

### 3. Fiscal policy: missed chances

#### The state and fiscal policy

Public finances are composed by the revenues and expenditures of public administration, which are the public or state authorities. Their main economic goal is to produce services having no buying / selling specifics (e.g. which are not sold and do not create a price) and to make a redistribution of revenues generated by obligatory payments (like taxes and social contributions).

State determines the social-economic and financial situation, in the country through its fiscal policy. Fiscal policy success depends on the existing judiciary system and assumes the superiority of law in the relations between different subjects of social-economic activity.

For the normal functioning of market economy the state has to ensure maintenance of financial discipline. Four simple rules must work: i) the buyers observe agreements and pay for delivered goods; ii) debtors do not neglect credit agreements and do reimburse credits; iii) taxpayers pay taxes; iv) companies cover their expenditures from obtained incomes.

It should be noted here that the fiscal policy was developing and consolidating, being an important instrument of state economic policy.

#### Republic of Moldova: fiscal policy evolution in the '90s

The Republic of Moldova managed to formulate its independent fiscal policy after obtaining the independence in 1991. Consolidation of fiscal and budget systems, as well fiscal policy, took place after the national currency introduction in November 1993, in an environment of reducing of inflation and interest rates.

Two periods of fiscal policy evolution should be distinguished:

*1991 – 1995*: period of evaluation of the legacy received and of adaptation to the new economic environment by modifying the existent legal framework. Since 1992 new taxes (applied in market economies) were introduced like, VAT, excises, road fees, customs duties and so on. The principles and methodologies of calculations were modified for the existent taxes.

*1996 – 1998*: period of fiscal and budget system reform, accompanied by deepening of budget crisis.

The constitution of the budget system – Law On Budget System and Budget Process – was adopted in 1996, which is the base for public sector functioning.

The apogee of reforms in this domain was reached in the period of 1996-1998, when the Concept of Fiscal Reform was adopted and the first chapters of Fiscal Code were elaborated and implemented.

The concept of fiscal reform had the following objectives:

- Contribution to the investments attracting (both internal and external) for ensuring further economic growth combined with creation of new working;
- Ensuring the equity of the fiscal system;
- Ensuring revenues necessary for financing of public programs and services;
- Simplification of the system;
- Ensuring the efficiency of the fiscal administration through consolidation of the existing structure, modernization of own facilities, automatization of data processing, improving the methods of collecting and controlling the fiscal legislation observance.

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In order to achieve this objectives the reform was divided in several phases:

1. Unification within the Code of all laws on taxation of incomes of individuals and economic entities and of all administrative provisions;
2. Reform of VAT system;
3. Improvement of land and real estate taxes;
4. Modernization of methods used by fiscal administration for tax collection;
5. Examining of other revenue sources in order to reduce or eliminate inefficient taxes which stop economic growth in Moldova.

In spite of realized measures of fiscal and budget systems consolidation and implementation of an adequate policy in this sphere, we see now that the results obtained are far from the forecasted ones.

There are a lot of explanations here. Certainly, in 1994 – 1995 monetary policy was tight, serving the consolidation of national currency and the creation of a credible environment with respect to the national currency and thus contributed to a relative financial stabilization. Even more, positive tendencies of budget deficit reduction were registered. These tendencies should have been immediately supported by structural reforms in such key domains like *energy sector* (this sector has impacts to all sectors of economy and to the economic indicators at micro and macro levels); *agriculture sector* (in that period at the political level and the halting of reform was accompanied by high climatic risks which generated financial and material distortions in this sector); *social sector* (framework inherited from the Soviet period did not change and the costs for this structure were continuously growing; a delay in introducing pay services in education, health care were generating year by year a 30 % deficit of financial resources need for this sphere.

In 1996 the fiscal policy should have been dominant in the economic state policy and monetary policy must have been adjusted to the fiscal policy and real sector's requirements. And the beginning of 1996 was in fact quite promising: several important laws were adopted such as laws on budget system and budgetary process, on public debt and state guaranties, the concept of fiscal system reform, law on bankruptcy, the process of treasury system implementation was initiated, new budget classification and new accounting standards were under elaboration, the state securities market consolidated. Economic indicators for first 6 months of 1996 showed tendencies of growth in the real sector of economy and of macroeconomic aggregates. Hence, the premises were creating for transposing the focus from the monetary policy towards the fiscal and budgetary policy.

