

Republic of Moldova: Joint Staff Advisory Note of the Poverty Reduction Strategy Paper

The attached Joint Staff Advisory Note (JSAN) of the Poverty Reduction Strategy Paper Progress Report for the Republic of Moldova, prepared by the staffs of both the World Bank and IMF, was submitted with the member country's Poverty Reduction Strategy Paper (PRSP) or Interim PRSP (IPRSP) to the Executive Boards of the two institutions. A JSAN evaluates the strengths and weaknesses of a country's poverty reduction objectives and strategies, and considers whether the PRSP or IPRSP provides a sound basis for concessional assistance from the Bank and Fund, as well as for debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Debt Initiative. The Boards then decide whether the poverty reduction strategy merits such support.

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INTERNATIONAL DEVELOPMENT ASSOCIATION

AND

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REPUBLIC OF MOLDOVA

Joint Staff Advisory Note for the Poverty Reduction Strategy Paper

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and the International Monetary Fund (IMF)

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I. OVERVIEW

1. Moldova's Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) is the first full Poverty Reduction Strategy Paper prepared by the government of Moldova in consultation with broad-based stakeholders and civil society. It builds upon the three-pillar strategy outlined in the Interim Poverty Reduction Strategy Paper (I-PRSP) and the PRSP Preparation Status Report presented to the Executive Boards of Directors of the International Development Association (IDA) and the International Monetary Fund (IMF) in 2000 and 2001, respectively. The EGPRSP, which was adopted by the government in May 2004, describes the participatory process underpinning the development of the strategy, provides a poverty diagnosis, and presents sector programs and policy measures for sustainable economic growth and poverty reduction over the 2004-06 period. It also includes the costing of proposed programs, developed in the context of a medium-term expenditure framework (MTEF). After the adoption of the EGPRSP, the government modified its external debt strategy, resuming interest payments to all creditors as of July 1, 2004. The staffs welcome this change, which will still need to be reflected in the underlying MTEF, but note their concern that the EGPRSP remains predicated on the continuing default on amortization payments to some bilateral creditors, or some rescheduling agreement still to be negotiated.

2. Overall, the EGPRSP is an important step toward achieving sustainable economic growth and poverty reduction. The staffs commend the authorities for their efforts to expedite completion of the paper and to finalize the EGPRSP, while enhancing consultation with civil society and stakeholders. The Joint Staff Advisory Note (JSAN) provides staffs' advice on key priorities for strengthening the EGPRSP and for ensuring effective implementation. It also highlights several critical areas where current policies do not match those articulated in the EGPRSP. This note is organized into four sections. Section II highlights key characteristics of the EGPRSP. Section III identifies key priorities and provides suggestions for strengthening the EGPRSP and addressing implementation risks. The final Section concludes and recommends issues for discussion by the Boards.

II. CHARACTERISTICS OF THE EGPRSP

A. Inclusive Participatory Process

3. **The government has fully endorsed a participatory approach to EGPRSP development by involving civil society at national, regional, and local levels.** A Participation Council, including representatives of Parliament, Presidency, government, civil society, private sector, academia, and donor community, was established in September 2002. Given the government's limited experience in broad consultations, the Council played an important role in both ensuring an inclusive participation and identifying suitable participation mechanisms for Moldova. Although inclusion was limited in the early stages of EGPRSP drafting, the authorities have gradually changed their attitude toward civil society involvement. During the extensive consultation process, the government became more willing to engage stakeholders in an open dialogue. In the

final stages, participation was extensive and involved a broad range of stakeholders through a variety of mechanisms. Since September 2003, more than 80 round tables, conferences, and seminars have been organized across the country. The participation process was further broadened by a communication strategy that used various channels, including radio and TV shows, leaflets, posters, special bulletins, and direct electronic communication distributed to some 800 NGOs and initiative groups. The EGPRSP web page (<http://www.scers.md>), launched in October 2003, provides information to stakeholders on the latest version of the overall paper and sectoral strategies, the timetable and location of public discussions, and summaries of these discussions. After parliamentary approval of the strategy the government intends to hold a national conference to discuss implementation plans with stakeholders.

