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Republic of Moldova
Ministry of Finance

The World Bank

Moldova: The Challenge of Fiscal Decentralization Reform

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with
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CHAPTER 1: ADMINISTRATIVE STRUCTURE

A. THE TERRITORIAL ADMINISTRATIVE STRUCTURE

While preserving its character of a unitary State, the Republic of Moldova has, since the break up of the Soviet Union, striven to improve the fiscal relations among the State and the subnational levels of government on the bases of autonomy, legality and cooperation principles.[1] Since 1996 the budgetary system consolidates the self-governing territorial units as autonomous entities.[2] Moreover, in 1997 the Parliament formally adopted the conventions of the European Charter of Self Local Governments, and since 1998 the law on local public administration and territorial reform discontinued the previous Soviet administration structure of *rayons.* In its place the Parliament created a basic legal framework for the implementation of a fiscal decentralization process in Moldova based on a two level structure: the first level formed by *towns/village/commune* (or, generically, the primarias); and the second level formed by the *Judets* (or, generically, the districts).[3] This law also established the operating rules for subnational governments' Council of Representatives (directly elected) and their respective executive authorities (the Judet Council's Chairman—assisted by the General Financial Division of the Judet—and the Mayor's Office).[4] The same legislation also created the post of Prefect (appointed by the President of the Republic and subordinated to the State Chancellery) situated at each judet to supervise the legality of the decisions of judet and primaria Councils. The Prefects were also assigned the role of coordinating and controlling the de-concentrated functions of the State government in the territory.

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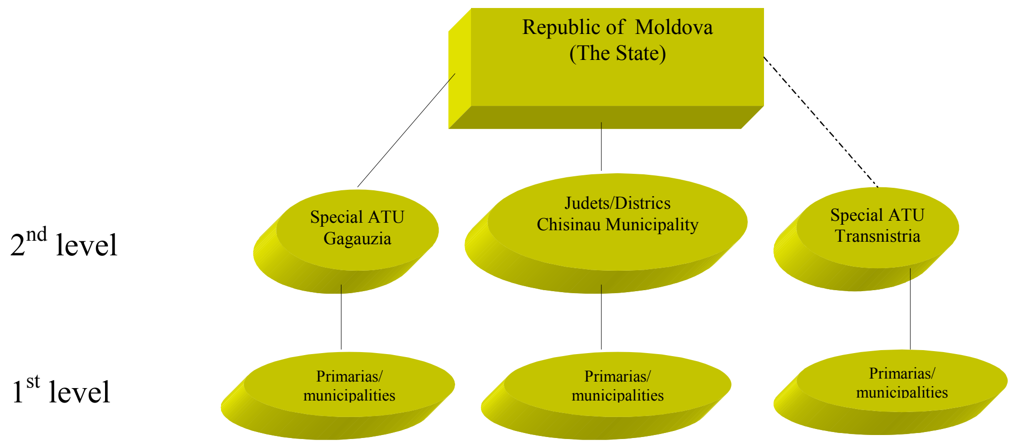
[1] The National Constitution (July 29, 1994) explicitly establishes that "the concept of autonomy encompasses both the organization and functioning of local public administration, as well as the management of the communities represented by that administration" (Art. 109). The Constitution defines that: (a) the unitary State of the Republic of Moldova is administratively and territorially structured in districts, towns and villages; (b) some towns may be legally declared municipalities; and (c) some regions may be granted special forms of autonomy (Art 110 and 111). Also, it establishes that villages' and towns' public administration authorities are represented by elected Local Councils and Mayors, and that the coordination of public services delivery at district level is performed according to the law by the elected District Council.

[2] In its Art.44, the Law on the Budget System # 847/96 (May 24, 1996) formally integrate the "Budgets of the Territorial-Administrative Units" in the budgetary process as autonomous entities as part of the National Consolidated Budget system.

[3] Henceforth, this report may generically refer to the first level of government as "primaria", whatever its particular condition is (villages, communes, and towns). Primaria is any settlement where there is a "primar", i.e., mayor). "Municipalities" has a higher status as compared to primarias, and also has a Mayor. In Moldova, the concept of municipality corresponds to the concept of Cities in some other European countries. Likewise, "districts" may be used to refer to intermediate level of government, whatever its particular denomination will be (Judet or rayon).

[4] Mayors were directly elected by the respective "primaria" or municipality citizens.

Diagram 1.1: Moldova: The Administrative Structure



1. The inherited administrative structure

While Moldova is a geographically small country it is, together with Armenia and Eastern European countries, one of the most populated areas in the Community of Independent States (CIS) region—127 inhabitants per km^2. But, apart from Chisinau municipality (753 thousand inhabitants), the population is fairly distributed across the country (4.3 million inhabitants, 33.8 thousand km^2). Immediately before the 1998 territorial administrative reform, Moldova still had the inherited Soviet structure with 45 rayons (including its 35 rayons, the municipality of Chisinau, plus 6 rayons in the left bank of Nistru river, and 3 rayons in the Gagauzia region) of approximately uniform geographical size (between 700 km^2 and 900 km^2), but with varying population size (Table A.1). Population size of rayons varied from around 30-40 thousand inhabitants (Basarabesca, Vulcanasti, Cainari) to around 137-190 thousand inhabitants (Orhei, Bender, Balti,Tiraspol). Excluding Chisinau municipality, the distribution of rayon by population size had an average of 81 thousand inhabitants and a mode of 79 (Tables and Figures 1.1 and 1.2).

Table 1.1, Moldova: Population per Judet, 2001

in thousand people	Total Population			percentage		
	Total	Urban	Rural	of total	Urban	Rural
Total Republic	**4264**	**1934**	**2330**	**100.0**	**45.4**	**54.6**
Without Transnistria and Bender	***3635***	***1501***	***2133***	***85.2***	***41.3***	***58.7***
Without Transnistria	***3771***	***1625***	***2147***	***88.4***	***43.1***	***56.9***
Balti	504	213	291	11.8	42.3	57.7
Cahul	191	48	143	4.5	25.1	74.9
Chisinau	383	53	330	9.0	13.8	86.2
Edinet	284	72	212	6.7	25.4	74.6
Lapusna	278	64	213	6.5	23.1	76.9
Orhei	302	67	235	7.1	22.3	77.7
Soroca	278	80	198	6.5	28.9	71.1
Taraclia	46	16	31	1.1	33.7	66.3
Tighina	170	35	136	4.0	20.3	79.7
Ungheni	261	76	185	6.1	29.2	70.8
Chisinau City	779	713	65	18.3	91.6	8.4
ATU Gagauzia	159	64	95	3.7	40.3	59.7
Transnistria including Bender	630	433	197	14.8	68.7	31.3

Source: Dept. of Statistical and Social Analises of the Rep.Moldova

Compared to most intermediate government units in Western and Central Europe (and transitional countries with three tiers of government), the rayons of pre-1998 reform were small, both in population and in geographic sizes, which raised questions as to whether those local government units were sub optimal, i.e., not sufficiently large for allowing a rational self-governing administration. This meant that many of the rayons:

- Did not have sufficient tax revenue capacity (see Chapter 3);
- Could not retain qualified staff with the necessary expertise to manage the local public businesses;
- Could not internalize potential externalities in consumption; and
- Could not operate optimally public service facilities that generate economies of scale (including public utilities such as water, sewerage, garbage disposal, and public transport, as well as social services such as health care, police, and education) (see Chapter 2).

As a result of these conditions, the quality of delivered local public services and the efficiency of public expenditures in most small rayons were jeopardized, and the horizontal fiscal disparities among rayons tended to increase. Apparently, the options for the rayon system were quite limited, since each unit was to a large extent structured and maintained around principles of economic autarky; neither cooperation/ association among the rayon were a common practice, nor were the public service delivery outsourced to the private sector as a tool to help overcome the efficiency constraints imposed by their smallness and inherited managerial system.[5]

2. The 1998 territorial administrative reform

The 1998 reform aimed at rationalizing the territorial administrative structure and at introducing an alternative system of intergovernmental relations. Law # 191 (December 12, 1998) established a new administrative and territorial organization of the country (Diagram 1.1) by creating 10 larger intermediary level self-governing Judets (plus ATU Garauzia and Chisinau municipality), which consolidated the rayons from the previous structure. The 1998 reform basically kept the first level local self-governments around 15 municipalities and 712 primarias—including 50 towns and 662 communes/villages. The municipality of Chisinau was granted the same self-governing status as the Judets. Gagauzia region enjoys

Table 1.2. Moldova: Distritubion of Territorial Units, by population size

thous.	Rayons, 1998						Judets, 2001					
Inhabitants	Units	% Freq	% Acc	Popul	% Freq	% Acc	Units	% Freq	% Acc	Popul	% Freq	% Acc
<30	1	2	2	25	1	1						
31- 40	2	4	7	66	2	2						
41 - 50	3	7	13	137	3	5	1	8	8	46	1	1
51 - 60	5	11	24	280	7	12			8			1
61 - 70	6	13	38	385	9	21			8			1
71 - 80	7	16	53	532	12	33			8			1
81 - 90	8	18	71	677	16	49			8			1
91 - 100	5	11	82	473	11	60			8			1
101 - 120	3	7	89	347	8	68			8			1
121 -150	2	4	93	271	6	74			8			1
151 - 200	2	4	98	345	8	82	3	25	33	520	14	16
201 - 300			98			82	4	33	67	1101	30	46
301 - 500			98			82	2	17	83	685	19	65
501 - 700			98			82	1	8	92	504	14	79
> 701	1	2	100	753	18	100	1	8	100	779	21	100
TOTAL	**45**	**100**		**4292**	**100**		**12**	**100**		**3635**	**100**	

