.3	19.0	20.1	20.1	20.4	20.4

SOURCE: Department of Statistics (2003)
NOTE: The numerator consists of enrolment data based on school surveys, and official population projections are used for the denominator. Higher education includes non-university and university.

Table 8.4: *Places, Occupancy and Enrolment Rates in Kindergartens, 1989-2002*

Variable	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Children in kindergarten ('000)	353	336	311	213	202	182	161	147	138	126	101	94	97	104
N. of places ('000) - urban - rural	294	268	270	218	216	205	194	182	177 83 94	166 80 86	152 74 78	143 65 78	145 64 81	150 64 86
Occupancy rate (%) - urban - rural	120	125	115	98	93	89	82	81	78 85 73	76 81 71	66 72 61	65 73 58	66 74 60	69 78 63
Enrolment rate (net) -All -males -females	... ...	... ...	... ...	... ...	... ...	... ...	... ...	... ...	50 73 66	49 66 60	44 53 48	44 49 45	47 50 46	54 54 50

SOURCE: Elaboration on Trans MONEE Database (for the data 1989-1996), and DSS (2003).

Table 8.5. *Enrolment in Primary, Secondary and Tertiary education, 1989-2003*

Year	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
A. Output indicators															
Primary - net - gross	na na	na na	95 na	95 na	96 na	96 na	95 na	95 na	96 99	95 100	94 100	93 99	92 99	88 95	
Lower secondary - net - gross	na 98	na 95	na 94	na 97	na 93	na 93	na 92	na 93	na 89	na 88	87 91	87 90	87 91	84 88	
Upper 2ry, gross -gen ed (000) -voc ed (000)	na 78 61	na 76 59	na 65 55	na 50 41	na 50 37	46 51 35	46 53 34	47 57 34	47 57 34	48 62 32	40 59 23	42 65 23	44 72 23	48 80 23	na 82 23
3ary, gross - college ('000) - univ (000) % private	na 55.4	na 54.7 ...	... 52.5	... 47.2 ...	... 46.8	... 49.3	... 54.7 4.2	... 58.3 6.4	40.4 32.7 65.5 9.4	41.8 29.6 72.7 12.4	41.2 25.4 77.3 16.8	38.9 19.9 79.0 19.6	39.6 17.0 86.4 22.8	42.4 15.2 95.0 23.8	18.7 104 23.1
% children in after school care	31	28	23	14	14	12	10	10	8	7	4	4	5	7	7
B. Input indicators															
Total education expendit.,% of GDP	na	na	na	7.8	6.0	8.7	7.6	10.3	10.0	7.0	4.7	4.5	4.8	5.5	4.8

SOURCE: Elaboration on Trans MONEE Database.

8.3 Basic Needs and Social Protection

The transition has been associated with severe declines in access to and quality of the most basic needs of households: potable water, electricity and other energy sources, and housing. Improving these would have a strong poverty reducing effect, and could be implemented in a pro-poor manner, because for the most part they do not require income testing or needs testing at the household level. The measures to achieve broader and better quality of access to water, energy and housing for the poor would be a central part of the public investment led government expenditure programme which this report recommends as the basis for a pro-poor growth programme.

In 1995, ninety-seven percent of the Moldovan urban population were estimated to have access to 'improved' water, though the proportion was less than twenty percent for rural households. The same percentage in urban areas had access to basic sanitation, and ten percent in rural areas (Czaki & Tuck 2000). By 2000, there had been a substantial improvement for rural households, with thirty percent having access to 'improved' water (Prohnitchi 2004). However, only eighty percent piped water was judged as satisfactory for consumption without some form of filtering. Part of the water problem arose from the severe deterioration of infrastructure, resulting in huge losses in central systems of thirty to sixty percent, due to bad installations and connections. Related to this, access to heating was limited both for the poor and the non-poor, because of deterioration of the centralized distribution system in cities. As a result, in the 2000s, about thirty percent of urbanites and ninety percent of rural Moldovans used wood stoves to warm their homes.