But 1996 was a year of elections and the elections need money, including public finance. In that period a lot of decisions were adopted, and their negative effects persisted till present: the government decision on netting out operations which generated chaos in the national economy, individual and branch tax exemptions, technical credits to the agricultural sector. At the same time the structural reforms in the economy have been suspended. Energy sector, agriculture sector and social sphere became an unsustainable burden for the budget.

It is known that Moldova has liberalized the internal and external trade relations. But this process was not completed and is running slowly. In the conditions of insufficient internal resources the state assumed the coordination of tariffs in the energy sector which generated financial blockage in this sector as well in the rest of the economy. Undertaking of the 140 million dollars debt in 1996 and recent undertaking of another 90 million dollars debt will burden the budget system for at list the next 7 years. Moreover, the reimbursement mechanism funds of withdrawn from the budget is not transparent and is not sustainable.

Liberalization was also hampered by the introduction of a huge number of licenses and restrictions of other nature applied for export transactions. At the same time, a facile import

regime was granted to some economic entities. Hence, through the Free Economic Zone, Moldovan Mitropoly, Olympic Club and others a traffic corridor for merchandise was created, of which other partner sides benefited from, thus avoiding fiscal legislation of Moldova and contributing to an unfair competition on the Moldovan market.

Acceptance of barter transactions after the disruption of economic relations with ex-Soviet countries during 1992-1993, and there further development on the domestic market in the next years has led to a diminution of the role of financial system. An economy which claims to be based upon market relations must be based upon Goods-Money-Goods relations. At the initial stage in Moldova the element of *money* is neglected, afterwards being partially substituted by *quasi-money*. A significant part of inter-payments was effected through mutual clearing which led to financial frauds. Until present there haven't been found other alternative instruments of clearing the financial blockages.

Another cause could represent the huge component of underground economy and of group interests. These phenomena, which have been frequently determining the adopted decisions on state level, delayed implementation of initial ideas, and also created a negative image towards the fiscal reform in the Republic of Moldova, that in its turn halts the investment activities.

Because of lack of a medium term economic policy, the fiscal and budget policy could not have been drawn up according to the demands of transitional economy. Government' programs Sangheli '92-'94 and '94-'97, Ciubuc - 1 did not draw a medium term economic policy but only a package of operative measures, or some mechanisms, which could not have resulted in a economic stability or growth. Moreover, they had a clear declarative content, since these decision, which were adopted after the approval of government programs, often were in contradiction with the programs themselves.

Unfortunately for the fiscal and budget policy there were suspended the reforms in the following sectors: energy, agriculture, education, health care, social assistance, which needed an important part of public financial resources. Due to the scarcity of funds, these sectors became a big burden for the budget, also creating financial blockages and rising debts on the expenditure side. Delays in pension system reform, non-transparent execution of the social insurance budget, have generated a chaos, and have also been a burden for state budget.

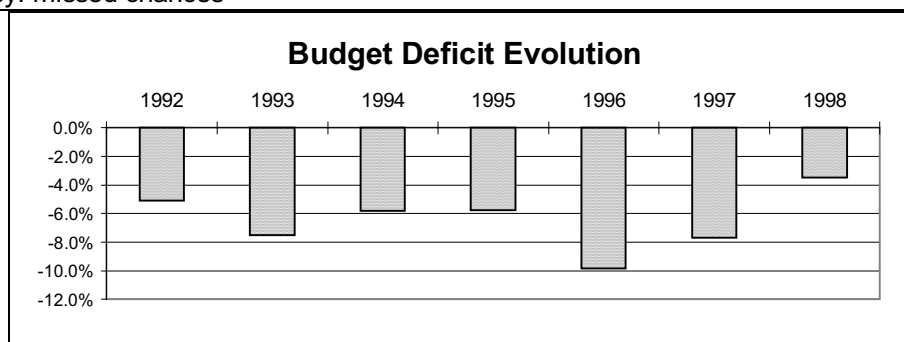
All above mentioned are the motives which transformed the employees of the budget sphere and pensioners into *state's creditors* since they can not get their salaries and pensions.

During this period were missed the possibilities of privatization of several objects of the communications and thermo-energy sectors, of the wine and tobacco industry, which could generate additional income for the country's budget system, and also more benefits (or at least avoidance of losses) for the economy as a whole.

