II. UNSUSTAINABLE FISCAL POLICY (1993-1997)

Abstract

Moldovan fiscal policy in recent years was driven by inertia and pressure from groups of interest. This statement is reflected 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. Arrears and netting-out operations led to the development of a non-payment culture. At macroeconomic level, expansionary fiscal policy led to high absorption in the economy that was not met by the supply side response due to the impeded restructuring process. It fuelled imports and the trade balance steadily deteriorated. At the same time, capital inflows necessary to finance the budget deficit, combined with domestic restrictive monetary policy, prevented the depreciation of the currency. The ultimate result of the policy mix was the rapid accumulation of external debt and expenditure arrears. The unsustainability of both internal and external position of the state led to the inevitable financial crisis.

1. Introduction: Fiscal Policy and Macroeconomic Stabilisation

It is well established that transition countries that implemented tight fiscal policy resumed the growth sooner and it was both more stable and higher in comparison to countries with large and unsustainable budget deficits and associated high levels of government spending. This paper argues that the reduction of state budget deficit is the most important condition for medium-term stabilization and growth of Moldovan economy. It also proves that the fiscal policy could not sufficiently be disciplined by a restrictive monetary policy.

Macroeconomic developments in Moldova in last years exhibits striking contrast between consequent tight monetary policy and loose, arguably unsustainable fiscal policy. While inflation and monetary aggregates show low dynamics, not yet achieved even by the most advanced transition economies, budget deficit share in GDP exhibited almost double digit values. This outcome can be somehow surprising as "it is generally established that fiscal adjustment plays a key role in both exchange rate-based and money-based disinflation efforts" (Ter-Minassian, Schwartz 1997). It is also widely recognised that efficient pursuit of macroeconomic policy requires a close degree of co-ordination of financial policies (Laurens, de la Piedra 1998).

It seems that these conditions have been violated in Moldova and apparently the reduction of budget deficit was not a sine qua non condition for a successful price stabilisation since 1993 until the autumn of 1998. This paper argues that this impression results mainly from the different time schedules of fiscal and monetary policy actions. Fiscal policy can be changed only with significant time lags and also it takes years until its full impact on economic development is observed. Monetary policy, on the other hand, can be adjusted more rapidly and the response of the economy is prompter. Namely, even under fiscal policy that is unsustainable in the longer run, the short-term monetary stabilisation can be achieved. Effects of inflation and exchange rate pressures, combined with high interest rates will accumulate slowly, with the adverse influence not only on the price stabilisation but also on the economic growth in the medium term horizon (Rosati, 1996). As Ter-Minassian, and Schwartz (1997) show, the long lasting stabilisation in Latin American countries were brought only by programs that combined both fiscal and monetary tightening. Programs that ignored the fiscal component yielded only temporary results at best. Non-inflationary sources of budget deficit financing cannot substitute for real fiscal adjustment. These conclusions can be drawn from analysis of crisis situation in transition countries presented in Markiewicz (1999). The literature on the Russian and Ukrainian crisis usually shows that the main cause of crisis is the accumulating effects of bad fiscal policy. Dabrowski (1999) points out that although most of the countries that reduced significantly the budget deficit financing from money emission achieved short-lived price stability, the scale of fiscal adjustment being the factor that differentiated recent macroeconomic developments in CIS countries and other countries of Central and Eastern Europe. In Moldova, internal imbalances have been persistently converted into external problems. The domination of demand over supply of goods, has not produced inflation, as it was settled through imports. Similarly, the budget deficit was financed without monetisation through foreign capital inflows. Financing twin deficits through external borrowings, was relatively easy since Moldova started its independent economic life in 1992 without foreign debt.

By analysing the policy-mix in Moldova in recent years, this paper will concentrate on two issues in which the co-ordination of fiscal and monetary policy is particularly important: financing of budget deficit and debt management. However, the problem is more general. Unsustainable fiscal policy put all the responsibility of maintaining stabilisation on the monetary policy, which leads directly to the necessity for further monetary tightening. Monetary policy could not, however, compensate for the weakness of fiscal budget in a longer time period. Moreover, the fiscal policy in Moldova was constantly undermining the credibility of the stabilisation, making required monetary policy still harsher. Possible results of such policy mix are listed below:

i) High real interest rates held by the deficit borrowing requirements, with reduction of the capital available to the growth-generating private investments;
ii) high costs of financing the budget deficit (high interest rates, tight credit control, low inflation, hence low inflation tax), emergence of expenditure arrears, raising costs of public debt service;
iii) falling competitiveness with large trade deficit and the accumulation of external debt;
iv) deterioration of liquidity in the economy, leading to the emergence of inter-enterprise arrears, and barter and netting-out operations.

All the above effects have deeply marked the Moldovan economy. As the government relied excessively on foreign borrowings, in the presence of money scarcity the third effect proved to be probably the most disastrous. The absence of hard budget constraint should be viewed as a component of loose fiscal policy that prevented restructuring, which led to non-cash transactions (fourth effect).

2. Fiscal Policy and the Structural Reforms in Moldova

2.1 Determinants of Fiscal Policy

The first requirement for an efficient policy mix is that both fiscal and monetary policies are each on a sustainable path. The size of budget deficit and its financing remain crucial for the future fiscal position of the state. Therefore, the government should adopt explicit strategy for the development of amount, timing and maturity structure of the resulting debt burden. Proper policy has to be focused on solvency and liquidity questions. The solvency means that expected economic growth or increase in the efficiency of the budget execution will generally allow the state to fulfil its total debt payment (positive net present value of the government). In other words, its budget deficit is sustainable. The liquidity can be defined as the ability to service timely current state obligations and it can stem either from the balanced budget or an easy access to the external financing sources. The policy should be therefore oriented towards monitoring, early warning and contracting actions against the following situations:

a) Budget deficit is unsustainable, although it can be financed in short-term. There are no signs of liquidity crisis, yet the currently conducted policy makes the country insolvent in longer run. The burden of debt rises as long as it reaches the level that will result either in default or in the deep economic policy change. This situation was common to most of CIS countries, including Moldova in recent years, as the favourable external borrowing conditions combined with high budget deficits lead to rapid increase in the indebtedness.

b) Sustainable fiscal policy is under serious thread due to improper liquidity management. There is no a real solvency problem but the country faces a liquidity crisis, as it is not capable to meet its current payment obligations. (This describes the scenarios of financial crises in Czech Republic and Slovakia in 1997.)

The sustainability considerations should constitute the basis for proper fiscal policy and the medium-term debt strategy. The liquidity constraints imply an optimal short-term debt management, especially the recommended structure of deficit financing. The development of a proper framework is therefore the prerequisite for good policy making. It was clearly not the case when the sustainability question was not addressed and liquidity considerations were limited to searching for necessary funds to finance current expenditure needs. In fact it is impossible to speak of fiscal policy in Moldova in the sense of any established strategic goals and policy instruments. As Dabrowski (1999) pointed it out, the fiscal policy is the reflection of the quality of reforms undertaken in the economy. The fiscal problems of Moldova reflected the weakness of state structures, the political climate favourable for populism and rent seeking, low pace of privatisation and restructuring and delayed reform in the social sphere. The opposition of strong vested interest put pressures on Moldovan fragmented policy-making. The link between structural changes and fiscal system is however mutual. Fiscal policy should provide the right incentives to economic agents, currently acting in a system with explicit and mainly implicit subsidies, tax exemptions granted at the discretion of government officials, which created incentives for intensive rent-seeking and not for market adjustment.