4. **The EGPRSP process provided for wide participation within the government and contributed to better coordination among donors.** Most line ministries played an active role in developing the sector strategies. Weak analytical capacity in most government agencies, however, was a serious hindrance to the process and many of these ministries had to rely heavily on the support of local consultants. External development partners have indicated their intention to align their strategies and programs with the EGPRSP. In-country donor support was mobilized and coordinated to strengthen the process. Indeed, the donor community played an important role in persuading the government of the necessity to broaden participation to build country ownership and gain broad policy consensus.

B. Adequate Poverty Diagnosis

5. **Poverty analysis, based on the most recent Household Budget Survey (HBS), provides an adequate basis for formulating an anti-poverty strategy.** Despite different methodologies used, the findings by the Poverty and Policy Monitoring Unit (PPMU) in the Ministry of Economy are broadly consistent with those in the World Bank's most recent report on "Recession, Recovery, and Poverty in Moldova." The poverty rate declined to the level obtained just before the 1998 crisis (48.5 percent in 2002 compared to 47 percent in 1997) and inequality was comparable to 1997 (the Gini coefficient was 0.34 in 2002 compared to 0.35 in 1997). The EGPRSP rightly identifies children, households with many children, workers in the agricultural sector, and underemployed as the most vulnerable to poverty. It also notes that, although the majority of poor live in rural areas, the urban population in small towns faces the highest risk of falling into poverty. The EGPRSP appropriately identifies the need to implement a poverty map and to improve information on non-income dimensions of poverty. The population census undertaken in October 2004 will provide a reliable demographic profile for poverty analysis and could be used to update the sampling frame for existing household surveys. The Department of Statistics and Sociology (DSS) has made the HBS data available to the public.

C. Three-Pillar Strategy

6. **The authorities have adopted a three-pillar strategy, covering sustainable economic growth, human development, and social protection and inclusion.** The

strategy addresses Moldova's key obstacles to sustainable economic growth and poverty reduction, and aims at achieving three medium-term objectives linked to the Millennium Development Goals (MDGs). These are: (a) achieving sustainable economic growth of at least 5 percent per annum; (b) reducing the proportion of the population living below the poverty line (\$2.15 per day, using purchasing power parity) by 12 percent during 2004-06; and (c) increasing net school enrollment of children, lowering the under-5 infant mortality rate, reducing the maternal mortality rate, and arresting and reversing the spread of HIV/AIDs, and TB.

7. **The first pillar of the strategy underscores the importance of maintaining macroeconomic stability, improving the business environment, and accelerating privatization and structural reforms.** The diagnosis of poverty and the transition experience suggest that the recent growth pattern is unsustainable without a change in the current business environment, which discourages investment and the needed domestic supply response. With a speedier implementation of structural reforms (including the resumption of privatization) and the adoption of prudent fiscal and monetary policies, the medium-term targets envisaged in the EGPRSP (a growth rate of 5 percent and an inflation rate of 6 percent) could be achieved. To improve the business environment, the EGPRSP envisages a simplification of the legal and regulatory environment and the elimination of existing restrictions and barriers to business. If accompanied by an even-handed and fair application of laws and regulations, this would encourage foreign investment and support domestic producers, especially small and medium enterprises.

8. **Economic growth and poverty reduction will be driven by reforms in agriculture and infrastructure, and by improving governance.** The agriculture strategy is consistent with the Letter of Development Policy and the Memorandum of Understanding on Agriculture contained in the Rural Investment and Services Project (RISP); however, a rural development strategy is lacking. The infrastructure strategy includes the energy, transport, water/sanitation, and telecommunication sectors. The energy sector strategy seeks to reduce dependence on energy imports, increase power generation capacity, and improve energy infrastructure. The transport strategy focuses on road rehabilitation as an important factor in facilitating international trade and transport and passenger services. The water supply and sewerage strategy aims at increasing access to drinking water and improving water supply and sewerage service quality. It will need to be further prioritized to draw additional resources to meet the sector's large investment needs. The telecommunication strategy will seek to improve the quality and access of consumers to telecommunication services and liberalize the telecommunication market. Finally, governance will be strengthened through reforms of public administration, civil service, and the justice system, and the implementation of an effective anti-corruption strategy.