Economic reform in ever economy would fail if it is not accompanied by juridical reform. Although the reform in this field was declared, it still remained as an isolated field, which is poorly reacting towards the reforming processes in the society. This fact determined lack of legal mechanisms for solving the some administrative, financial and organizational disputes. Corporate management practically doesn't function, it is difficult to avoid and eliminate financial frauds; overlapping of functions and lack of responsibility with respect to the Law generate financial crimes, fiscal evasion, non-compliance with terms of agreements and business contracts, etc.

*Budget deficit* is a starting point in estimating the fiscal and budget policy implemented by the state. In conditions of transition towards market economy this indicator is being influenced by many factors.

During the transition to market economy the Republic of Moldova is facing the problem of high budget deficit. So, starting from 1992, every year onward a budget deficit is recorded, fluctuating between 5.1% and 9.8% of GDP.



*Note: According to IMF methodology the 1996 budget deficit is 7.0 % in GDP. Since 1997 the new budget classification was implemented and the volume of the budget deficit is closely to that methodology*

At the initial stage the main causes of high budget deficit are the following: sharp and lasting economic decline, to a large extent caused by brake up of economic links and/or establishing of non-economic relations with former partners, as well as high rates of inflation.

Problems, which emerged at the initial stage, have already generated new burden for the budget for the next period. Hence, the decline in production sector led to a need in higher subsidies (both direct and indirect) for enterprises and population. It also created a long range of tax exemptions, decreasing fiscal revenues. Any tax exemption is supposed to stimulate the branch of industry to which it is applied. Hence, in this environment the activities that are not liable for taxation are flourishing. As a result even in countries with economic growth budget revenues may drop, since the growth takes place on the account of tax-exempted sectors.

Besides, changes in the fiscal system create difficulties for taxpayers in accommodating to new conditions. Tax evasion and non-payments to the budget grew considerably. The phenomenon of “forgiveness” for some economic agents by the Parliament created the system of non-contributions to the budget by the entities that previously honored their debts.

During the transition period budget expenditure increased: subventions were growing as well as expenses for internal and external debt service by the state. Crediting of enterprises by the budget also increased. Lately the increase in budget expenditures was also induced by previously accumulated expenditure arrears.

The increase in the last years of the state debt, serviced by the Government, was caused also by the needs to finance the budget deficit, and it leads to the growth of expenditures required for debt service. Thus, share of these expenditures in the volume of deficit has risen from about 40% in 1994 to almost 60% in 1997, as a result of growth of state debts serviced by the Government from 33% of GDP to 49% for the respective period.

Budget deficit financing is effected through combining internal and external sources, both being used in the same proportion.

Internal financing is done by receiving credits from the National Bank and by issuance of state securities. Along with the development of the securities market the structure of internal financing has changed, being reoriented from direct NBM lending to the Government during 1992-1995 towards attracting credits from the NBM against state securities during 1996-1997. Moreover, the Budget Law for 1998 foreseen that NBM would not grant any loans for financing budget deficit.

Thus, financing through state securities has become a permanent instrument for budget deficit financing. Interest rate lowered 2-4 times during 1995-1997, easing the pressure on budget.

External financing of budget deficit utilized in recent years has contributed to a rapid growth of state external debt, although the costs are relatively low (comparing to internal financing).

Budget deficit is a tool for measuring the impact of fiscal policy on the economy. Public sector deficit affects domestic savings and diminishes future living standards in the following ways:

domestic investment plummets, foreign debt raises, leading to further drop in national income. High levels of public debt and budget deficit affects both investment and economic growth.

International practice and theory suggests the following criteria for financial stability: low inflation level, a ratio of state debt to GDP not exceeding 60%, budget deficit below 3% of GDP. Otherwise the deficit should be gradually reduced to reach international acceptable levels.

During the transition a budget deficit is inevitable, but its maintenance for seven straight years requires its reduction to 2-3 percent of GDP in the nearest future. This is especially true when having an excessive level of state debt, when its further growth may seriously affect state finances.

Further development of state securities market, refusal from NBM credits, and moderate external financing of the budget deficit are the objectives that will determine the budget deficit financing for 1999-2000.

High cost of internal loans leads to a rapid increase of domestic debt servicing expenditure. Thus internal financing of the budget deficit should be determined by the necessity of reduction of domestic interest rates.