In such a situation, the fiscal policy of successive Moldovan governments were driven on the expenditure side by the inertia of spending commitments and on the revenue side by the inability to actually collect taxes. The former came from the lack of a political group that would try to gather the general support for explicit social spending constraints and to eliminate support for the inefficient sectors of the economy. The latter was the result of widespread corruption and fiscal evasion.

2.1.1 Tax Revenues: A Malfunctioning Tax System

Like many other CIS countries, Moldova suffered a significant drop in tax revenues in the years following the independence. This negative development was the result of both steady decline in GDP and the disruption of the tax collection system. The comparison of tax collection in with other transition countries shows that the tax burden in Moldova was relatively small (Table 4).

Table 4: Tax Revenues (% of GDP, 1996) excluding social contributions

	Moldova	Ukraine	Romania (1997)	Belarus	Poland
Total, including:	21.1	26,7	21,5	29,2	28,9
Personal Income Tax	2.8	3,3	5,6	5,1	9,2
Corporate Income Tax	4.7	6,8	3,2	7,1	3,1
VAT/Sales Tax	8.0	7,8	5,4	13,8	8,1
Excise Taxes	2.6	0,8	2,2	6,1	4,3
Trade Taxes	1.2	0,6	2,1	3,3	2,6

Source: Ministry of Finance of Moldova, Ministry of Finance of Romania, IMF (1997)

The evolution of revenue collection by main items is shown in Table 5.

Table 5. Tax Revenues (% GDP)

Year	Income	Profit	VAT	Excise	Duty	TOTAL
1994	2.7	8.8	6.0	3.2	0.6	23.9
1995	3.1	6.1	8.9	2.9	0.8	23.5
1996	2.8	4.7	8.0	2.6	1.2	21.1
1997	3.2	2.7	10.6	4.5	1.4	24.9
*1998**	2.5	2.0	12.8	4.3	1.2	24.1

Source: Ministry of Finance

The most rapidly diminishing part of the state revenues was the profit tax, whose share in GDP decreased by 7 percentage points between 1994 and 1998. This substantial reduction reflects primarily the general decline of production in Moldovan enterprises and their slumping profitability. The emergence of private business and higher level of independence of state enterprises also contributed to a lower level of profits that state budget could appropriate. The loss was partly offset by the revenues generated through VAT that was introduced in 1994. Revenues from VAT rose steadily, excepting 1996 and 1998, two years of significant deterioration of fiscal buoyancy. Excise taxes have been rather unpredictable source of income for the consolidated budget. Subsequent efforts to gather higher revenues yielded through higher tax rates did not always lead to any rise in budget revenues.

There are several causes of low and decreasing tax revenues in Moldova and some of them have roots in issues that differ from those covered in usual economic analyses: weak and rotten state structures, lack of effective law enforcement, corruption, absence of well-defined territorial borders of the country. Poor performance of revenues from income taxes stems primarily from the widespread reluctance to report properly income and earnings. The share of shadow economy is quite frequently evaluated at above 40% or even 60% of the formal sector. In 1997, about 82% of taxes due were collected (Fitch IBCA 1998), including revenues settled through the netting-out operations. Still tax arrears constituted 7% of GDP in 1997. According to the CISR (1998), based on the cases of evasion detected by tax officers, the fiscal evasion amounted to 25% of total budget revenue in 1997, while in 1995 it was only 4%. The strongest negative impact on tax compliance can be attributed to the events of "tax forgiveness". By the decisions taken by the Parliament at the end of each year, some economic agents are ex-post exempted from taxes and their liabilities towards state budget are simply cancelled out. Such practices, characteristic especially for the period 1993-1997, provide absolutely wrong incentives to economic agents and undermine the credibility of the tax enforcement system. Moreover, municipalities do not have incentives to raise higher volumes of local tax revenue since it results in reduced money transfers from central budget. However, the highest losses stem from the fact that the state controls less than 40% of total length of its border. The unprotected border with Transnistria that conducts independent economic policy also exerts a big cost on Moldovan tax collection. Smuggling via Transnistria into Moldova of big amounts of excised goods as spirits, tobacco and oil products incurs Moldova with costs estimated sometimes even at 9% of GDP through the diminished revenues from external trade, VAT and excise taxes (Catan 1999).

Several attempts were made in order to raise the tax revenues of the consolidated budget, some of them having a character of "quick fixes". Special attention has to be attached to the positive results of 1997 that are reported in Table 2. The visible improvement was only partly the result of increased tax rates, moderate economic growth or better tax collection. The relative improvement was mainly the effect of some measures that raised artificially the tax collections. The most important is represented by the netting out operations, which resulted in high tax revenues in December 1997 (21% of total revenues in comparison with 15% in previous years). During the last years, only 30% of revenues from VAT were paid in cash, with the ratio declining even to 10% in December, when netting out operations were conducted.

Netting out operations proved to be a persistent and harmful element of economic life in Moldova. In-kind operations and tax arrears contradict the hard-budget constraints. The non-payment culture emerged as the government first allowed to run up the tax arrears, budget expenditure arrears and then decided to offset these two non-payment flows. It further reduced the compliance rate and increased the difficulties of tax collection. Barter operations allow enterprises to underreport their earnings, leading therefore to increased tax evasion. In addition, non-cash transactions allow enterprises to avoid placing their financial means within the banking system, where they can be seized against tax liabilities. Instantaneously, the financial intermediation role of banks is reduced with negative impact on state revenues, the demand for state treasuries and investment possibilities. Barter transactions, coupled with netting-out operations, increased significantly the administrative costs of tax collection and opened a wide scope for tax evasion. Enterprises are now ready to supply public entities with goods at artificially higher prices. At the end of the year they swap these receivables for the accrued tax liabilities. Such operations are also profitable for the officials from public entities, because they can extend the financial means at their disposal through these implicit borrowings, besides the significant opportunity for bribery. Non-cash tax revenues cannot be efficiently distributed according to spending priorities.

Netting-out operations aggravated also the general non-payment culture in the Moldovan economy, which has a negative impact on the general economic situation. Due to non-cash operations it is still possible to take production decisions without the evaluation of market demand and without undertaking marketing activities. The enterprises do not match their supply (both the structure and volume) with the effective needs of the market, expressed by the demand side. Instead, the production activities are driven by inertia. The economy is therefore confronted with a specific category of commodities – the non-marketable goods. The low market value of inventories of these goods forces enterprises to trade them on a non-market basis – for tax liabilities, or to transfer them to workers as a substitute for wages. Effectively, the enterprises force a third party (the state or the workers) to take over marketing tasks by settling its obligations through in-kind payments. This is especially characteristic for state-owned enterprises, which therefore have non-purely economic relations with the state structures. Barter and in-kind operations preserve therefore the inadequate composition of production and impede restructuring, while adjustment to the market demand is the very first requirement for the rebound of production in the economy. Barter transactions hamper price adjustment between demanded and non-demanded products and therefore they effectively transfer money from good enterprises to bad ones and therefore represent a part of the income redistribution system: netting-out operations can be viewed as the subsidy to inefficient enterprises.