9. **The second pillar of the strategy seeks to strengthen human development through improved education and health.** The education strategy presents an adequate analysis, an appropriate strategic direction, and well-defined medium-term actions. The broad priorities in the education sector are: increasing funds for basic education, supporting the increased availability of school transportation for rural settlements, improving the school grant system to target the poor, rationalizing the network of school

facilities, and reviewing the support to children with special needs. The health strategy aims at improving access to health for the poor through the establishment of mandatory health insurance and continued restructuring and consolidation of medical infrastructure.

10. **The third pillar of the strategy underlines the need to strengthen social protection and inclusion.** Improvements in social insurance rely on the continuation of pension reform. However, a proper implementation plan and essential issues related to social insurance administration are absent. The social assistance strategy focuses on improving targeting of cash benefits and shifting institutional care from residential to community-based care services. Employment and labor market policies seek to enhance job creation and labor market flexibility through improvements in the investment climate and reductions in the burden of regulations.

D. Alignment with the MTEF

11. **The process of synchronization between the EGPRSP and the MTEF has begun.** Although they are carried out separately by the Ministries of Finance and Economy, both Ministries have worked closely to coordinate sequencing and implementation of policy measures. The MTEF should help correlate available resources and public expenditures with government policies and priorities articulated in the EGPRSP. MTEF sector strategies are limited to education, health, and social protection, with the underlying budget allocation reflecting the priorities identified in the EGPRSP. The original MTEF assumes a default on scheduled debt service payments to bilateral creditors, but as of mid-2004 the government resumed interest payments to these creditors.

III. MOVING FORWARD: STRENGTHENING THE EGPRSP AND ADDRESSING IMPLEMENTATION RISKS

12. **In moving forward, the staffs have identified priorities for strengthening the EGPRSP and addressing implementation risks.** These include revising the MTEF, improving prioritization, strengthening ownership of the strategy and the participatory process in implementation, improving poverty analysis and monitoring, and addressing external vulnerabilities and domestic capacity constraints.

13. **Macroeconomic Framework.** The credibility of the macroeconomic framework underpinning the MTEF is weakened by optimistic revenue forecasts, projected increases in public spending in excess of the growth in available resources, continued default on scheduled amortization payments to some bilateral creditors (in the absence of fresh rescheduling agreements), and large unidentified financing. The authorities' optimistic medium-term revenue projections reflect their expectation of a strong positive effect from the planned income tax cuts. The increasing reliance on collection of VAT on imports also entails risks if the growth in workers' remittances, which finance the large part of imports, decelerates. To reduce risks of revenue erosion it will be important that the authorities develop contingency revenue plans and a comprehensive strategy to strengthen tax administration along the lines discussed with the IMF's technical assistance missions. Special efforts will be needed to improve VAT administration. On

the expenditure side, the state budget wage bill is assumed to increase by more than 30 percent during 2005-06, implying an increase in real wages that would outstrip real GDP growth. Large public expenditure expansion plans should be more closely aligned with available resources to put the public finances on a sustainable footing and allow fiscal policy to play an active role in supporting macroeconomic stability. The external debt strategy assumes that any remaining external arrears would be consolidated and rescheduled in the context of a Fund-supported program. Although the authorities have made good progress in rescheduling some commercial and bilateral debts, the success of this strategy hinges heavily on their willingness to accelerate structural reforms and their efforts to meet current debt service obligations. This would help unlock financial support from international financial institutions and donors, and ease Moldova's debt burden. Finally, the large amount of unidentified financing indicates a high degree of uncertainty about spending envisaged under the EGPRSP. Only about one-third of the resources required for 2004-06 has been included in the MTEF, which is already fairly optimistic regarding available financing for the strategy. In this situation, expenditure prioritization would be required to ensure debt sustainability even if external borrowing were available.

14. In revising the MTEF, the authorities are encouraged to undertake realistic revenue forecasts and adopt sustainable expenditure plans. In particular, tax revenue projections need to be further scrutinized in light of planned cuts in personal income and profit tax rates. The risks these cuts pose to revenue mobilization should be explored in more detail. On the expenditure side, the authorities are encouraged to pursue a more prudent public sector wage policy in which wage bill increases are closely linked to projected real GDP growth and inflation. A rapid increase in the government's wage bill will inevitably reduce available resources for implementing the EGPRSP. The authorities should also develop realistic costing of expenditure programs, at least in key areas. The revision should be carried out in the context of the next 2006-08 MTEF (planned for early 2005) and should be reflected in the first annual progress report of the EGPRSP.