Access to housing worsened as a result of sharp price increases after 1995. Since 2000, with increases in household purchasing power, housing conditions have improved. However, during winter a four-member household living in a three-bedroom apartment paid more than one thousand Leu for housing, representing two-thirds of the official minimum consumption basket. In such conditions, access to other basic social services, health and education, were difficult (Prohnitchi 2004). The poor state of roads impeded access of children to remote schools and of farmers to market outlets. With little expenditure on operations and maintenance, around one hundred and fifty kilometres of national and local roads deteriorate each year.

The social protection system in Moldova consists of a set of *social insurance* and *social assistance* programs. In 2002, social insurance benefits, primarily pensions and short-term benefits to those enrolled to social security, accounted for three quarters of the social budget, 7.7 percent of GDP. Because of falling revenue in the aftermath of the Russian crisis, the budget for social assistance benefits shrank from 2.3 percent in 1999 to 1.4 percent in 2002 (see Box 8.1). Social insurance benefits were subject to previous enrolment into social security of the recipient or her or his dependent. Social assistance programs target specific groups (categorical targeting): children, disabled, elderly, veterans, single pensioners, single mothers, and families with many children. These programs were targeted at specific groups and, within the group, income tested.

The main goal of social assistance programmes was poverty alleviation, and that of the social insurance programmes is to compensate for income loss due to sickness, maternity, unemployment, or death of a dependent of an income earning spouse. At the time this report was written, twenty-five percent of the population received direct social insurance recipients, and about six percent received social assistance benefits. Including the recipients and members of their households, social programmes reached forty-seven percent of the population. Table 8.6 presents the coverage of the social safety nets in Moldova by age groups.

Box 8.1: Social protection, main cash benefit programmes

Social Insurance benefits include:*
- Old age, disability, and survivors pensions (60)
- Sick leave benefits (5)
- Maternity Leave benefits
- Unemployment benefits (2)

Social Assistance benefits include:
- Gas and energy compensations (16)
- Social pensions (2)
- Children's benefits (4)
- In replacement of unpaid separated parent's child support
- To single mothers of children between 1.5 and 16 years of age (income tested)
- To mothers of children under 18 months old
- To families with many children (income tested)
- To each mother having given birth

Benefits to orphan children at education institutions and benefits to adopted children
Compensations and supplements to rehabilitated people
Death Allowances
Local material assistance and other transfers

Women in full-time employment receive a maternal allowance, funded from the social insurance contributions. The payment is quite small, about US$ ten per month.

Besides these cash transfers, the public social safety net is defined to include administration of institutions for disabled children and elderly and special transport for the disabled, as well as other programmes administered by the Ministries of Labour such as active labour market programmes.

*The figures in the bracket indicate the percentage of social safety funds going to that category. The figure on the sick leave benefits also includes maternity leave benefits.

SOURCE : Andrews (2003)

Taken as a whole, the social protection system of Moldova is pro-poor, especially the old age pension, which has been highly successful in protecting the elderly from poverty. However, it remains quite limited in what it can achieve. About seventy-three percent of extremely poor recipients had less than three quarter of their needs covered by social assistance benefits. Gas and energy compensation benefits would seem the least effective programmes. The compensations for gas and energy and payments for wood and coal for heat were not distributed in a pro-poor manner. In 2003, the share of such benefits going to the top income quintile was forty-five percent, nine times more than the three percent enjoyed by the bottom income quintile. Households with children less than fourteen years old, and pensioners benefited least. These problems could be resolved within a universal entitlement by a simpler, standard payment per household.

The government changed the pension system in 1999, introducing new minimum payments, which was fully applied in 2003. In August of that year, the government passed a new law on pension indexation, and eliminated privileged pensions and early retirement. As a study for the World

Bank concluded, the present universal entitlement of the old age pension is well-suited to Moldova's conditions,[91] and has a substantial poverty reducing effect.