2.1.2 The Expenditures: Policy Inertia

The last stages of existence of centrally planned economies were characterised by the build-up of extensive social expenditure programs. Moldovan economy shrank by 65% between 1991 and 1997; however the policy-makers were reluctant to reduce expenditures accordingly. As a result the social spending bill constitutes the largest share of GDP, compared to the standard levels in case of transitional economies or middle income countries (Table 6).

Table 6. Selected Expenditures (% of GDP)

	1994	1995	1996	1997	1998	Transition Economies	Middle Income Countries
Education	7.5	7.5	9.0	8.8	6.3	4.9	3.8
Health	5.3	4.9	5.9	5.3	4.4	3.7	2.0
Social Security and Welfare	12.8	11.0	11.2	12.7	12	8.4	5.7

Transition countries include: Kyrgyz Republic, Mongolia, Romania, Turkmenistan, Ukraine – 1995/1996

Middle Income Countries include: Barbados, Botswana, Chile, Columbia, Costa Rica, Cyprus, Dominican Republic, Egypt, El Salvador, Fiji, Hungary, Iran, Jordan, Malta, Mauritius, Morocco, Panama, Paraguay, Peru, Romania, Swaziland, Thailand, Tunisia, Turkey, Uruguay, and Zimbabwe.

Source: IMF (1998a)

The inability to openly reduce expenditure commitments is the major weakness of Moldovan policy-makers. It especially concerns the expenditures on health and education that constitute together about one-third of government expenditures. The social expenditure commitments became the rigid part of the subsequent budget bills, although some of these commitments were not executed later on due to the scarcity of financial resources. Since the creditors are reluctant to finance unexpected increase in government imbalances, the budget is forced to withhold its due expenditures. The expenditure adjustment that should have taken place in the budgeting process is therefore postponed to a later date, although one may argue that the problem of unrealistic forecast is minor. There is, however, a big difference between planned reduction in expenditure commitments and ad hoc withholding of budget expenses (especially the emergence of expenditure arrears). Ad hoc cuts in expenditures, although favourable for the budget in short term, aggravate the fundamental problem of Moldovan public finance: the absence of prioritisation of budget expenses. During the budgeting process it became a common practice to increase planned revenues to meet the expenditure commitments. On the contrary, there is hardly any other effort to adjust expenditure commitments ex ante in line with forecasted revenues. As long as policy-makers tend to neglect realistic tax revenue forecasting, the chances for sustainable and efficient fiscal policy are very low.

Ad hoc cuts are usually made according to the political sensitiveness of expenditures; therefore, the allocation of scarce public resources is increasingly based on the relative strength of groups of interests and extrapolation of existing spending patterns. The reduction of expenditures is also often short-lived: after the period of wage increase freeze, an offsetting rapid growth of wages may be expected. Sustainable reductions and distribution of expenditures based on economic or equity considerations would only be possible if the government starts to realistically assess its spending capabilities in the budgeting process. The general inefficiency of the expenditure stems also from the widespread use of in-kind payments and tax offsets that further decreases the flexibility of expenditure patterns.

As a result, the structure of spending is characteristic for a communist country rather than for a market oriented economy. The social assistance is not focused on the most vulnerable groups but rather to a wide share of population through numerous privileges, subsidies and compensations. Those are especially concentrated in the energy consumption, which leads to its huge over-consumption. Furthermore, according to IMF (1998a), the public sector wage bill represents 7.2% of GDP in 1997, significantly more than in OECD countries (4.5%), in Romania (5.8%) or Poland (6.1%). While wages in the public sector are low, the excessive employment, especially in education and health care, remains at the core of the problem. In the health care system expenditures are biased towards an excessive number of hospital beds and doctors with insufficient focus on basic preventive health care. Some co-payments schemes in education and health are therefore currently considered, combined with redirecting the education and health care spending towards the basic services. The reform of Social Fund is also rapidly needed, as it is becoming rapidly dependent on the state budget.

Apart from that, the decline of productive sector led initially to the pressure on higher subsidies (both direct and indirect) for enterprises. Only in 1998 more serious attempts to limit direct budget subsidies to enterprises were made, crediting of enterprises amounting to 2-3% of GDP throughout the period.

2.2 Fiscal Deficits between 1993 and 1998

After the explosion of state budget deficit, shortly following the Moldova's independence in 1991, consolidated budget deficit (on cash basis) peaked 25% in 1992. Sharp adjustment, mainly on the expenditure side, reduced the gap to a less frightening level of 9% in 1993. This reduction could have been the promising prelude to the further fiscal consolidation that should have been a part of the stabilisation program. However, no further significant cuts in the deficit were introduced after 1993. The extent of the stagnating fiscal problem between 1993 and1996 is reflected in the constant high commitment deficit that reached above 12% of GDP in 1994 and 1996. Only 1997 seems to show some positive adjustments. In comparison to 1996, the committed deficit in 1997 was reduced by 7.8%. However, as mentioned before, the reduction was mainly the result of the decision to allow the netting out operations in tax settlements and the one-off proceedings from the sales of military equipment (nearly 2% of GDP). The freeze of wages at 1996 level and a slight recovery of the economic activity also contributed to this improvement. In 1998, the year of economic crisis, the deterioration of tax revenues re-emerged together with an overall deficit of 9.3% of GDP (Table 7).

Table 7. Consolidated Budget Deficit (% GDP)

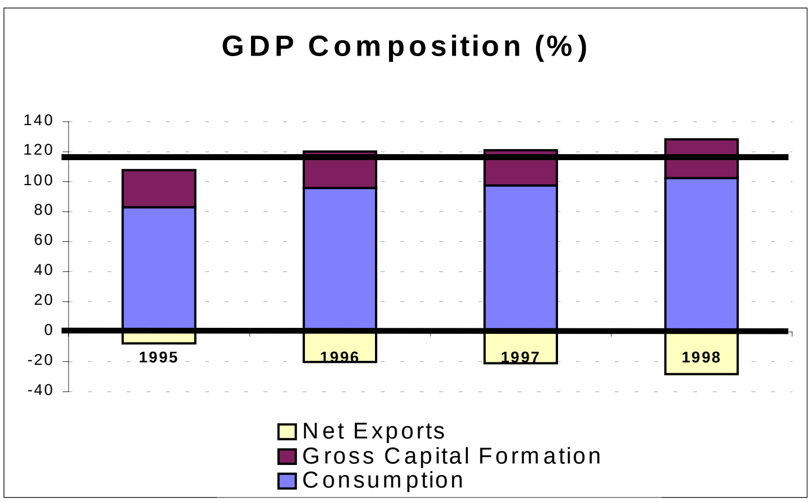
	1993	1994	1995	1996	1997	1998
Budget Deficit (Commitment)	10.4	12.9	9.0	12.4	4.6	9.3
Primary Deficit	9.1	9.4	4.9	9.2	0.4	4.5