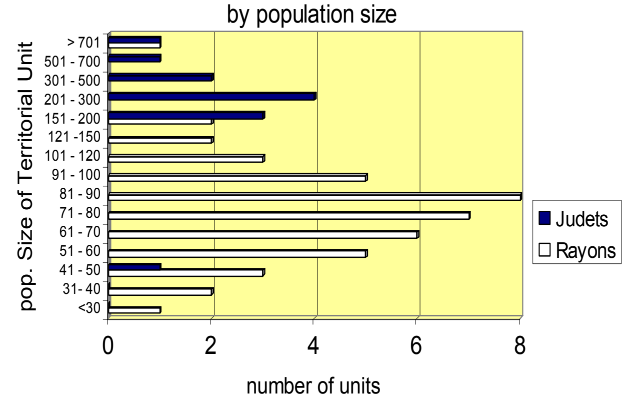
Source: Tables 1.1, and A.1

[5] See "Intergovernmental Fiscal Relations in the Republic of Moldova", prepared by KPMG for USAID, 1994; also Monika Huppi, "Fiscal Decentralization", background paper for PER (World Bank), 1996.

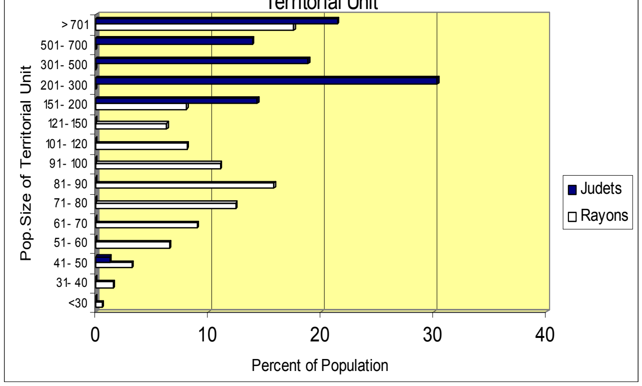
the special status of an autonomous territorial unit (ATU-Gagauzia). The territory on the left bank of the Nistru river (the Transnistria region) is still a contentions issue, and its status in the Republic of Moldova has not yet been entirely defined (Table 1.1).[6]

The new territorial administrative structure was organized basically in accordance with the principles in the European Charter of Self-Local Governments, and its second-level (the intermediary level of government) reflected a more economically reasonable distribution of the number of judets by population size, and of the distribution of the population per territorial unit size (Table 1.2). Figures 1.1 and 1.2 compare the size distribution of rayons versus judets according to their numbers and according to the percentage of the population that they housed. Only one judet (Taraclia) may be considered of small size (46 thousand inhabitants), all the others were above 150 thousand inhabitants, accommodating 99 percent of the country's population.

Figure 1.1. Moldova: Distribution of Territorial Units, by population size



Figuere 1.2. Moldova: Distribution of Population by Size of Territorial Unit



Finally, the 1999 *Law on Local Public Finance* formalized the budgetary and intergovernmental fiscal relations of the vertical structure of government # 491 (July 9, 1999)). This Law established a resource basis (including local "own" taxes, shared State taxes, and non-tax revenues), a broad expenditure assignment of responsibilities, a formula for a transfer mechanism (although still "gap-fill" based), the rules to access borrowing, and the principles of the Treasury system for the sub national governments.

Although the new legal framework provided some *autonomy* to sub national governments (judets and primarias), in practice the Moldovan system of intergovernmental finance remained extremely *hierarchical*. The Law on Local Government Finance, for instance, gave judets significant discretion to interfere in the affairs of the primarias in their jurisdiction, including on revenue assignments, transfers and to some extent expenditure allocation. The paring of these two very different principles—the *autonomy* of primarias and the hierarchical financial *dependency* of primarias from judets—rendered the system contradictory and to a large extent unworkable.

[6] On the status of Gagauzia and Transnistria regions, see Section C in this Chapter

Also, the implementation of the 1998 reforms was actually too weak. Two years have elapsed from the approval of the basic organic laws (the Laws on Territorial Administrative Organization, on Public Administration, on Local Public Finance) without any specific regulation for a proper implementation of these significant reforms. For example, clear formalization of functions and responsibilities, including revenue sharing and delegated functions between Judets and primarias were never specified. Also, the definition of property rights and the transfer of properties to the subnational governments was not completed. Moreover, during this period, neither a satisfactory coordination of the decentralization process took place, nor any relevant integrated capacity building program was developed to help the newly decentralized authorities and respective staff to perform their role effectively and responsibly. The absence of a concerted implementation effort for so long time created a sense of lack of strategic direction for the fiscal decentralization policy, which allowed for increasing regional discontent and political maneuverings—including allegations of corruption and generalized financial mismanagement practices, although not always convincingly demonstrated.

3. Rolling back reform

In the wake of the 2000/2001 political campaign, the hesitation and implementation weaknesses of the fiscal decentralization program drive were extensively discussed and political alliances were forged with the objective of backtracking the reforms initiated in the late 1990s. As a result, instead of improving the system, and, for example, making use of the Courts and the existing institutions of the judicial system to enforce existing laws on the alleged misdoings,[7] the Parliament proceeded to change the *core* of the fiscal decentralization system that had started being installed just two years ago. The Amendment Law # 496, passed by the Parliament in June 27, 2001, shifted the General Financial Division from the locally elected Judet Council's authority to the centrally appointed Prefect's Office.[8] This move to a large extent deprived the regional representatives of their legal financial autonomy.[9]

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[7] As was prescribed by the Law on Public Administration (Law # 186/98), in its Art. 30 (2), which said: "The dismissal or cessation of the activity of the local council shall be done by the Parliament, at grounded recommendation of the head of the state administration (Prefect), *based on final decision of the Court*. The amendment to this Law approved by Parliament on January 2002 dropped the phrase "based on final decision of the Court."

[8] The word Prefect and the phrase Prefect's Office were introduced in the *Law on Local Public Finance* for the first time by the Amendment (Law # 496/2001). The post of Prefect was created in 1998 by the *Law on Public Administration* and, according to its Art. 12, Prefects are appointed by the President of the Republic, by suggestion of the government, as the head of State administration in the territory. Prefects are subordinated and report to the State Chancellery. Previous to the Amendment (Law # 496/2001) the functions of the Prefect—besides coordinating the implementation of de-concentrated functions of the central government in the territory—were essentially the following: (a) to supervise the legality of Council' decisions, (b) to report to the central government, and (c) to *initiate judicial actions* to revert illegal Councils' decisions, if necessary. As amended by Law # 496/2001 the Prefect's executive powers over the local government were *unduly extended*, while the financial executive power of the elected Judet Council was *eliminated*.

[9] Initially, this change also created a confusion in the vertical hierarchy of the public administration, since the General Financial Division of local governments, which were previously under and reporting to the Ministry of Finance, after the Amendment (Law # 496/01)—as an organ of the Prefect's Office—became

This amendment marked the formal beginning of a process to shift the focus of the government from implementing decentralization of fiscal powers, back to emphasizing a policy of de-concentrated functions of the State throughout the national territory. As a first step in that direction, a parliamentary commission for regulating Law # 496/01 and reviewing the territorial division of the country was installed. Inter alia, the commission basically worked under two principles: (a) to increase the "vertical consolidation of the State Power;" and (b) to "reinstate the territorial administrative organization of pre-1998 reform". It appears that this simply meant restructuring local governments to resemble local branches of the central government, rather than to build upon the *autonomous units* as intended by the original 1998 legislation.[10]

One view of these changes is that they flatly contradict the *subsidiarity* principle of the European Charter of Self Local Governments, signed by Moldova, which states that *decisions on policy should be taken at the most decentralized level* consistent with making them efficient and effective. There are at least two key reasons why Moldova should observe the principle of subsidiarity. First, the central government is already swamped with its own policies and reforms, and would not have enough capacity to effectively deal with all the details required by the local issues. Second, common measures adopted from the center will hardly please every regional interest—given the regional diversities in incomes, traditions, and social attitudes. These limitations could soon revive regional discontent.

In reality, the policy of emphasizing the de-concentration of central government functions at local level is the other side of the coin of the policy of dismantling the process of decentralization drive only recently initiated. These frequent shifts in policy strategic direction may increase the risks of instability and may undermine the consolidation of an accountable fiscal system in the medium term.

B. UNSETTLED REFORMS IN INTERGOVERNMENTAL FISCAL RELATIONS

The fiscal decentralization reform process in Moldova is still in a state of flux. The government approved Resolution no. 1387 in December 13, 2001 and the State Chancellery (through no. 1310-166) submitted a new draft-Law "on territorial administrative structure" and a draft-Law amending and supplementing the "Law on local public administration no. 186/98" for the Parliament consideration. After approval by Parliament the bills will become Laws in the early 2002. The new legislation formally will keep the three-level government structure (basically as reflected in Diagram 1.1), but replace the judets with the rayons, and essentially will strengthen the hierarchical

subordinated/reporting directly to the State Chancellery. Later, through an executive arrangement, Prefects were to authorize the respective General Financial Division to report directly to the Ministry of Finance.