15. **Prioritization.** The suggested revisions to the MTEF would impose a hard budget constraint and help improve program prioritization. The staffs also note that the EGPRSP has not drawn on an ex-post analysis of the impact of past structural reforms. This analysis could have helped draw lessons from past reform efforts and thus improve prioritization. In this context, while the diagnosis of Moldova's economic growth prospect is appropriate, it could be enhanced by strengthening the analysis of sources of growth and their poverty and distributional impacts. This would enable the government to focus on pro-poor growth strategies. For instance, in the health sector, an analysis of the impact of health insurance and the rationalization of the hospital sector on poverty and inequality should be carried out. If proven to be pro-poor, the health sector could benefit from additional resources to ensure access to a guaranteed package of basic universal health care.

16. **Ownership.** The staffs are concerned that contradictions between EGPRSP policies and current government actions call into question government's ownership of the EGPRSP, especially since it represents a radical departure from the government's 2001 Economic Revival program. In contrast to the policy directions articulated in the

EGPRSP, the government has continued to intervene excessively in private sector activity. A few examples illustrate these contradictions:

- While the EGPRSP underscores the role of the private sector as a driving force toward a market economy, the government's actions have aimed at reintroducing and expanding state monopolies and increasing effective trade protection for selected sectors through formal and informal restrictions.
- While the EGPRSP vows to adhere to the Memorandum of Understanding on Agriculture,¹ the government has attempted to revise the land code to allow a non-market approach for consolidation of land and farms, and targets agriculture subsidies largely to producer cooperatives. The staffs believe that the fragmented structure of land ownership needs to be addressed through market-based approaches that do not discriminate against different forms of legal structure. Transparent consolidation measures should be promoted to encourage farm restructuring, ensure equal treatment of all business forms, and protect investments. Further, the government's intention to target agriculture subsidies largely to producer cooperatives discriminates against other forms of farm ownership.
- Regarding pension reform, the EGPRSP states that the indexation mechanism introduced in 2003 will continue to be implemented. The staffs note that although the legal provision for the indexation mechanism was acceptable and pensions were indexed to average wage and price inflation in 2004, as legislated, the November 2004 ad-hoc pension increase threatens medium-term sustainability and the success of pension reform.
- The EGPRSP commits to complete privatization of strategic enterprises in the energy, telecommunication, and winery sectors and to accelerate the privatization program. In reality, progress in privatization of strategic enterprises has been slow, and a number of state enterprises and properties have recently been removed from the privatization program.

17. Government ownership can be more credibly demonstrated if its actions adhere to the policies articulated in the EGPRSP. To this end, the authorities need to demonstrate a track record of good implementation, both by reversing actions that are inconsistent with the EGPRSP and by effectively implementing the outlined structural reforms.

18. **Poverty Analysis and Program Monitoring.** The authorities are encouraged to strengthen poverty analysis by including sensitivity analysis and by selecting and officially approving a methodology for poverty measurement. The staffs note the lack of a sensitivity analysis (for example, relative risks of poverty for children versus elderly),

¹ The Memorandum confirms the government's commitment to implement agricultural policies and support agricultural institutions aimed at developing a vibrant market-oriented rural economy. It serves as a basis for IDA/Moldova collaboration in creating an effective post-privatization environment in the agricultural sector.

and its implications for social policy. Further, the adoption of a single methodology for poverty measurement will help monitor progress in poverty reduction.

19. Monitoring indicators should focus on priority actions and should be linked to outcomes. The authorities have made good efforts to set appropriate monitoring indicators aligned with the MDGs. However, some indicators are too general and do not necessarily help measure the impact of the actions in the EGPRSP policy matrix. The staffs understand that the chosen indicators were determined to a large extent by the availability of statistical data. Attention should be given to improving statistical data to monitor the impact on the poor in terms of health, education, and social assistance policies. Also, targets have been fixed only for a few indicators, the rest being used only to show baseline data. Well-defined targets and overall improvement in fiscal transparency will be important to guide policy makers and other stakeholders in understanding whether the EGPRP is achieving its expected results. In the medium term, the planned modernization of the Treasury system would enable the government to track poverty-reducing expenditure programs more effectively.