Source: IMF (1998b), Ministry of Finance, own calculations

2.3 Budget Deficit and Aggregate Demand

In the standard Keynesian macroeconomics, fiscal deficit is the tool of stimulating economy during the period of recession. If the failure of private agents to consume and invest enough to meet the production capabilities is the cause of the decline in the output, fiscal expansion can stimulate the economy by enhancement of aggregate demand, leading to the reversal of the economy towards the full employment equilibrium. This result is obviously valid only if the output is under its full employment level and if recession can be indeed vied as the consequence of a weak demand. The evolution of Moldovan GDP exhibits 70% fall within the period 1990 - 1998. Did it constitute the case for the fiscal expansion? It might be difficult to argue that the economy needed a fiscal contraction[1]. The analysis of the composition of Moldovan GDP brings the response to this question (Figure 16).

Figure 16



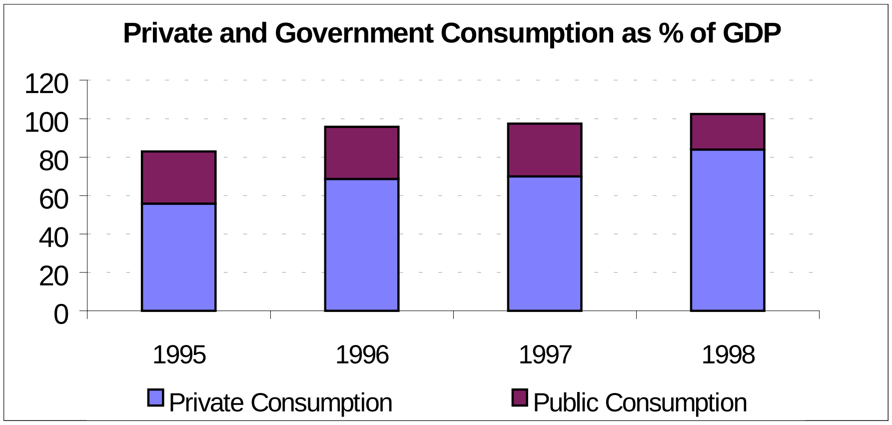
Source: Department of Statistics

As it can be seen, the share of final consumption in GDP was steadily growing and increased from 80% of GDP in 1995 up to 102% of GDP in 1998. However, the rate of investment in the economy did not fall significantly and fluctuated around 25% of GDP throughout the period. This was possible only through substantial external borrowings that offset domestic dis-saving.

[1] Similarly Krugman (1998) comments the discussions on the reforms in Brazil: "Brazil, we are informed, must suffer a recession because of its unresolved budget deficit. Huh? Since when does a budget deficit require a recession?"

Clearly, throughout this period Moldova was significantly credited by its trading partners, which is reflected by the increasing trade deficit (8% in 1995, versus the near-collapse level of 28% in 1998). Such trade imbalance induced an extreme risk to the external position of Moldova and made it very vulnerable to changes in the pattern of capital flows. It is interesting to see what is the role of government consumption in this process (Figure 17).

Figure 17



Source: Department of Statistics

Somehow surprisingly, it was the private consumption that was growing very fast (as measured as the share of GDP) in recent years. In 1995 private consumption amounted to only 55% of GDP, while in 1998 this figure raised to 85%. Meanwhile, public consumption remained stable (27%) until 1997, but it dropped sharply to 18%[2] in 1998. Developments of 1998 can be interpreted as the substitution of consumption of public services and goods (as education or health care) with private consumption of similar services. However, the rapid growth of private consumption between 1995 and1998 can be explained by the massive drop in savings and the declining ability of state to collect taxes (leading to the raise in the share of disposal income in GDP).

There is one clear message from this analysis: the recovery of Moldovan economy will not be possible by stimulating the aggregate demand. The Keynesian solution to the current recession is completely inapplicable since the rapid growth in final consumption fuels exclusively the increasing trade deficit.

3. Financing the Budget Deficit

The economic consequence of fiscal deficits depends not only on their size but also on the way of financing those deficits. According to Laurens and de la Piedra E. (1998), the fiscal deficit should be limited to the level at which:

a) its financing through domestic capital market does not distort the allocation of resources;
b) does not require direct credits from the Central Bank for financing it;
c) does not lead to excessive external borrowings

Accordingly, there are three basic alternatives of financing the deficit, in order to fully understand the impact of the deficit on the economy - considering the deficit calculated on the commitment basis and with privatisation receipts incorporated into the budget revenues:

- direct credit form central bank (with resulting change in monetary base – *Mbase*);
- domestic borrowing from commercial banks and private agents (B^D);
- external borrowings (B^F),

[2] It is also possible that public wages and other expenditures related to the provision of in-kind social benefits for population are included in private consumption, which means that public consumption is actually under-evaluated .

The above elements can be represented by following the equation:

$$D_t = (Mbase_t - Mbase_{t-1}) + (B_t^D - B_{t-1}^D) + (B_t^F - B_{t-1}^F)$$

In addition, there is a heterodox solution for deficit financing – through the accumulation of expenditure arrears (*A*). Therefore the above can be rewritten as:

$$D_t = (Mbase_t - Mbase_{t-1}) + (B_t^D - B_{t-1}^D) + (B_t^F - B_{t-1}^F) + (A_t - A_{t-1})$$

These four alternatives have various impacts on price stability, on the amount of credits available for private investments, as well as on the external balance. Moreover, the availability of these instruments depends on the independence of Central Bank, the development of domestic financial sector, the external openness of the economy and the ability to induce involuntary savings (arrears). If the access to external markers is limited and domestic financial markets undeveloped, while the government cannot run up arrears, there is a direct conflict of goals between fiscal and monetary policy. This is due to the fact that only three elements in the above equation can be determined independently. Table 8 and Figure 18 show the relative importance of each source of deficit financing in Moldova in recent years. The next sections describe in more details the consequence of each financing alternatives.