[10] These rearrangements in the territorial configuration of the country are issues still highly politically charged.

character of the government structure in the new system.[11] The new legislation also retains the idea of *removing from the local governments the autonomy for budget execution*, since it maintains the subordination of the General Financing Division directly to the Ministry of Finance, instead of to the District Council—i.e., the rearrangement introduced by the amendment Law 496/2001 is preserved. In this regard, the new legislation to come into force in 2002 will resolve the contradiction embedded in the current system (between the fiscal autonomy of primarias and their fiscal dependency to the districts), albeit it does that by suppressing local autonomy and, therefore, going contrary to the principles of fiscal decentralization.

Specifically, the new legislation will introduce in 2002 the following changes in the structure of the territorial administrative system:

a. The 10 judets structure will be discontinued and replaced by 32 smaller rayons—plus 5 municipalities (Chisinau, Belti, and Bender/Tighina, Tiraspol, and Comrat), plus ATU Gagauzia, and plus ATU Transnistria;
b. The number of primarias (and Mayors) will increase approximately by 140, by lowering the population threshold from the current 2,500 to 1,500;
c. As is currently done, local administration will be carried out by directly elected Local Councils (at primaria level and at the district level). But, the number of Councilors will be increased by an average of 73 percent (see Table A.2 in the Statistical Appendix).[12]
d. Primaria and district will have Executive Committees headed by a Mayor and a Chairman, respectively—both *indirectly* elected among the members of the respective Local Councils;
e. The post of Prefect and Prefect's Office will be discontinued (to avoid duplication and conflict of authority)

Besides the increased hierarchical decision-making process and the loss in local autonomy, the new legislation will have several major implications, including the following:

a. The problem of the smallness (sub optimal scale) of the territorial administrative units is back in the scene again and a strategy to deal with this problem will be required;
b. The considerable increase in the number of Mayors (and staffing of their respective offices) and in the number of Councilors in all Local Councils quite certainly will substantially expand the structural recurrent expenditures on a permanent basis;[13]

[11] The "Explanatory Note" which forwarded these draft Laws to the Parliament states that the first among the main objectives of the reform is the "vertical consolidation of State power."

[12] Elections for Local Council representatives is expected to be anticipated for sometime during the first half of 2002.

[13] Surprisingly, the "Explanatory Note" to the draft Laws argues in favor of substantial savings to be brought about by the new legislation. It argues for a reduction in the current wage-bill, on account of the dismissal of "redundant" staffing of the "local" administrations, as compared to the existing "normative." Whatever the resulting wage-bill savings will be, it appears to be a stretch to attribute them to this reform. First, it appears that the number of "local" administration employees used for the calculations includes State civil servants stationed at the local level (which at least confuses the reasoning). Second, it could be

c. The transformation of a directly elected into an indirectly elected Mayor is definitively backtracking at least in terms of political accountability.[14] The loss in accountability could have major implications on economic efficiency and governance in general; and
d. The elimination of the role of the Courts in providing final judicial decision for the disputes involving local governments represents a major setback in the process of the separation of powers in the Republic of Moldova.

C. TERRITORIAL ADMINISTRATIVE UNITS WITH SPECIAL STATUS

Despite the relative small size of Moldova, the design and implementation of intergovernmental fiscal relations in the country is complicated by sharp disparities in economic base and by ethnic and political tensions. Nevertheless, as has been the case in many other countries, an adequately decentralized system of governance and finance may be an important contributor to solving some of the existing tensions. It should be understood, however, that the essence of these problems tends to be political and, correspondingly, the solutions also need to be political. This is the case with the heavy presence of the municipality of Chisinau in the economic and political arenas, the special demands by the ethnic region of Gagauzia, and the politically complex problem of the Transnistria region.

The municipality of Chisinau does not only play an overwhelming role in the generation and distribution of fiscal resources in the country, but it also plays the role of the capital city, housing 20 percent of the country's population. The municipality of Chisinau is on a fiscal basis treated differently from the rest of the intermediate levels of government. It benefits form higher per capita expenditure norms for health and education, for example, but it also is asked to contribute to the national coffers a higher share of the taxes collected in its territory. In addition, Chisinau's Mayor traditionally has had a representative seat at the Government of the Republic of Moldova, and the municipality's statute is regulated by an special organic law. In general terms, there is little justification for any special fiscal treatment of Chisinau municipality other than for the fact that it is the capital city. This calls for the explicit compensation for the potential additional costs to the municipality in the delivery of public services, including security, transportation, and environment.[15] This compensation should preferably be in the form of a transparent transfers of resources as opposed to, as is now the case, special rules for Chisinau in

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argued that if there are personnel redundancies in "excess to the current normative," then they should be eliminated anyway, independently of any structural reform.

[14] In fact, the population will be electing representatives to Local Council (that can change functions and responsibilities from time to time), and not anymore directly choosing the chief executive officer that people can easily identify and make him/her personally accountable for the decisions taken

[15] There are, on the other hand, important benefits Chisinau municipality derives from being the capital of the country. In particular, many enterprises have their headquarters located in Chisinau even though the factories may be spread across the rest of the country. This fact, in combination with the derivation principle for the sharing of tax revenues as used in Moldova, has significantly benefited Chisinau from the revenue allocation system (Chapter 3).

many of the steps involved in the formulation of subnational budgets (Chapters 2, 4, and 5).

The region of Gagauzia has retained a special autonomy status since December 1994 (Law # 344/94) in recognition for its ethnical, linguistic, and cultural peculiarities. The People's Assembly of Gagauzia can pass its own laws and regulations (as long as they are in conformity with the Constitution of the Republic of Moldova). The region also has its own judicial system, and its elected Governor (the Bashkan of Gagauzia) has a representative seat at the Government of the Republic of Moldova. Outstanding issues for Gagauzia are more of a political and economic nature. Politically, Gagauzia has revealed its interest of having an independent representation at the Parliament, although so far not considered by the Republic of Moldova. Economically, Gagauzia has been pressing the central government for a "single channel" fiscal arrangement, whereby the autonomous government would keep all revenues from all taxes collected in Gagauzia's territory and then would negotiate a single annual payment with the central government as Gagauzia's contribution to the costs of national services.[16] Apart from these outstanding issues, Gagauzia region already enjoys greater fiscal autonomy than the other regions, and it is well integrated into the country's economic and political space.

The region of Transnistria not only has its independent institutions (a directly elected Supreme Soviet, a Constitution, the Presidency, a Judicial system, a Central Bank, and its currency—the Transnistrian Rouble) and runs its own affairs but, except for smuggling activity, it is a separate economic space from the Republic of Moldova. This is especially true in respect to the fiscal aspects, where there is no connection at all between the fiscal budget of the *Transnistrian Moldovan Republic* and the rest of Moldova. Transnistria has no representation neither at the Parliament nor at the Government of the Republic of Moldova. Transnistria has developed its own independent foreign relations (especially with Ukraine and Russia) and pays no tax, nor submit itself to any legal constraint of the Republic of Moldova.

While the problem of Gagauzia is more a question of finding the appropriate scope of fiscal autonomy, under the principles of the European Charter of Local Self-Government, the issues involving Transnistria are far more complex and go beyond the question of fiscal autonomy, including intricate problems of political and international relations. In this regard, the local self-governing issues of Chisinau and Gagauzia can likely be managed in the short- and medium-term in the context of an appropriate asymmetric assignment of responsibilities and adequate levels of fiscal autonomy, which take into account their peculiar resource base and income capacity, and the special expenditure needs. In this respect, Moldova may certainly profit from the experience of the other countries which have adopted an asymmetric approach in fiscal decentralization. Otherwise, the improvement of the intergovernmental fiscal relations with Transnistria will certainly involve more complex and difficult arrangements,

[16] Gagauzia's authorities have argued that the "single channel" arrangement is anticipated in the special autonomy status Law, but Chisinau has rebutted the argument on the ground that this is an overstretched interpretation of the autonomy Law.

possibly demanding an economic integration approach to start with, and high-level political agreements with a long-term perspective.

D. CHALLENGES AND OPTIONS

Moldova is striving to overcome many institutional and economic development challenges. The restructuring of its territorial administrative system is one of these challenges, which directly concerns to the attribution of fiscal powers on public policy decision-making and implementation processes. In this regard, the *designing of the territorial administrative structure is crucial, since it will underpin the institutional set up under which fiscal decentralization will take place.* The basic element underlying a sustainable design for decentralization is to provide local government with enough autonomy to perform, one that embodies the right incentives for the system to operate maximizing allocative and technical efficiencies.