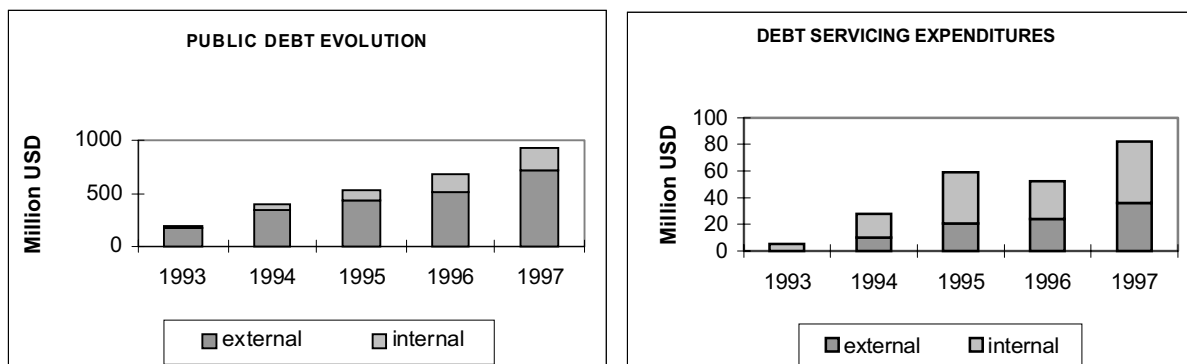
The policy of financing from domestic sources should be based not on budgetary needs, but must have the objective to reduce the negative consequences of foreign debt service burden on economic growth. Budget loans will be attracted from the to non-banking sector, drawing in the population and other small investors. After 1999 this will become the principal source of budget deficit financing.

The policy of attracting foreign funds will be oriented towards the aggravation on foreign debt indices: its ratio to GDP (in 1997 it was 61 of percent), ratio of foreign debt service to exports of goods and services. Following these considerations the newly attracted credits should be used for structural and sector changes.

Since the repayment of foreign debts is enlarging in the following years, the net foreign financing will become insignificant, or even negative. While honoring all the foreign payment requirements, the share of primary deficit (deficit without state deficit service) will remain at the same level, taking into account the decreasing budget deficit.

A new problem, that may become a very serious one, is the admission of local budget deficits. Their drawing of commercial credits at local level may cause a debt crisis on territories, impacting the central budget. Therefore, the local financing policy should be strictly coordinated by central authorities – the legal framework should be revised / created.

*Public debt.* Since 1992, with first budget expenditure financing problems, the public debt accumulation started. The initial public debt was accumulated through direct credits from the NBM, while foreign debt accumulation started in 1992.



Since 1998 the NBM does not offer credits for budget deficit financing, with the exception of short-term loans (up to one year).

The majority of countries with market oriented economies consider the secondary market for securities as a sound economic tool for budget deficit financing. There are cases (Russia, for

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example) when these tools insufficiently conducted and monitored create a so-called *pyramid of state securities*. This pyramid is also known as the *mechanism of debt self-reproduction* and consists in:

*Increase in primary budget deficit > increase in the amount of new loans > public debt raises > interest rate soars > expenditures for debt service grow > general budget deficit expands > need for new credits > new increase in the public debt > expenditures for debt service grow > etc. > default...*

The Republic of Moldova has huge foreign debt accumulations. Unfortunately it was not used according to the rule *one ban spent today brings two tomorrow*, but according to *let's spend today, they are gonna give us more tomorrow*. The absence of the law on money laundry and the tergiversation of its adoption cannot be justified.

*Securities market.* Starting April 1995 Government, represented by the Ministry of Finance commenced the issuance of state securities for covering budget deficit. First issues were at around 90% annual interest rates. Interest rates have gradually diminished reaching 18-20% by end-1997. Under these circumstances budget deficit financing through this mechanism was justified.

However, beginning with 1998 the Government's financial situation has deteriorated considerably, the interest rates went up reaching 40%, although the low level of inflation and leu's stability did not serve as a basis for lack of confidence.

In the conditions of internal and external financial crisis this phenomenon can faster lead to a default of the country, and therefore a collapse of internal financial market. Along with continuous disturbances in the national economy the state securities market became in 1998 a burden for the budget and for the banking system. Furthermore, in September-October 1998 this situation lead to a need in a direct crediting of the Government by the National Bank which was actually done.