Table 8. Sources of Financing the Deficit (% of total financing needs)

Share	1993	1994	1995	1996	1997	1998
NBM credit	58	18	19	-7	35	101
Change in expenditure arrears	14	18	25	38	-69	63
Net domestic borrowing (Commercial Banks and Non-banks)	0	1	13	20	64	-27
Net foreign borrowing	28	63	43	48	69	-38
TOTAL (COMMITMENT DEFICIT)	100	100	100	100	100	100

Source: IMF (1998b), MET, own calculations

3.1 Central Bank Direct Credit : Money Printing

Direct credits from Central Bank fuel the growth of money stock and therefore the inflation. In a most adverse scenario, this leads to hyperinflation. In spite of this peril, such a policy option has been often adopted in Moldova. Until 1993 the government deficit was covered by direct credit from the Central Bank and segniorage was one of most important sources of government finance. This was obviously accompanied by high inflation in the economy, with an average monthly rate of 20% in 1993. The reform of National Bank of Moldova and free access to foreign capital markets removed this practise. Since 1994, fiscal and monetary policies have became increasingly independent. As in many other countries, the direct credit from the Central Bank was apparently the only available source for financing the budget deficit during the first stages of the stabilization process. Later on, the Central Bank became the lender of last resort to the government, when the access to non-inflationary sources was temporarily lost. Such developments are characteristic for countries with persistent budget deficit, insufficiently developed domestic financial markets for government debt and with limited access to international capital markets. Laurens and de la Piedra E. (1998) point out that while the median OECD government was repaying its credit to the Central Bank in the period of 1979-1993, the median developing country government was covering 30% of its financing needs from the Central Bank during the same period. Similarly, the analyses of consolidated banking system balance sheet show the same bias in case of developing countries. The Central Bank net credit to the government amounted to 12% of total banking system net credit in the median OECD, respectively 66% in a median developing country (in Moldova roughly 33% at the end of 1997). The impact of monetisation of deficit on inflation is particularly large in CIS economies where the banking sector is small and the level of monetisation in very low (Markiewicz 1999), which also reduces the possible gains from segniorage.

In Moldova, the direct government credits to enterprises represented the main source of deficit financing in 1992 and 1993. As it is shown in Figure 4, the volume of those credits amounted to 6 % of GDP in 1993. The next two years this source of budget financing decreased (2.3% and 1.7% of GDP, respectively) while in 1996 it became negative, when the state started to pay back the credit to NBM. In 1997 the recourse to this source reappeared (1.6% of GDP) but in 1998 the Budget Law prohibited explicitly such a procedure. In practice, NBM gives direct credits to the government for short-tem coverage of its financial needs. Moreover, in September-October 1998 NBM was forced to credit directly the government in order to avoid its default on treasury securities, which resulted in a very high ratio (9.3%). The role of direct NBM credits for deficit financing was mainly determined by the availability of cheap international financing. On the other hand, the role of NBM as an independent and relatively strong Central Bank should not be underestimated. However, the independence of central bank and its refusal to issue a direct credit to the government unfortunately to impose the corresponding adjustment of fiscal policy.

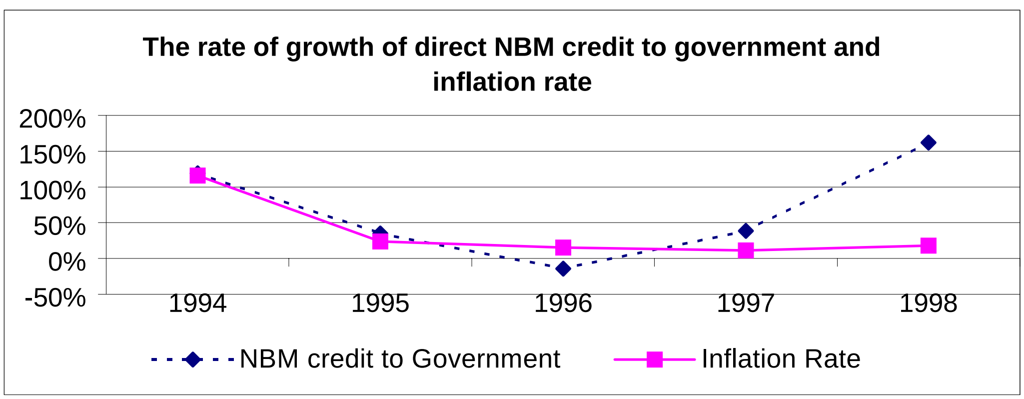
Financing the budget deficit through direct credit does not necessarily lead to increased inflation if it is combined with offsetting tightening of credits to commercial banks or decreasing stock of foreign assets. It is interesting to analyse the close influence of NBM credits to the government on the monetary aggregates, and consequently on the inflation rate (Table 9 and Figure 18).

Table 9. NBM direct credit to government

	1993	1994	1995	1996	1997	1998
as % of:						
reserve money	60	58	55	43	46	126
broad money	40	42	35	26	27	76
as % of growth of:						
reserve money	NA	56	49	-85	53	-1342
broad money	NA	43	23	-32	29	-498

Source: IMF(1998b), MET, own calculations

Figure 18



Source: IMF (1998b), MET

NBM credits to the government amounted to 60% of the supply of reserve money in 1993, but this share was reduced up to 43% in 1996. Similarly, the share of credits in broad money was reduced from 42% in 1993 to 23% in 1996. Until the end of 1995 the extended credit to the government caused more than half of the growth of reserve money. In 1996 the stock of money increased independently from the evolution of NBM credits. In 1997 the situation was similar to that from 1993 and 1994, with significant money growth resulting from direct deficit financing. 1998 brought more spectacular changes with plunging foreign assets of the Central Bank, which offset an important part of growth of NBM credits to the government.

Until 1998 the NBM tight policy, which was possible due to favourable conditions on the world capital markets, led to non-inflationary financing of the deficit. As a result, successful dis-inflation occurred between 1995 and 1997. However, the containment of direct credits to the government was not based on a sustainable policy, but rather on the capital markets' propensity to credit Moldovan government, which could not last forever.

3.2 Domestic borrowings : Shallow Markets

Financing budget deficit through domestic borrowing is usually regarded as being superior to other means, since it allows the Central Bank to conduct independently its policy with respect to money growth, and therefore to reduce the inflationary pressure. Borrowing on domestic markets does not lead to external exposure. However, lax fiscal policy combined with offsetting restrictive policy may lead to crowding out of private investment and rising cost of government borrowings. Moreover, economic agents may expect the future monetisation of debt, which would further drive the current interest rates up. The excessive accumulation of internal debt may temporarily slow down inflationary pressures, but may also lead to its surge in the future. Obviously, the cost of placing the debt on the market in short run depends directly on the monetary policy conducted by the Central Bank. However, the same is not true for a longer time horizon.

Expansionary policy allows initially for prevailing low interest rates. Later on, rising inflation implies higher nominal interest rates, excessive budget deficit, and consequently increased risk premium required for government T-bills. On the other hand, a restrictive monetary policy may further undermine the sustainability of fiscal policy, as it raises the primary surplus needed for servicing the outstanding debt. Tight monetary policy may also slow down the economic growth, and therefore reduce tax revenues and the income from (non-inflationary) segniorage. In case of Moldova, the main cause for the deteriorating fiscal position was a reckless fiscal policy, and not the tightness of monetary policy. Rising the domestic interest rate, which put a check on planned fiscal deficits, provides budget makers with clear market signals of the expected effects of a given policy. Such signals were ignored in Moldova, as policy makers claimed that the excessively tight monetary policy has been the reason for difficulties in the execution of fiscal policy (e.g. more liquidity necessary to prevent arrears accumulation).