20. **Participation in Implementation.** The composition of the Participation Council should be broadened, the monitoring system should be institutionalized, and participation mechanisms should be identified. The Participation Council should be expanded to allow broader participation by civil society in the monitoring of EGPRSP implementation. Although not explicitly stated in the document, the government has established an EGPRSP Implementation and Monitoring Unit (EIMU), which combines the Department of Macroeconomics and Development Programs and the Poverty and Policy Monitoring Unit (PPMU) in the Ministry of Economy. The EIMU is expected to play a major role in overseeing the implementation of the strategy, monitoring poverty and the impact of policies, ensuring the dissemination of relevant information to other stakeholders, and facilitating their participation in monitoring and evaluation. Monitoring units in each line ministry will be created to follow up on the implementation of the sector action plans and to analyze specific policies' impact on each sector. Important technical support will be needed to strengthen the capacities of the governmental structures involved in the monitoring and evaluation of the EGPRSP. Finally, the staffs suggest that an effective participatory process should include monitoring mechanisms that engage civil society and citizens in providing feedback and evaluation of EGPRSP implementation, thus enhancing the dialogue between civil society and the authorities.

21. **Vulnerability to External Factors.** In the next couple of years, the balance of payments situation will continue to depend critically on the inflow of workers' remittances as new external financing is expected to be relatively scarce. A reduction in the inflow of remittances would negatively affect growth, which in turn would limit the resources for implementing the poverty strategy. Further, Moldova's exports could be dampened by declines in world oil prices that could constrain economic growth in Russia, a key trading partner. While Moldova may have little control over these vulnerabilities over the short term, effective implementation of structural reforms and broadening of the economic base, as envisaged in the EGPRSP, would mitigate the impact of external factors over time and help unlock supplemental external assistance.

22. **Domestic Capacity.** Limited institutional capacity, lack of experience of government agencies, and weakness in statistical and administrative data pose additional risk to the successful implementation of the EGPRSP. The delay in completing the EGPRSP clearly reflects these weaknesses. The proposed strategy, which calls for implementation of broad policy measures and participatory monitoring during the next few years is, therefore, ambitious. Implementation of the EGPRSP would be accelerated by efficient coordination of donors' technical assistance.

23. **Annual Progress Report.** The staffs encourage the authorities to incorporate the annual EGPRSP review in the existing budget process. For example, the annual budget execution report prepared by the Ministry of Finance and presented to Parliament could be accompanied by a progress report on EGPRSP implementation, and highlight how budget policies reflect EGPRSP priorities.

IV. CONCLUSION AND ISSUES FOR DISCUSSION

24. On balance, the staffs of the World Bank and the IMF believe that the poverty reduction strategy outlined in the EGPRSP is comprehensive and contains critical policy actions that, over time, could help foster growth and reduce poverty. In particular, the EGPRSP has substantial merit in its analysis of recent economic developments and poverty trends, the recognition of the current unsustainable growth path, the need to improve the business environment and strengthen governance. It also aligns the proposed priority programs to the MTEF, and is based on extensive consultation with a broad range of stakeholders.

25. However, the staffs have identified several priority areas for developing the EGPRSP into an effective and credible policy framework for poverty reduction. These include: aligning spending plans more closely in line with realistic projections of fiscal revenues and identifying all sources of financing necessary for their implementation; improving prioritization; strengthening ownership of the strategy; improving poverty analysis and monitoring; strengthening the participatory process in implementation; and addressing external vulnerabilities and domestic capacity constraints.

26. The staffs have also identified several critical areas where current policies contradict the EGPRSP, putting into question the credibility of the strategy. The staffs are particularly concerned about the observed slowdown in structural reform implementation (including privatization), the increased government intervention in economic activity, and the unsustainable medium-term fiscal and external debt plans. These inconsistencies limit scope for Bank and Fund concessional assistance.

27. Do the Executive Directors concur with the areas identified by staffs (a) as priorities for strengthening the EGPRSP, and (b) where action by the authorities is needed to facilitate Bank and Fund concessional assistance?