A second challenge faced by Moldova is *to what extent should the country decentralize at all its fiscal policies.* Actually, there is, a priori, no compelling reason why it should not do it. Although the country itself is already geographically and demographically rather small, it is densely populated and composed by several ethnic groups, with diverse regional peculiarities that may require a regional/local approach. The question, then, should be better formulated as: in what areas of policies and to what a degree should fiscal decentralization be carried out in Moldova? On this, the general basic rule to follow is the *subsidiarity principle* of the European Charter of Self Local Governments, which acknowledges that <u>decisions</u> on policy should be taken at the most <u>decentralized</u> level consistent with making them efficient and effective. The observance of this principle would help Moldova to choose its strategic direction and could guide reforms of the administrative structure for an effective and consistent policy implementation. Moreover, as mentioned above, the observance of this principle would release the central government officials from the administrative burden of detailed issues related to local interest, would allow the central authorities to focus on the other important challenges and reforms related to sectoral and macroeconomic policies, and would contribute to abate regional tensions.

A third challenge is *to clarify from the outset between de-concentrated functions of the central government in the territory from the true decentralization of decision powers (autonomy) to the local governments*. The country will only realize the full benefits of the fiscal decentralization process when increasingly an appropriate, significant degree of autonomy is attributed to the local governments, and when local authorities and managers are made accountable for results. Conversely, intensifying de-concentration of central government functions at local level may correspond to dismantle the decentralization drive initiated after the 1998 reforms in Moldova. A reversal in policy direction may demoralize the institutions of the administrative structure and undermine the credibility of the decentralization process.

In order to restore credibility in the decentralized fiscal system, the Moldovan administrative structure and institutions have to be strengthen by: (a) boosting capacity for policy implementation; (b) developing fiscal and political accountability; (c) promoting flexible cooperation/ association among administrative units; and (d) exercising central coordination of the decentralization process.

(a) Boosting capacity for policy implementation. Since the mid-1990s, Moldova had experienced significant progress on the development of the legal framework and the territorial administrative structure in support of the fiscal decentralization policy. However, policy implementation was never properly carried out for lack of the required detailed regulation, for lack of technical and administrative capacities, for lack of understanding by the local authorities of the spirit of the decentralization reform, and for lack of enough commitment by the central government. For instance, as observed above, the fiscal relations between the judets and primarias were never formally regulated, and no integrated capacity building program was developed, in order to clarify implementation issues and qualify local administrations to adequately execute their new responsibilities regarding to implementation of decentralized fiscal policies. After all, structural reform does not finish with the mere approval of an improved basic legal framework. Although a necessary step, this is not a sufficient condition for the results of decentralization to come to fruition. An effective implementation of the specific policies have to take place, but this requires detailed and adequate regulations of the approved organic laws, a minimum critical level of understanding by the local authorities of the government intents, and a minimum level of development of technical and administrative capacities. Therefore, in order to effect policy implementation the government of Moldova should be prepared to boost sooner than later an *integrated capacity building program*, aiming at qualifying staff and authorities at the local as well as at the central levels, in order to develop, upgrade, and at least maintain a critical level of technical and administrative capacities. Although a *sine qua non* condition for the success of fiscal decentralization, this should not necessarily be seen as a policy sequencing issue, since the challenge of capacity building can be better overcome in the process of policy implementation.

(b) Developing political and fiduciary accountability of local administrations. The benefits of decentralization can only be realized when local authorities and managers are provided with enough autonomy to perform and are made fully accountable for their decisions. Moldova may consider restoring the exercise of accountability both horizontally and vertically. Horizontally, elected public authorities would be judged by their own constituencies on the bases of their performance, and can be kept or removed from office through the democratic election process. In this regard, direct election of the local chief executive officers (the Mayors in the case of primarias, and the Council Chairman in the case of the districts) would be the most effective system in order to keep local authorities accountable. Vertically, the local executive officers and public sector managers are to report to the respective local Councils, and to respond to enquiries from, the Government and the National Parliament. As a minimum, fiduciary accountability can only be complete in Moldova if an effective external audit system (to audit primarias and district accounts) is put in place (Chapter 5), and the role of the courts is reinstated to take final decisions on the disputes involving the local governments.

The set up of such *stable* institutional administrative structure is sine qua non for the effectiveness of decentralization policies, which Moldova still have to complete by: (i) finalizing the transfer of property rights over assets to the local governments; (ii) restoring revenue and budgetary autonomy (Chapter 3); (iii) discontinuing the mechanism of annual "negotiated"/"regulated" tax sharing ratio and the "gap-fill" transfers (Chapter 4); and (iv) reforming the intergovernmental fiscal relations—including the transfer mechanisms and the formalization of the relations between districts and primarias (Chapter 4).

(c) Promoting flexible cooperation/association among administrative units. Especially now with an even more fragmented (the new 32 smaller rayons) district structure, Moldova government may consider promoting association schemes among territorial-administrative units aiming at optimizing efficiency in consumption and in the production and delivery of essential public services. Certainly this is the case with the utilities (energy, transportation, water treatment, garbage collection), but also with health care, where economy of scale (and in certain cases externalities) plays a major role. In this regard, the transfers/grants mechanisms may be one possible instrument to be used to promote association of territorial units or their outsourcing of service provision. Thus, in addition to the association of primarias and/or districts themselves around one larger provider, a more intense participation of the private sector (including for the education sector) should be encouraged both in the provision as well as in the financing of those services. Certainly the central government should exercise the power of adequately regulating the sectors' operation, but in such a way to preserve the economic incentives in order to increase efficiency by reducing waste in consumption and reducing production costs.

(d) Exercising central coordination of the decentralization process. The novelty and complexity of the tasks faced by local governments in the decentralization implementation process and the constant need for adjustments in the laws (in order to keep the basic strategic orientation on track, as established by the basic organic Laws) require central government leadership and coordination. For this, Moldova could consider establishing a Multilevel-Interministerial Standing Committee, with representation of the local governments, and having deliberative powers to conduct *decisions* on decentralization. This committee should be supported by an independent Group of International Experts, and by a Decentralization Monitoring Department at the Ministry of Finance. The Group of Advisors would specifically work on the strategic issues for the Standing Committee deliberation, while the Ministry of Finance's Monitoring Department would operate as a repository of information and on the preparation of follow-up studies on the decentralization implementation process. The activities of these agencies should be fully transparent.

CHAPTER 2: EXPENDITURE RESPONSIBILITIES

In developing economies and countries in transition to market system, devolution of fiscal responsibilities are critical to improve efficiency and fairness, to increase accountability to the citizens, and to promote economic stabilization, thereby of prime policy concern. Devolution of responsibilities encompasses the decentralization of fiscal powers to local and regional authorities, as well as a more balanced participation of the private sector (both in the production/delivery and in the financing of public services).

Moldova has made progress towards a market economy, but still has a long way to go on properly defining the role of the government in the new system, since many business activities and most service delivery activities, including those related to utilities, housing, health care, and education still remain to be divested. The government role, at all levels, still needs to be optimized in the new open market economy in Moldova. In principle, government intervention could only be justified where the private sector cannot do a better job—i.e., if there is no economic or social rationale for the government to intervene, the operation of any activity should just be left to the private sector, regardless of other considerations. In this regard, apart from pursuing social equity objectives, the public sector intervention would be basically justified when there is a compelling market failure, such as those resulting from the presence of public goods (national defense, public order, and security), externalities (pollution, spill over effects), and uncontestable markets (public utilities, communications—where decreasing costs may drive out competitive forces). In addition, the government should pursue social equity objectives in a way that minimizes distortions to the working of the market economy.

While still maintaining an undefined role of the State in the economy, Moldova has been experiencing a staggering decentralization process of fiscal powers among levels of governments since independence. Because this process is eminently political in nature, difficulties in implementation are always expected, especially in the absence of strong administrative capacity, committed champion institutions, and clearly established strategic policy directions. Successful implementation of fiscal decentralization policies requires a strong capacity building effort and a certain level of political consensus and consultation. Decentralization policies that simply aim pushing down fiscal responsibilities to sub national governments may not be effective and may end up having counterproductive effects on the delivery of public services.

Since the fiscal decentralization reform of 1998, Moldova's public administration has been struggling with the assignment of expenditure responsibilities to the three-level government: the municipalities/primarias (first level), the judets (second level), and the State (third level). Except for few obvious areas, neither a clear definition of attribution of government functions, regarding social and economic sectors, nor specific competences, regarding regulation, financing and service delivery of functions has being sufficiently developed so far. In practice this has generated confusion at all levels of government and reluctance on the part of the central bureaucracy to relinquish fiscal powers to local authorities. The recently approved reforms on the local public administration legislation[17] made progress in some areas, but fell short of addressing most of the key pending issues and, in fact, did not help with some innovations in other areas.[18]

A. ASSIGNMENT OF RESPONSIBILITIES

The assignment of public expenditure responsibilities in Moldova was first spelled out in law in 1998. Before then, the lack of legal basis, allowed responsibilities for public service delivery to be easily shifted back and forth between the central and local governments. Most public service expenditures were delegated to local governments, which acted basically as agents, executing central government mandates, without any relevant delegation or devolution of decision power. Local autonomy was weak, local budgetary predictability practically did not exist and, consequently, incentives for local authorities accountability to the citizens were not existent, if not perverse.