Financing the budget deficit through borrowings on the domestic capital market is also favourable because it facilitates the development of the financial sector, as T-bills are usually the main instruments traded on the emerging markets. Obviously, the Central Bank can still facilitate deficit financing through providing additional liquidity for treasury securities. As Laurens and de la Piedra E. (1998), argue, the best arrangement of monetary policy is to have central bank conduct open market operations in the government securities on a secondary market, while the treasury issues the debt on the primary market. Such arrangement gives both institutions the possibility to pursue its own policy targets. Apart from open market operations, the Central Bank can also allow commercial banks to place government securities as collateral for loans, rediscount them or even substitute them for required reserves. All these arrangements lead to increased demand for such securities.

There are, however, some necessary preconditions for the development of domestic T-bill market: apart from institutional arrangements, curbed inflation, confidence in the domestic currency and a sound banking sector is required. Moldovan government started to place the debt instruments on the domestic market since April 1995 with the annual yield of 90% that were lowered to 20% towards 1997, as a result of the achieved stabilization. Moldova, with a level of monetisation higher than in other CIS countries, had more chances to finance budget deficit through the T-bill market. Still, the domestic sources were quickly saturated: Dabrowski (1999) argues that it took only 1 to 1.5 years to saturate domestic financial resources in Russia and Ukraine. Non-resident participation was therefore allowed, in order to increase the financing base and buy some additional time, when the situation on global financial markets was very favourable. Since the beginning of 1998 the economic agents started to realize that the fiscal policy was not anymore sustainable, and therefore the interest rate spiked to 40%. Obviously, it was in part the result of the general confidence in emerging markets after the Asian crisis in 1997. In the wake of the Asian crisis the foreign participation on the T-bill market decreased from 38% to 22%. The importance of external factors cannot be however overestimated: the financial pyramid built by the government since 1995 could not be sustained, even if the sentiment of foreign investors did not change so rapidly.

Excessive government borrowings on the domestic markets may divert the nature of banking activities, directed almost exclusively towards servicing the state. High interest rate will provide banks with safe profit, which will discourage portfolio diversification. In principle (according to the Mundell-Flemming model), in a country with fixed exchange rate and perfect capital mobility the lessening of fiscal policy should not lead to crowding out of private investments. Any increase in the interest rate, resulting from government borrowings, will be offset by capital inflow. However, if capital is not perfectly mobile (as in portfolio balance theory), fiscal expansion will drive the interest rate up and will crowd out investments.

The Moldovan government, through the conducted policy, entered the indebtedness vicious circle (Table 10). High costs of servicing outstanding debt require higher borrowings at higher interest rate (increased risk premium). In 1998, the net financing from domestic capital markets remained negative.

Table 10. The evolution of domestic debt (% GDP)

	NBM Loans	Treasury Securities	Total
1994	5	0	6
1995	6	2	7
1996	6	4	10
1997	6	5	11
1998	11	6	18

Source: MET

3.3 External Borrowing : Towards a Debt Crisis

The budget deficit of described size, with under-developed capital markets, would usually put significant pressure on the Central Bank for increased money supply. As NBM had already managed to gain the reputation of a conservative Central Bank before 1995, such pressures should have been rejected. The exceptionally good situation in the world capital markets allowed Moldova to finance even very high deficits from external borrowings. Alternatively, it may be judged that the credibility of NBM was built on the basis of foreign financing of the deficit. As Ter-Minassian and Schwartz (1997) note, some Latin American countries also avoided significant fiscal adjustment due to the favourable access to the world capital markets throughout eighties. Indeed, in 1996 net financing from abroad amounted to 5% of GDP in Moldova, while between 1994 and 1997, more than half of net average borrowing requirements were financed by external sources. The availability of external financing reflected the hope of international investors in the recovery of Moldovan economy, which outweighed even the fears related to the unsustainable internal and external positions. The interest rate paid on debt issued to external agents was significantly lower than on domestic markets, which led to excessive external borrowings.

The capital inflow also represented the mirror image of the constantly deteriorating trade balance of the country. As it was argued in the previous section, the trade balance is driven by the high share of private consumption in GDP. The major part of this consumption is the result of the budget deficit, most of the current account deficit being covered by external borrowings. The resulting debt accumulation is the main characteristic of Moldovan economy. Since Russia took over the historic debt of the former Soviet Union, Moldova started the transformation with a debt close to zero. The indebtedness raised later from 14% of GDP an the end of 1993 up to 74% at the end of 1998 (Table 11 and Table 12). Although the indebtedness is not surprisingly high for the world standards, it should be noted that among all former soviet countries only Tadjikistan records a higher level of indebtedness than Moldova. However, the most important sign of the un-sustainability of macroeconomic policy is the speed of debt accumulation. While the rapid increase of indebtedness in 1998 was the result of currency devaluation, in 1997 this was the result of short-sighted policies regarding the external indebtedness. Since the consumption is the driving force in this process, the share of FDI in capital inflow is insignificant. Also portfolio-equity investments remained negligible. Foreign participation on the T-bill market was close to 40% at the end of 1997. Obviously, this means also a pressure on the exchange rate, leading either to currency appreciation, or increased money supply (Central Bank buying currency in the forex market).

Table 11. External Debt of Moldova (% GDP)

	Direct Public Debt	Publicly Guaranteed Debt	IMF	Total
1993	7	0	7	14
1994	29	0	14	43
1995	30	1	16	47
1996	33	3	15	51
1997	41	4	12	58
1998	56	7	11	74

Source: MET, own calculations

Table 12. External Debt (million US $)

	1993	1994	1995	1996	1997	1998
Total (IMF included)	173.6	505.9	665.2	800.3	1029.9	1002.1
Total (IMF excluded)	86.3	343.0	434.8	552.5	795.9	825.7
Direct public debt	86.3	343.0	416.9	506.0	710.1	719.0
Multilateral creditors	59.3	158.4	203.5	221.1	257.0	293.4
IBRD & IDA	28.6	95.7	145.8	145.8	185.7	216.9
EBRD	0.0	0.0	0.0	0.3	5.2	6.1
EU	30.7	62.7	57.6	75.0	66.2	70.4
Bilateral creditors	19.8	162.7	177.3	173.9	155.7	160.2
Japan		29.7	37.8	33.4	30.0	33.7
Russia		93.4	90.3	78.8	64.0	62.0
USA	19.8	39.6	49.2	61.7	61.7	61.7
Commercial creditors	0.0	0.0	15.0	90.7	277.3	245.2
Commercial banks	0.0	0.0	15.0	60.7	32.3	30.2
Eurobonds	0.0	0.0	0.0	30.0	105.0	75.0
Gazprom					140.0	140.0
Commodity loans	7.3	21.9	21.2	20.3	20.1	20.3
Publicy guaranteed debt			17.8	46.5	85.8	106.7
Multilateral creditors		0.0	8.4	33.1	45.7	53.4
EBRD		0.0	8.4	33.1	45.7	53.4
Commercial creditors		0.0	9.4	13.5	40.1	53.3
IMF	87.4	162.9	230.4	247.8	234.1	176.4

As it can be seen from the above tables, Moldova is confronted not only with an increasing debt, but also with an unfavourable structure of that debt. Since Moldova repeatedly failed to achieve the conditionality criteria, IMF stopped disbursements in the mid 1997 and this decision was followed by the World Bank, which suspended its Structural Adjustment Loan II. Since 1994 the debt towards bilateral creditors was fairly constant. In this situation the part of debt that was increasing at the fastest pace since 1996 was the short-term commercial debt. The proceedings from private placement in 1996 and issuance of Eurobonds in 1997 were used only to cover the budget deficit. However, the most important and least controllable source of debt accumulation is the energy sector debt. Lack of restructuring in this sector resulted in a large debt towards Gazprom (140 million in 1997 and US$ 90 million in 1998).