With regard to social assistance, in 2000 a range of small benefits was eliminated, and new categories of vulnerable groups defined. A new benefit was introduced to compensate the cost of heating and energy. At the same time, the government introduced income testing for some child benefits. It has been argued that eliminating payments for energy using the funds to increase benefits to families that have three or more children would have a net positive impact on poverty (Lerman 2001, World Bank 2001). The government could commission a review to assess this proposal.

Table 8.6: *Social Payments Recipients, Percent of age group, 2002*

	Young	Middle Age	Early Retirement	Retirement	Elderly
Social Insurance	3.7	10.2	27.7	94.5	97.7
Social Assistance	5.8	6.6	11.0	9.4	11.0
Pensions					
Old-age	0.0	0.0	4.1	86.0	92.6
Disability	2.2	8.5	15.4	6.6	3.5
Survivor	1.4	0.0	0.0	0.2	0.8
Privileged	0.1	1.6	8.0	1.6	0.8
Social	1.2	0.2	0.4	0.2	0.8
Energy Subsidies	2.7	6.5	10.8	8.8	9.9
Child Benefits	2.4	0.0	0.2	0.2	0.0

SOURCE : Department of Statistics (2002)
NOTES: Young, 14-44 for males and females; Middle age, women 45-51, men 45-56; Early retirement, women 52-56, men 57-61; Retirement, Women 57-64, men 62-64; Elderly, 65 and older, men and women.

Table 8.7: *Pensioners and Pensions in Moldova, 1999-2004*

	1999	2000	2001	2002	2003	2004
Av. monthly pension, Leu	83.9	82.8	85.1	135.8	160.8	210.5
Annual real increase, %			46	13	17	na
No. of pensioners, 1 Jan	758	728	706	684	658	628

SOURCE: Department of Statistics

91 Comparing a 'unitary' system that is not income tested to an income tested 'two-tiered' system, Mabbett concludes, 'Moldova probably does not fulfil the three criteria [for a two-tiered system]' (Mabbett 1996).

8.4 Social Policy for Poverty Reduction

A pro-poor social policy in Moldova would have the goal of reducing poverty, rather than merely alleviating it. This implies that social policies facilitate the poor in acquiring the means to permanently exit poverty. From this perspective, social policy does not provide 'safety nets' that catch the few or many that fall into poverty. Social policy is part of a growth strategy that progressively reduces the conditions that generate poverty.

In a low-income country, social policy faces many trade-offs, and there are inherent limits to its capacity to reduce poverty and provide equitable access to services and benefits. The measures listed below recognise the trade-offs and limits, guided by the principle that policy should not endorse the division of Moldova between the poor and the non-poor, but should foster systems that progressively eliminate that division. That objective would be achieved by combining social insurance and assistance programmes with a more equitable access to health and education, within a macro framework of progressive taxation and public investment.

1. Because of the nature of the Moldovan economy, its structure (relatively few formal sector wage earners) and characteristics (importance of remittances), there are serious practical difficulties to using income testing for access to benefits. The inherent arbitrariness of income testing that results from this structure and characteristics suggests that the its use be avoided when alternatives are feasible.
2. A benefit system based on targeting categories of the population with universal access has proved poverty reducing in Moldova, with the old age pension an example. This approach should be extended to other population groups.
3. Progressive taxation is the key to funding pro-poor health and education systems.
4. Constraints on revenue limit the quality and extent of public health services. This requires clear priorities for health expenditures. Policies should be avoided that would institutionalise a two-tiered health system, in which free access is to a minimal system which is income tested, and other health services are obtained through private payment. Institutionalising a two-tiered system would institutionalise poverty.
5. Primary and secondary education should be provided to all without charge. This requires increased funding for teachers' salaries, education materials, and construction of facilities. The capital expenditure would be part of a public investment fostering growth strategy.
6. Unequal access to university education cannot be eliminated in the foreseeable future; however, it can be moderated by income tested funding of university fees within a system of access on the basis of ability and school performance.

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