After independence, and particularly since the mid-1990, Moldova started moving towards integration into the world economy and began setting up institutions congruent with the modern democratic European economies. Following the accepted principles of local self-governance established in its new Constitution (1994), the country subscribed to the European Charter of Local Self-Governments (1997), and the Parliament passed a new Law on the Local Public Administration (Law # 186, 1998) and a new Law on Local Government Finance (Law # 491, 1999). These reforms of late 1990s started putting in place a basic, modern legal framework for intergovernmental fiscal relations, where, for the first time, the new Law on Local Public Administration explicitly assigned expenditure functions to the local government—Judet and municipalities/primarias. This new legal framework was broadly consistent with the European Union principle of subsidiarity, which aims to maximize allocative efficiency by proposing that decision-making be taken at the lowest possible level of government, conditional to geographic internalization of the benefits and service delivery at minimum cost (Box 2.1, on principles and practice).

[17] Law no. 781-XV December, 28th 2001, on Amending Law no. 186-XIV/98.

[18] An adequate fiscal decentralization design for Moldova will require that:

(a) all the relevant financial inter-jurisdictional relationship be considered as part of a consistent, sustainable system. This will require a clear definition of the scope of fiscal decentralization, by putting in place the adequate incentives for efficient local expenditures and service delivery, by providing local authorities and managers with autonomy to perform, and by assuring central policy coordination; and

(b) implementation be congruent with an adequate policy sequencing. This will require that assignment of revenue sources should follow functions (the assignment of expenditure responsibilities), and not the other way around. A clear definition of expenditure functions and competences at the outset of the fiscal decentralization process is critical, in order to gauge required revenue sources and compensatory grants, allow for local budget predictability, and make the local authorities' and managers' accountable for their responsibilities.

Box 2.1 – Principles and Practice on Expenditure Assignment

There is no fix, established rule on how expenditures should be assigned among government levels. The extent and nature of decision-making power exercised by lower level authorities has varied considerably from country to country and may change from time to time, depending on technology and preferences. Especially in unitary country, subnational governments are not constitutionally empowered to make independent decisions over a range specified public functions or services.

However, general principles can be derived from best practices which indicates that policy decision on *economic stabilization and income distribution* are typically assigned to central government, while those related to *allocative efficiency* may be assigned to the local governments. Otherwise, when decisions on economic stabilization and income distribution are left to the local governments, wrong incentive and conflicts may arise, and policies may render unsustainable. Observance of the principle of subsidiarity—i.e., decisions taken at the lowest possible level of government consistent with allocative efficiency, including the internalization of the benefits within the geographic area and the provision of services at minimum cost—is fundamental to define the scope of local governments.

More specifically, the *national government* in general retain responsibility for the provision of national public goods, international affairs, monetary policy, regulation, distribution and transfers to persons and businesses, fiscal policy coordination, regional equity, and preservation/promotion of internal common market. The *intermediate level governments* may be responsible for education, health, social insurance, inter-municipal issues, and oversight local governments. *Local governments* may take the responsibility for some local services, including the provision of utilities. Beyond areas of exclusive functions/responsibilities which are attributed to each government level, the law should clearly specify *competences on shared functions*. In this regard, central government should keep decisions on overall policies, setting standards, and auditing, while intermediate governments should be given competence on over-sighting implementation, and local governments should be more directly involved in providing/ delivering the services (and infrastructure).

Assignment of respective responsibilities to regional vis-à-vis local governments should respond to the country conditions and be dependent on considerations such as *economy of scale (arising from the indivisibilities and specializations), economy of scope (arising from related activities), cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and flexibility on expenditure priorities*. In this regard, because of different local population size, distinct rural and urban characteristics, and diverse fiscal capacities, the assignment of responsibilities could be *asymmetric*, where larger local governments may end up having relatively larger responsibilities and higher degree of autonomy.

Although there is no fixed rule, the bottom line for a workable expenditure assignment in Moldova should at least: (a) *obey the general best-practice guidelines* delineated above; and (b) whatever is the final design of the expenditure assignment, it should *be clear and well-specified in the law* and be enforced accordingly.

The 1998-99 intergovernmental relations reform in Moldova should be understood only as an initial step, although critical to define the scope of decentralization and the role of local governments on public service delivery and its political accountability to the citizens. This basic legal framework of intergovernmental fiscal relations of 1998-99 conforms to conventional principles of assignments of responsibilities to local governments, and by and large with the Council of Europe's *Charter of Local Self-Governments*, such as:[19]

(a) *Reserving the stabilization and distribution functions to the central government*;

(b) *Assigning to the local governments (primarias and municipalities) responsibility for typically local functions; those able of increasing allocative efficiency, internalizing the benefits within the geographic area, and minimizing costs;* and

(c) *Assigning to the intermediate level of government (judets) mostly coordinating responsibilities, and some functions whose efficient operation requires larger benefit areas (than one municipality/ primaria) because of economy of scale, as in the case of some services in the health sector.*

However, while this framework was put in place, the adopted basic legislation remained too general, insufficiently regulated, and in certain cases still confusing. Further complementary legislation and regulation defining administrative procedures and specific competences (especially on policy formulation, on financing, and on the final service delivery) should be subsequently developed to sustain an effective implementation of the decentralization process. Nevertheless, the reform stopped practically at the first step, and fell short of attributing specific detailed authorities, and of better defining competences in shared responsibilities, which ended-up exposing the new system to fundamental weaknesses, such as:

(i) ***confusion and arbitrariness***, since the competences (on setting policies, regulation, financing and service delivery), were never clearly understood, with responsibilities being disputed by different authorities and being shifted back and forth. For instance, social assistance to the poor (including relief to unemployed) were simply pushed downward from the central government to the local governments, without the necessary reviewing the affordability of entitlement system, or without defining specific competences of authorities or financing sources—contrary to the conventional wisdom on social assistance of assuring central financing and relying on local service delivery;

(ii) ***unclear rules on shared responsibilities****, especially on education and health care.* In practice, the setting of policies and regulation, as well as wages (of teachers and doctors) continued to be paid by the center, while the maintenance of facilities (school and hospitals) was simply understood as left up to the local governments;

(iii) ***policy inconsistencies*** *with respect to ownership and maintenance of the capital stocks. Although the legislation still establishes that local governments are also responsible for the capital expenditures, in practice investment has been understood by the local authorities as a central government responsibility,* since most of property rights of local facilities—including utilities—are still central government's.

[19] See Box 2.2.

Compounding to these weaknesses there was also an almost complete absence of capacity building, coordination and leadership by the central government in the implementation process of fiscal decentralization. This situation on the assignment of responsibilities of local governments rendered the implementation of decentralization ineffective and hardly sustainable.

Box 2.2
Republic of Moldova – Assignment of Responsibilities

Responsibility/ Functions	State Functions :		Decentralized Functions to :	
	Central	**Territorial Agencies (de-concentrated functions)**	**Judets/*Districts***	**Municipalities/ primarias[1]**
Monetary Policy	NBM			
Foreign Affairs and Trade	Min. Foreign Affairs			
Statistical Serv.	St.&Soc.Dept.	Terrt. Division of Statistics		
Defense	Min. of Defense	Military Centers (conscription centers)	-Coordination of administrative activities	-Military administrative activities (conscriptions)
Justice/Internal Security	Min. Justice Min. Interior Nat. Sec.Ministr	Terr.Div.for Nat. Security Offices of Registration Regulation of Land Properties Police Inspectorate-Civil defense	-Regional police services	-Local police services -Fire brigade
Economic Policies	Min. Finance Min. Economy	Territ. Agency for Privatization Control & Audit Division Territ. Agency of State Treasury		-Local markets and market places
Agriculture	Min. Agriculture and Food Proc.	Veterinary inspectorate Rural Extension Services	-Some agricultural related services	-Some agricultural related services
Regional Development	Min.Transp:regl. Roads Fund: finances	Terr.Construction Inspectorate	-Construction and mainten. of Regional roads and other infrastructures	-constr.&maint.of local infrastructures (roads, streets,st.lighting,bridges etc)
Traffic and Public Transport	Min. Transport Regulates	-Highways, air, and rail transport		Local transport -Local transport subsidies
Education	Min. Education	-Colleges, Univers., Resear. Inst. -Curriculum development -Teaching material -Teachers' salary; Subs. buildings	***-Pre- & primary schools*** ***-Second. school & Gymn.*** ***-Lyceums*** ***-Vocational schools***	***-Pre- & primary schools*** ***-Second. school & Gymn.*** ***-Lyceums*** ***-Vocational schools***
Health care	Min. Health	- Specialized hospital care - Public Health - Health Protection - Doctors' salary	*-Non-specialized hospitals* *-District hospitals* *-Social & sanitary establish.* *-Health care (incl. primary)*	*-Ambulatory care* *-Ambulance service*
Culture, Leisure Recreation and Parks	- Min. Culture	-Libraries -Sports, Leisure -Bldgs.cultur. events (maint.)	-Coord. Sports, Leisure -Coord.cultural events	-Museums, Libraries -Sports, Leisure, Parks -Bldg.cult.events (mainten.)
Public Utilities	-Regulated by Line Ministries -off-bdgt.comp.	-District heating -Electricity -Gas		-Water treatm.&supply -Sewerage, solid waste
Urban development and tourism	- Regulated by Min.Env.Constr. & Terr.Develop.		-Regional Spatial Planning -Regional Econ. Development -Tourism	-Town planning -Spatial planning -Tourism
Housing and communal serv.	-Regulated by Min.Int.Aff.			-Housing and communal services
Social Security and Welfare	Nat. Sec. Min. (Social Sec. System)—Social Fund	Terr. Division for the National Security System		-Personal serv.for the elderly & handicapped -Nurseries, homeless, families & child care -Housing for the poor
Social Protection	Labor, Social Prot. & Family Ministry	Insp.for the Protection of Labor Force Office		Social Assistance for the poor, including unemployment relief
Environment & public sanitation	Min. of Environment	Environmental protection (Terr. Ecological Agency)	-Regional environmental issues	-Local environ.protection -Sanitation & cemeteries