Additionally, the dependence on external financing induces a greater thread on macroeconomic stability than domestic financial obligations, as it makes the economy increasingly vulnerable to changes in perceived creditworthiness. Namely, the external debt payment stream is subject to:

- the risk of currency depreciation, which increases the debt burden;
- the risk of a shift in market sentiment, which determines the lenders to require higher interest rates to extend new credit for rolling over the existing debt (e.g. several treasury bills spikes across CIS that reflected the failing confidence preceding the Russian crisis);
- the risk of a negative impact of external financial crisis.

The risk of devaluation is extremely high when then external debt is high. The Asian crisis in the 1997 and especially the deterioration of the economic situation in Russia led to an explosive path of public debt. As a result, the financial adjustment burden for Moldova was getting higher and higher.

3.4 Arrears : How Much the Population Can Bear

When the planned revenue is not met, the government is prone to accumulate expenditure arrears. In fact, a large number of state employees may be regarded as creditors to the state. Arrears appear to be the most important and persistent source of financing the budget deficit (calculated on the commitment basis). Since the government was unable to reduce its commitments, it simply sequestered its outlays, especially in 1996. The increase in arrears was especially high in 1996, when the unexpected dip in revenues (mainly from corporate income tax and VAT), combined with raising spending on health care and education programs, led to a substantial budget gap. The state responded with sequestering cash outlays, but without adjustment in expenditure commitments. As a result, arrears soared by more than 4% of GDP (Table 13). Similar situation occurred in 1998, when the government could find only one reliable source of financing – its employees and pensioners. On the contrary, the government in 1997 showed some determination in reducing arrears.

Table 13. The evolution of arrears (% GDP)

	1993	1994	1995	1996	1997	1998
Budget Deficit (Cash)	9.0	10.6	6.7	7.6	7.8	3.4
Budget Deficit (Commitment)	10.4	12.9	9.0	12.4	4.6	9.3
Arrears	1.4	2.3	2.2	4.8	3.2	5.9

Source: IMF(1998b), CISR (1999), own calculations

The cost of this liability is low in money terms, although the social impact is disastrous. A large share of population depends crucially on wages, pensions and other benefits paid by the state; thus, the accumulation of arrears pushes these persons into poverty. Moreover, economic decisions are biased, since arrears distort the expected real returns on various economic activities. Public sector employees face uncertainty about the income they will receive while staying within the sector. At the same time, fictional transactions replace the real economic life. Arrears also undermine the credibility of the state, making the economic agents more reluctant to meet their tax obligations towards the budget. Workers in state enterprises perform jobs that do no bring any value added; however, instead of labour adjustment or wage constraint, workers are obliged to receive money that it is not paid. The budget finances extensive education and health programs that cannot be afforded; the quality of those programs falls therefore accordingly.

Surprisingly, the political cost of running up arrears is apparently lower than the open reduction of social expenditures. Still, it seems politically impossible to increase furthermore the stock of arrears.

4. Servicing the Debt

The assessment about the volume of external borrowing must not be conducted separately from its utilisation in terms of future income generation. The growth potential of Moldovan economy was not enhanced, as the funds were not directed to productive investments, but to the inefficient state sector. Moreover, borrowed money was not spent on structural reforms that would have limited the primary deficit of the budget. Instead, the overwhelming majority of funds was used to suspend the restructuring in the energy sector and fiscal adjustment. Externally financed government consumption possibilities undermined the incentives for reform implementation. Such a policy led to increasing difficulties of debt servicing. The cost of servicing the debt increased to 4.8% in 1998, from 4.2% in 1997 (Table 14).

Table 14. Debt Service versus Exports and State Revenues

Ratio between debt service and:	1993	1994	1995	1996	1997	1998
Exports	1	2	10	6	17	28
Government Revenues	2	6	18	9	25	42

Source: IMF (1998b), Ministry of Finance, own calculations

Indeed if Moldova would have met all its obligations, the external debt service would have consumed 7.5% of GDP in 1997 and 8.7% in 1998. Serious problems with servicing the external debt appeared already at the end of 1997 beginning of 1998. While social expenditures prove to be rigid, the increase of debt servicing costs leads to the collapse of the budget and financial instability.

Moldova had to reschedule two credits from Russia (US$ 30 million) at the end of 1997, but in the course of 1998 it failed again to meet its obligations on this debt. The government also failed to honour some external guarantees. Payment arrears on energy supplies were developing particularly quickly and there is always the possibility that they will be converted into state debt under the pressure of energy resource suppliers. It is expected that repayments in future years will be so substantial that external financing will remain negative. As an indicator of country external exposure, the spread on Moldovan Eurobonds increased from 380 basic points to 800 at the end of 1997.

In fact, the external exposure of Moldova was already unsustainable in the first half of 1998, as the country in a debt trap and liquidity crisis. Similar cases appeared in other transitional countries (cf. Markiewicz 1999). The Hungarian crisis from 1994, for instance, led to the rebound of inflation. This situation came after 1993 difficulties, when the budget deficit grew to 7.6% of GDP, the public debt accounted for 17.9%, current account deficit increased to 9%, interest payments reached 4.5%, and external debt went to 64%. The 1995 crisis in Bulgaria had also its indirect roots in the accumulation of debt. The National Bank of Bulgaria tried to decrease the interest rates in order to alleviate the burden of debt service. In Russia, during the pre-crisis situation from 1997 the interest payments accounted for 5% of GDP, while public debt in GDP exceeded 60%. In Ukraine, in the eve of the crisis, the public debt represented around 30% of GDP.

5. Conclusions and Policy Recommendations

Instead of structural reforms and consequent fiscal adjustment the Moldovan governments have been heavily dependent on "quick fixes", which represent ,,measures that are easily implementable and relatively less costly politically, albeit nondurable and distortive" (Ter-Minassian, Schwartz 1997): in kind tax payments, netting out operations, across the board cuts in non-entitlement programs, reduction of undergoing investment and maintenance spending, delays in civil service wage adjustments, forced and unpaid leaves, payment arrears. The import surcharge tax implemented in 1999 belongs also to such a package of measures. It is however clearer today than at the beginning of transition that a sustainable fiscal policy cannot be run without implementation of structural reforms. Privatisation and restructuring represent the necessary condition to stop the losses generated by the public sector. The social protection system should be focused on the most needing groups. Netting-out operations and in-kind settlements need to be eliminated. The scale of barter must be reduced in order to provide enterprises with right incentives. Spending programs have to be thoroughly reviewed and adjusted. Although short-term macroeconomic considerations may induce the bias towards quick-fix measures, which are expected to bring rapidly positive budget outcomes, if long run structural solutions are not undertaken the quality of stabilisation is unacceptable.