Because of the financial crisis in the world Moldova lost it's opportunities to borrow from capital markets abroad, by issuance of Eurobonds. Russian crisis aggravated even more the situation on the internal securities market, Moldova found itself very close to a default. It is impossible now to regain the confidence of the investors and at the same time it is dangerous for the Government to issue securities at any cost (which actually happened in Russia before the crisis). This could lead to acceleration of the process of self-reproduction of debt resulting in the end with a default of the country.

During 1999-2000 the policy regarding the state securities market should be: i) oriented towards redemption of issued T-Bills and T-Bonds; ii) utilized as a mechanism for reimbursement of loans received from NBM during 1992-1998.

#### **Fiscal policy in 1998**

*The year 1998 will be year of big endeavors, including tough acceptance of the simple truths of economic realities such as: that we can not consume without paying; nobody is willing to support or to credit someone else forever; it is impossible to continuously accumulate external debt without having the capacity to reimburse it; market mechanisms imply revenue distribution according to individual and group performance; unity and social solidarity are easier to realize in a society which is doing well; in open systems performances are estimated in relative terms (it is important not only what we are doing, but what our neighbors are doing).*

This is an extract from the introductory part of the Economic Survey no. 1 issued in July 1998 by CISR. These phrases have become even more actual after the world financial crisis, and especially the Russian crisis from August 1998.

Consequences of this crisis for Moldovan economy, especially for the budget, are difficult to be expressed in figures. It is though clear that: Moldovan exporters have to store the produces commodities, to supply the goods without a certainty that they will get paid for this, to halt the

production of goods for the CIS markets, especially for Russia. Costs of this phenomenon can generate soon a rise in unemployment and much higher social costs.

The budget will not receive those revenues previously forecasted, referring to the VAT (VAT with Russia is calculated on the basis of the country of origin), excises, income tax.

However, there are also other causes (other than crisis related) which block the Moldovan exports: introduction of an import surcharges by Russia and Romania. Thus, Moldovan production suddenly became non competitive. At the same time imports into Moldova are rising, because the import regime is quite liberal, while Balance of Payments has persistent problems. In the end state budget has losses, or simply speaking the budget expenditure arrears are increasing.

### **Suggestions for the fiscal policy**

In order to implement a successful fiscal policy it is extremely important to delimit the customs territory of the country. "Transparency" of Moldovan borders, especially of the Eastern borders, the liberal regime for importing goods subject to VAT and excises, generate financial losses both the national economy and budget system.

It is almost suspended the accounting reform. This situation contributes to financial frauds, embezzlement and room for different kind of "settlements" between tax payers and financial and fiscal control inspectors. In case if till mid-1999 new accounting standards will not be fully implemented, the Republic of Moldova risks to loose its budget system.

Along with the implementation of the new pension system which provides for introduction of personal accounts, it is appropriate to increase the payroll tax from the individuals (from 1% to 5% for the initial period). This will mean that individuals would be interested to contribute to the Social Fund. Secondly, it would eliminate double accounting which is present at the economic entities. Individual would be interested in showing the actual rewarded amount in the accounting papers. At the same time the contribution rate paid by economic entities can be reduced by 5 percentage points.

Any fiscal policy, as an element of state's financial policy, will fail, until the non-financial relations persist between economic entities and budget system, or between economic entities themselves. Hence, it is urgently needed to eliminate barter transactions, netting out operations, and payments in kind. Economic entities have accommodated to this types of businesses, managing to avoid payments to the budget system.

Although introduction of VAT in the Republic of Moldova is considered to be a success, a step towards the market economy, still the VAT, as it exists in Moldova, is a serious disadvantage for the economy. The huge list of tax exemptions, of legal acts regarding VAT, cause chaos in the accounting statements and contribute to the irresponsibility and incompetence of control bodies. Moreover, they generate considerable fiscal evasions. It may be appropriate to suspend the VAT provisions for 6-12 months and to clear up the situation here and simplify the VAT system. It may be suggested to temporary reintroduce the turnover tax.

For a short period of time it would be advisable to introduce a surcharge on imported goods which would halt the inflow of goods. Especially because the neighboring countries have introduced such surcharge already. This step would contribute to a diminution of trade balance deficit in a short run.

A number of discussion take place on public finance: existing tax system, existing system of redistribution through the budget. All ideas coming out of these discussion have their pros and cons. But speaking about public finance, and not only about this, we must be guided by the famous assertion of the President Kennedy: *"Don't ask yourselves what a country can do for you, but what you can do for the country."*