Sources:
Notes: 1 includes towns, communes, and villages

Deconcentrated vs. decentralized responsibilities

The 1998 Law on Local Public Administration (Law # 186/98) distinguished between the deconcentrated and decentralized public services, attributing the responsibility for the former to the central government and for the latter to the local authorities. The *deconcentrated* public services are responsibility of the ministries and other central agencies. Many of these authorities are situated in the territory and until very recently were locally supervised by the Prefects (Box 2.2). Examples of these central agencies and bodies include: Territorial Division of Statistics, Military Conscription Centers, Territorial Division for National Security, Police Inspectorates, Territorial Agencies for Privatization, Territorial Agencies of the State Treasury, Veterinary Inspectorates, Territorial Division for the National Security System, Territorial Environmental Protection Agencies, Territorial Construction Inspectorate, Territorial Education Department, Territorial Health Department, Territorial Inspectorate for the Protection of the Labor Force, as well as Colleges, Universities, specialized hospitals, and libraries.

The Law defined *decentralized* public services those that are *not* subordinate to central authorities, and that should be *autonomously* organized at the administrative-territorial unit level. The latter includes all the local public agencies pertaining to the autonomous territorial units, judets, and primarias/ cities/ towns/ villages. However, in December 2001 article I of the amendment (Law # 781-XV/2001) to the Law on Local Public Administration eliminated the distinction between deconcentrated and decentralized public services, which may have added to the present confusion of responsibilities of functions and competences among levels of governments. Apparently, some sectors of the central bureaucracy continue to be reluctant to accept the idea of *decentralizing* functions/ competences to local authorities.

Exclusive, shared and delegated responsibilities.

The current legislation has not yet established a clear distinction between exclusive, shared and delegated responsibilities of sub national governments in Moldova. So far, the responsibility for the implementation of the most of public services has been pushed down to the local governments without a clear specification of their competences—whether regulation, financing, or service delivery. The general understanding is that *regulation* (including policy formulation, and setting standards) has been retained by the central government, while financing and delivery competences have varied according to the function. In some cases, it has been implicitly understood that urban services in general, especially housing and supply of some utilities (e.g., water treatment and supply, sewerage and solid waste collection),[20] as well as local urban

[20] But district heating, electricity and gas are kept as responsibilities of the central government.

services (e.g., local transportation services, construction and maintenance of local infrastructure like local roads, bridges, street and street lighting) are *exclusive* responsibilities of the first level local governments (i.e., municipalities/ primarias). It has been also understood that those services should be financed by local governments' respective budgets; although the State still exercise the power of regulating and approving the tariffs charged on utility services. Are also exclusive responsibility of the first level local governments conscription administrative activities, local policy services, fire brigade, local markets and some agricultural related activities, local tourism, spatial and city planning, and the operation and maintenance of local museums, libraries, parks, leisure, sports and cultural buildings.

The second level of local governments (Judets) is assigned with coordination of regional activities (including administrative, fiscal, and social), regional police services, some agricultural related activities, regional tourism, regional spatial planning and economic development, regional road and infrastructure, and the delivery of most of the health care services (including non-specialized and district hospitals, sanitary establishments, and primary health care).[21]

Important areas of education, health care, and environment are considered areas of *shared responsibility*, although still without a precise formal definition of the specific competences of central, judet, and first level local governments. In practice, in the health sector the central government has been responsible for the specialized hospitals, public health programs and the health protection system, while the judets are responsible for the non-specialized and district hospitals, social and sanitary establishments and the primary health care, and the municipalities/primarias for the ambulatories, outpatient health care, and the ambulance services.

In education, the central government is in charge of tertiary education, curriculum development and teaching materials, and local governments (first and second level) are in charge of pre-, primary, and secondary schools, gymnasium, lyceums and vocational schools. Nevertheless, the specific responsibilities and competences of judets and primarias/municipalities in the area of education have not yet been formally defined, leaving room for concurrent involvements and, so, inefficiencies. In environment and public sanitation the local governments are responsible for sanitation and cemeteries, but the rest of environmental protection responsibilities are also shared among the central, judet, and first level local authorities, but also without attribution of specific competences. The problem with the poorly defined areas of shared responsibilities is that services tend to be either duplicated or under-provided, which end up increasing inefficiencies. Given the severe budgetary restrictions in Moldova, the under-provision of the public services tends to be the most likely scenario in these areas of local interest, with a direct negative impact on the population.

The law does not distinguish *delegated* responsibilities either. The Law on Local Public Finance (Art. 2) refers to "delegated functions" by the central government to the

[21] But responsibilities for highways, air and rail transport, as well as the public health protection programs and specialized hospital care are State responsibilities.

territorial units, but does not define what these delegated functions are. Yet, in order to avoid indiscriminate unfunded mandates, the same Law has a provision (Art. 10.1.a) which establishes that the State budget has to provide the territorial unit budget with "special purpose transfer" corresponding to the expenditures of delegated functions. However, since the end-1990s the delivery of many functions (mainly social assistance services) have been pushed down (implicitly, or informally delegated) to local governments, but without the provision of corresponding source of revenues or a careful review of affordable entitlements, so that local authorities could properly gauge the need for "special purpose transfers". Basically, most of the public services under the broad category of "social assistance" (including support to the elderly and handicapped, nurseries, homeless families, destitute child care, unemployment relief, and social assistance to the poor) are apparently understood as delegated functions to the local governments. As delegated functions these would be financed by the State. However, some other times the same list of functions have been understood as shared functions. This lack of clarity has been a major source of confusion and inefficiency. The lack of clarity has de facto imposed unfunded mandates on local governments. The overall outcome has been worsening in the access by beneficiaries to the services, increasing deterioration in the quality of services, and an accumulation of payment arrears at the local government levels, mainly salaries.

B. PATTERN AND STRUCTURES OF EXPENDITURES

The Law on the Budgetary System and Process (organic Law # 847/96, Article 2) formally acknowledges and integrates local governments (Judets and Municipalities/ Primarias) as *autonomous* entities into the country's budgetary system. Together, with the State budget, the local budget forms the consolidated budget system.[22] Nevertheless, annually the central government issues expenditure "norms" for the preparation of the budgets, which the local governments have to follow suit in order to access supplementary resources from the State budget (Box 2.3). In Moldova, expenditure norms have not only played a central political role in the negotiations of grants and transfers for planning purpose, but frequently been also used as a policy tool to condition execution of local budgets.[23]

[22] The national public budget system also includes the State Social Fund Budget, and the other extra-budget Funds (performed by "off-budget" institutions, like public autarkies—e.g., the some universities, hospitals, research institutes—and state enterprises, e.g., utility companies), but these are not part of the *so-called* consolidated budget. The State Social Fund Budget includes pension, unemployment, and also "categorical" social assistance (e.g., for single mothers, disabled, war veterans). Most social assistance for the needy (e.g., elderly people, orphans, the poor, and the destitute in general) is also carried out by the local government budgets.

[23] Sometimes the "norms" initially used as merely a planning tool ended up conditioning the use of transfers for a particular purpose—e.g., pay teachers' salary—during the execution process. This is a pending issue still to be clarified. If the government wants to operate conditional transfers, better to do it through "block transfers associated to programs" rather than to protect generic budget line items, like salaries. The latter can be justified on efficiency grounds, since the "protection of generic budget line item (i.e., input)" may limit the optimum allocation of factors of production in the local provision of public services, while "block transfers associated/conditional to programs" can more easily be evaluated against measurable outcomes indicators.

Moldova can also significantly improve on expenditure budgeting, particularly in respect to the system of expenditure "norms", which is still regulated centrally. As these norms do not (cannot) take into account all local peculiarities and specificities, they tend to cause misallocation of public resources. Also arrears accumulation tends to emerge as a consequence of the implicit "unfunded mandates" to sub national governments that the fixed norms may end up representing. Although efforts have been made to establish the norms on a capitation basis (per capita, per student, per occupied bed), in reality, because of the political pressures, the system has still been functioning as oriented by the maintenance of the existing institutions and employment. An evidence of these inefficiencies has been the accumulation of arrears in several sectors and the increasing employment in the already bloated public institutions (Box 2.3).

BOX 2.3: The Use of Expenditure Norms for Budgeting

The central government of Moldova issues expenditure norms for practically all areas of local government budgets, and this work has been the responsibility of the branch departments of the Ministry of Finance. Unlike the old Soviet norms, however, which were often expressed in physical standards, the current norms are already mostly client-based. This criterion avoids many of the inefficiencies associated with the use of norms, such as hoarding idle facilities or building excess capacity. It is important to emphasize the importance of this change in policy for increasing the efficiency of public resources. Nevertheless, the setting of budgetary norms remains one of the most contentious issues in budget formulation (and execution) and has been a central piece of negotiations and discussions between upper and lower-level governments.