Discrepancies between predicted and actual state budget items erode credibility of the government. Wishful thinking while budgeting may decrease the general support for reforms. Moreover, unexpected shortfall of revenue financing or expenditure peaks may force the government to undertake costly emergency borrowings. Therefore, tools for responsible budget projections should be developed. It is especially important in case of tax collection analysis, since foreseen low budget income needs to be reflected in expenditure cuts. As a general rule, projections of tax revenues should be based on the real economic performance, taking into account all factors that can lead to their reduction. Especially the tax base should not be projected on the basis of production capacities, but should account for low level of tax compliance and for the impact of exemptions on effective tax rates. In case of Social Fund, a serious viability analysis of the system should be undertaken. The external audit and budget evaluation should follow the execution of the budget, which can deter the misuse of government resources.

5.1 Sustainable Policies

Sustainability considerations are crucial for the development of good economic policy and need to be explicitly addressed by the Moldovan government. At the end of 1998, Moldova recorded both unsustainable budget and liquidity constraints. This is mainly due to the lax fiscal policy, short-sighted policy towards indebtedness and limited experience in the sovereign borrowings. Moreover, the excessive external borrowings were largely made not to speed up structural changes, but to suspend their necessity, since they were undertaken by public or publicly guaranteed debtors to cover current budgetary outflows. Slow progress of restructuring impedes the growth of the economy, which implies higher relative burden of debt repayments: Moldova has now a large amount of short-term debts. Even in comparison to other transition economies, Moldova is facing a severe indebtedness crisis, especially if interest rates remain high.

Sustainability analysis suggests that the cost of fiscal contraction costs becomes higher as indebtedness rises, therefore the "wait and see" strategy should be immediately dismissed and solvency crisis should be addressed through fiscal tightening. Unsustainable budget deficit is the major cause of current account deficit, since domestic private savings cannot offset the government dis-saving and the budget deficit is financed through negative current account imbalances. Moldova has an alarming current account deficit that exceeds 20% of GDP. The situation has to be alleviated through export promotion and enhanced energy sector efficiency. However, in a medium-term perspective CA improvement will not be large enough to support the increased interest payments.

Table 15 below presents some assessments of fiscal tightening that are necessary to stabilize the existing indebtedness. Obviously, since the economic growth was negative in 1998 and is also likely to be negative in 1999, the increase in the debt ratio can be only compensated by a higher primary budget surplus. The aggravation of the economic performance since the beginning of 1998 complicates furthermore the unsustainability matter of economic policies. The decline in industrial production and exports lead to further decline in tax revenues without corresponding cut of expenditures.

Table 15. Sustainable Budget Balance (%GDP)

Interest-Growth Rate Gap	***Moldova* 1997**	Moldova 1998	Ukraine 1996	Russia 1996	Poland 1996
5%	3.1	4.3	1.5	2.5	2.3
7,5%	4.6	6.4	2.3	3.7	3.5
10%	6.2	8.5	3	5.0	4.7
Actual Primary Budget Deficit	-0.4	-4.5	-5,6	-3,1	2,9
Growth Rate (Expected)	1.7	-5.0	0	1.0	5.8
Debt/GDP Ratio	63	81	30	50	49

*Calculated at the end of indicated year.
The reported Sustainable Budget Balance is estimated as to stabilise the indebtedness at current level, when interest rates exceed the real growth by 5%, 7.5 % and 10% .
Source: IMF (1997), Ministry of Finance, own calculations

The Moldovan central authorities should assume the strategy of debt burden reduction through fiscal consolidation and no-borrowing policy. Further increase in the indebtedness will inevitably lead to the deterioration of debt structure, as the share of multilateral lenders will decline and rising unsustainability and the risk will cause the increase of interest rates on Moldovan liabilities. While the country should run a substantial primary balance, any overall budget deficit should be financed domestically. External borrowings may appear cheaper in short term, when domestic markets are premature and do not offer longer maturity. However, domestic financial markets in Moldova should be developed in order to lessen the exposure to the exchange market volatility and reduce the costs of borrowing in longer-run. Increased share of domestic borrowings in total debt can stimulate the development of domestic financial markets and, ideally, encourage domestic savings. The government should particularly eliminate the explicit or implicit debt guarantees, in particular to the energy sector. This debt is especially hazardous as it is very difficult to be monitored and generally its repayment profile is unknown. The government should make every effort to ensure that agreement with Gazprom on establishment of the new joint stock company MoldovaGas and debt-equity swap contains provisions that will protect the budget from pressures coming from future payment arrears of non-public agents.

5.2 Fiscal Reform

Moldova has enough reserves to raise additional budget revenues. This increase should be conducted through strict limitation of tax exemptions, unifying tax rates across various tax categories and elimination of sectoral differences in tax treatment (including agriculture). With this respect, there are several measures to be implemented in order to improve tax collection. More transparency should be introduced into the tax system, which is currently too complicated and provides opportunities for serious misconduct. Barter agreements and net settlements should be restricted or eliminated to avoid tax evasion. A simpler system and procedures may also promote the switch of activity from shadow economy to the legal economic life. A better tax administration, as well as more efficient procedures and enforcement methods are needed. As far as administration is concerned, the major obstacles to improvement are: inadequate staffing, poor training and low wages. The immediate response should involve the set up of internal control and accountability system to detect incorrect tax assessment and corruption among tax officers. Bonus-based system wages should be considered in the tax administration. Enforcement measures against non-compliant could involve (IMF 1997): instant prosecution of the most flagrant cases of fraud, appropriation of accounts receivables, seizure and sale of property, large interest and penalties on overdue tax payments, accurate and current monitoring of outstanding tax arrears, no further tax exemption of tax penalties.

With respect to the expenditure side of the budget, the economic situation requires a major reduction of certain items, knowing that the implementation of radical reforms will bring additional expenditures to the budget (unemployment benefits, for instance). The social schemes should be thoroughly reviewed and future spending should be determined on the basis of explicitly assumed priorities and not as the renewal of appropriations from previous budgets. The excessive employment should be reduced. Important efficiency gains are possible through the consolidation of activities in the education and health care sectors. The state should withdraw from any kind of implicit subsidies to households and enterprises: tax concessions, deliveries of cheap energy and other utilities or tolerance of non-payment for such deliveries. Such subsidies tend to impede real restructuring. Charging market price for utilities and public services will lead to reduced waste of energy and resources. Remaining subsidies should be made explicit and transparent to eliminate the scope for rent seeking. At the same time, social assistance should be channelled directly to the poorest in order to offset the negative impact of higher prices. Unlike the inherited social protection system, which was not designed to prevent or alleviate poverty, the focus must be put on the most vulnerable groups of population.