The current methodology used in the computation of expenditure needs for sub national governments is similar across the different areas of functional expenditures. In the case of education, there are different capitation norms for each level of education (e.g., kindergarten, primary). The amount of lei per student is set on the bases of how much was spent in the previous year and projected inflation for next year. In principle, "norms" are adjusted upwards if there is a change in mandated expenditures, such as an increase in teacher salaries. However, the overall adjustment does not necessarily reflect inflation and salary increases, but rather reflects "what is feasible for the entire budget." The actual expenditure needs is computed as a function of the number of children of school age rather than the number of students actually enrolled, and the basic per student norm is actually adjusted for several jurisdictions, in general to compensate for unit cost differentials. In recent years, norm setting has been more often driven by fiscal realities and less and less by declarative legislation. For example, the Law on Education of 1995 states that expenditures on education in the consolidated budget should be at least 7 percent of GDP. However, this aggregate sectoral norm has not been respected for years. In reality, as norms have been reduced in real terms, no money has been available for capital repairs and maintenance, making it clear to the territorial units the need to use more cost recovery measures and to adjust the quality/quantity of services provided.

Below are some examples of the norms setting, used in the instructions for the preparation of the local budgets for 2002.

Education. Pre-school education expenditures is based on the total number of children aged 3 to 6 registered on January 1, 2001 as presented by the Department of Statistical and Social Analysis, at an average cost of Lei 918.3 per child. Primary, secondary, and high school education expenditures are based on the number of children aged 7-16, at an average cost of Lei 827.4 per student. For Boarding Schools (normal schools) the average expenditure is Lei 3,637.85 per student and for special schools Lei 4,717.84.

Exceptions are allowed in the system of norms. For example Chisinau gets a favorable treatment "…because Chisinau incurs much higher expenditures in supporting children and pupils in educational institutions ...registering the highest levels of class and group completion .." Thus the average cost for pre-school students in Chisinau is Lei 2,306 and Lei 1,547 for primary and secondary students, respectively. Another example is ATU Gagauzia, which is also given preferential treatment, based on the allegation that Gagauzians have to master several languages. However, rather than different norms, Gagauzia got in the 2002 budget an additional conditional grant for education of Lei 1.2 million.

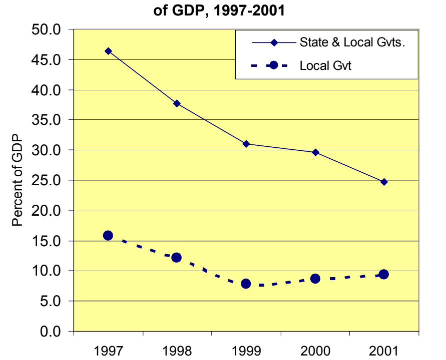
Culture, arts and sports. Expenditure norms are calculated on the basis of population, with Lei 7.5 per capita; but Chisinau gets 2.25 times that amount, and ATU Gagauzia gets a conditional grant of Lei 0.5 million.

Health care. Expenditure norms are supposed to cover Basic Free Healthcare Package with Lei 64.72 for children under 14, Lei 93.84 for the working age population, and Lei 161.80 for the population of retirement age. The health norms for Chisinau are increased by 62 percent on the basis of more frequent visits and higher cost of utilities. In the case of health care the central government also tells local governments how their funds should be spent. In particular, for 2002 it requires that at least 35 percent of the local budgets on health should be spent on primary care and 15 percent for emergency assistance.

Local Government Expenditure Patterns

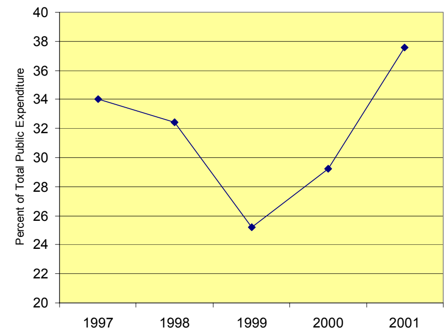
While the consolidated public expenditure in Moldova experienced a dramatic continued fall as a share of GDP, since mid-1990s—from 46.3 percent in 1997 to 24.7 percent in 2001—the local government expenditures, after dropping from 15.7 to 7.8 percent of GDP between 1997 and 1999, recovered to 9.3 in 2001. The local government expenditures that had fallen as a share of the consolidated public expenditure until 1999 to 24.4 percent, increased to 37.8 in 2001 (Figures 2.1 and 2.2). These current local government shares in GDP and public expenditures in Moldova do not differ much from those of other European countries, specially countries in transition and those in the Southern Europe.

Fig. 2.1. Moldova: Public Expenditure as a share of GDP, 1997-2001



The real per capita expenditure of the State budget systematically dropped 50 percent between 1997 and 2001, while that of the local budget dropped 54 percent until 1999 but increased almost 30 percent after that—which dramatically recovered the share of the local budgets in total public spending (Figure 2.2). This may have been a significant positive impact of the local public finance system reform which took place since 1998 (Chapter 1) by relatively protecting local government budget expenditures despite the more recent fiscal adjustment policies.

Fig. 2.2. Molvoda - Local Govts. Share in Public Expenditures



The share of each level of government and internal composition of their budgets remained quite stable since the end-1990s, and their averages in the last five yeas are shown in Table 2.1. This structure is consistent with the statutory assignment of responsibilities described in the previous Section. The central government budget has almost solely responded for the expenditures on external activities, national defense, judicial system, maintenance of public order, scientific research, social security, environment, transport and information, the complex of fuel and energy, national public debt service, and services related to economic activities. The local government budgets have a dominance in the social sectors and have significantly responded for expenditures on education, health care, public utilities and housing, but also on capital expenditures—the latter mainly due to the fact that not much investment was afforded by the central government due to severe financial constraints during the period.

Table 2.1 - Total Expenditures by Level of Government, Functional Composition, 1997-2001[1]

	hares by Level of Go			unctional Compositic		
	State	Local	Total	State	Local	Total
Total Expenditures	68.3	31.7	100.0	100.0	100.0	100.0
Current Expenditures (*)	69.3	30.7	100.0	96.4	92.0	95.0
General Public Services	57.3	42.7	100.0	4.7	7.4	5.5
External activity	100.0		100.0	2.0		1.3
National Defense	100.0		100.0	2.4		1.6
Judicial authorities	99.9	0.1	100.0	1.1	0.0	0.8
Mantenance Publ. Order & Nat.Sec.	83.1	16.9	100.0	7.1	3.1	5.8
Education	28.7	71.3	100.0	7.7	40.5	18.0
Scientific research	100.0		100.0	1.0		0.7
Culture, art,sport & youth actions	59.2	40.8	100.0	1.7	2.5	1.9
Health Care	37.6	62.4	100.0	6.0	21.8	11.1
Social Security and Support	88.1	11.9	100.0	14.9	4.4	11.5
Agr., Forestry, Fish. & Water Mgt.	77.6	22.4	100.0	3.0	1.7	2.6
Environ.prot.& Hydrometeorology	97.7	2.3	100.0	0.3	0.0	0.2
Industry and Construction	76.0	24.0	100.0	0.1	0.1	0.1
Transp,RoadMgt.,Com.& Inform.	87.2	12.8	100.0	2.7	0.9	2.1
Complex for Fuel and Energy	99.3	0.7	100.0	0.6	0.0	0.4
Public utilities and Housing	10.6	89.4	100.0	0.4	4.8	1.8
Public Debt Service	100.0		100.0	24.0		16.5
Completion of State Reserves	100.0		100.0	0.4		0.3
Serv.related to Economic activity	90.8	9.2	100.0	0.5	0.1	0.4
Other expenditures	88.2	11.8	100.0	15.8	4.7	12.2
Capital expenditures (**)	39.5	60.5	100.0	2.9	8.0	4.5
Net Lending	100.0		100.0	0.7		0.5

Source: Ministry of Finance

[1] Exclude extra-budgetary public expenditures

(*) Include maintenance expenditures

(**) Include only "Capital Investment" (since maintenance expenditures are include in "current expenditues")

In terms of functional composition of expenditure, the structures of the local vis-à-vis State budget are also quite distinct, reflecting their more specific assignments of responsibilities. On the one hand, although almost 40 percent of the State budget has been spent on public debt service and social security[24], the State budget has also spent resources in practically all the other public budget items, since some areas are still considered of shared or concurrent responsibilities with the local governments. On the other hand, although the local governments have a limited and focused mandate, some decentralization of functions and competences has already taken place in critical areas of public services, so that local budgets have allocated more than 60 percent of their resources on education and health related expenditures (table 2.1).

[24] I.e., mainly subsidies to the State Social Fund Budget.

Functional Composition of Expenditures

The specific assignment of responsibilities between the Judets and municipalities/ primarias is not completely defined in the legislation, especially with respect to education, and many of the attributions have been decided at the Judet level taking into account the delivery capacities at the primarias' level. The experience of the period 1999-2001 shows that judets' administration assumed most of the responsibilities for health care, maintenance of public order, social assistance, agriculture related issues, environment, transportation, road management, and capital expenditures. Especially education, but also to certain extent culture, arts and sports, were the functions where municipalities/ primarias have played a relatively more significant role in service delivery.

Table 2.2 : Moldova: Local Expenditures by Function, 1999-2001
(Share of each level and Structure of Budgets)

Item	Share of Each Level			Structure of Budgets		
	Local Total	Judet Bdgt.	Mun/Primaria Bdgt.	Local Total	Judet Bdgt.	Mun/Primaria Bdgt.
Expenditure and Net Lending	100	63	37	100	100	100
Current Expenditures	100	61	39	91	87	97
General Public Services	100	44	56	9	6	13
External activity						
National Defense						
Judicial authorities	67	39	28	0	0	0
Mantenance Publ. Order	100	98	2	3	5	0
Education	100	36	64	40	23	69
Scientific research						
Culture, art,sport & youth	100	57	43	3	2	3
Health Care	100	97	3	21	32	2
Social Sec.& Support	100	78	22	4	5	2
Agr., Forestry, Fishery	100	98	2	2	3	0
Environ.prot.& Hydrom.	100	99	1	0	0	0
Industry and Construction	100	100	0	0	0	0
Transp,RoadMgt.& Inform.	100	92	8	1	2	0
Complex Fuel and Energy	100	0	100	0	0	0
Public utilities and Housing	100	60	40	5	5	5
Completion of State Reserves						
Serv.related to Econ. Activ.	100	123	-23	0	0	0
Other current expenditures	100	79	21	3	4	2
Capital Expenditures	100	87	13	9	13	3
Capital investments	100	88	12	9	13	3
Net lending					0	0

Source: Ministry of Finance

As observed in the relationship between the State and the judets, here also the mandates of the first level of government is relatively limited and more focused in few areas. In terms of the structure of their budgets, "education" and "general public services" have been by far the most important budgetary areas of municipalities/ primarias level of government (82 percent of total expenditures), while "health care" and "education" have been the most important for the judets' administration (together 55 percent). Judet budgets also cover a larger range of functions than that of the municipalities/ primarias.

It is difficult to evaluate the allocative efficiency of local budgets, since competences on regulation, financing and delivery have been confusing and not well defined among the second and first level. In the social sectors, especially in education, there implicitly is an array of joint/ concurrent responsibilities. These ill-defined responsibilities may be causing inefficiencies, because of the waste of resources, which may emerge from duplication, or under-provision of services in the overlapping areas of authority. For instance, although the law establishes that capital expenditures (including maintenance and investment) are a responsibility of the respective jurisdiction budget (judet or municipal), this has not been always the current understanding of the Judet's Council representatives and Mayors who end up deciding on the final allocations. This issue may have major practical efficiency implications that the pure observation of the ex-post budgetary allocation cannot reveal.

Another area of overlapping responsibility, which may be generating inefficiencies, is social assistance. While it is clear that payment of pension for retirees, unemployed and some few other specified benefits are up to the national Social Fund Budget, it does not seem clear who is responsible for the "social assistance to the poor". For instance, although arguing that social assistance is an exclusive State budget responsibility (against what is established in the Law on Local Public Finance), some Judets and municipalities have developed their own schemes to help support the local poor. Some Judets charge a 1 percent payroll tax on local businesses in order to fund these expenditures in their jurisdiction. Also, one municipality reported that it has created a municipal fund to additionally support the local poor—with such a fund maintained by one day of salary per year charged on local businesses. Arguing of low purchasing power, some municipalities have also been heavily subsidizing utility services (mainly water supply) to the local population *in general*, without any selection or targeting criteria for their social assistance programs "to the poor." It seems that there is indeed much duplication of social services and overlapping authorities going on in Moldova, which represents a significant potential for waste of resources and/or under-provision of services to the population. The government may consider reviewing this issue, with the objective of consolidating and rationalizing programs and assigning responsibilities accordingly.

Since financing capacity tends to be inversely correlated with poverty indicators, responsibility to combat absolute poverty would be better assigned to the central budget. By the same token, basic education (mainly primary) and a minimum package of public health care (including prevention of contagious diseases) should be regulated and *financed* directly by the central government. Nonetheless, delivery should be *delegated* to local authorities, who are better positioned for selecting and targeting beneficiaries. These are example of areas where better reassignment and clarification of responsibilities are certainly needed in Moldova.

The importance of "public utilities and housing" has been more or less equivalent for both judets and municipalities/ primarias (about 5 percent of the budgets). But this may be hiding a major problem for the government in general, since this area has represented a great fiscal risk. Utilities have been supplied by off-budget companies which, depending on the specific service, are administered either by the State directly (electricity and gas, for example), by the judets, or by the municipalities/ primarias. Although the utility subsidies tend to be high, they do not appear explicitly in the governments' budget as *subsidy*. Especially the local governments have operated a two-tariff policy with respect to the off-budget utility companies: (a) a lower tariff, which applies to the households; and (b) a higher tariff, which applies to the "budget entities" (e.g., schools, hospitals, other institutions). The specific example provided was for water, and the relation between (b) and (a) was 5.5 times (household tariff was Lei 1.39 per cubic meter, while "budget entities" tariff was Lei 7.64). Under this dual-tariff arrangement, the utility companies are authorized to manage the balance of their accounts but, because of consumer price distortions introduced by this system, inefficiencies are been generated in the allocation of public resources anyway. On the one hand, the population will not be encouraged to save; and on the other hand, the cost structure of the "budget entities" will not reflect the actual scarcity of resources. Moreover, the implicit subsidy is not targeted to needy households, but it benefits the whole population, characterizing a highly regressive policy.

Another area of concern in public utilities is that poor policy and management are allowing an implicit contingent liability to accumulate, which may spillover on the governments' budget in the near future. Two main problems have to be addressed urgently in this area. The first problem refers to the ownership of the companies' assets, which although administered by the local governments, still belong to the State. This situation, of having the ownership at one level of government and the management at another, has created great confusion and perverse incentives in relation to the responsibilities for the maintenance, replacement and expansion of the companies' assets. The consequence has been a lack of proper maintenance and a faster deterioration of the capital stock. This does not augur well and tends to compromise the sustainability of the utility supply in the near future.

The second problem concerns the current deplorable financial situation of most of these off-budget utility companies. At the root of this problem is the weak management and lack of a full cost recovery approach in the provision of services. The tariff policies are in general lagging behind the real costs, and the rate of collection of service bills has been too low (as low as 30 percent in certain cases). This means that consumers have been subsidized across the board (without a target mechanism to select the neediest) and the providers have either not always been compensated by the costs, or had to operate a dual-tariff scheme which is highly distorting to the rest of the economic system (as mentioned above). This policy orientation has implied waste in consumption, deterioration of the utility supply capacity, and distortions to the rest of the economy. Owing to these weak policy and management procedures, and the lack of local budget resources to fully compensate for the subsidies, companies have seen a lack of maintenance and replacement and, ultimately, depletion of their capital stock.

Economic Composition of Expenditures

As suggested by Tables 2.1 and 2.2, the weight of General Public Services in the budget has been higher the lower the level of government in Moldova. Also, the economic composition of local government spending seems to indicate that Moldova is operating with a relatively large cost of personnel (Tables 2.3). The local governments' expenditures only on

Table 2.3. Moldova: Economic Structure of Local Govts. Budgets, Average 1999-2001

Economic Categories	% of GDP	% Expend.
Expenditure & Net Lending	8.58	100.00
Current Expenditure	7.95	90.56
Goods and services	6.28	71.55
Wages and salaries (*)	3.92	43.92
Other goods & services	2.36	27.63
o/w Energy	0.69	8.60
Interest on debt (due)	0.11	1.76
Subsidies and transfers	0.73	8.26
Other current expenditures	0.83	9.00
Capital expenditures	0.92	9.44

Source: MOF

wages and salaries (including contributions) seems to be absorbing an abnormally high share of their budgets (an average 44 percent during the period 1999-2001). Although partially explained by the concentration of their responsibilities on education and health—which are more labor intensive sectors[25]—the composition of inputs for the delivery of local services seems to be inefficient. As indicated by Table 2.3, the relative allocation between "goods and services" and "wages and salaries" is only 0.6, away below the international standards.[26] As the wages are considered to be low in Moldova, then the levels of employment by the local governments in Moldova may be too high relatively to spending on supplies and materials for operations and maintenance (O&M) of facilities and equipment. Thus, the indications are that likely an important area for significant efficiency gains can be realized by reforming public wage and employment policies at the local government level.

Among the classified current expenditures, subsidies and transfers (addressed to utilities, housing, and social assistance, as commented above) are also relatively important expenditure items. These are areas of probable expanding demand and increasing pressures on local government budgets, if the current policies of loose subsidies continue. Reforms in these areas should aim at disciplining spending by: (a) redesigning the tariff policies and increasing the collection ratio of utility bills, in order to make the utility companies less dependent on the public budgets and to render these services self-sustainable; and (b) properly measuring affordable benefits (including on housing and social assistance), with clear identification of sources of finance, in order to avoid unfunded mandates and accumulation of arrears.

Expenditure on "interest on debt" has only been of some significance for the City of Chisinau, since the current weak creditworthiness—for lack of revenue capacity and autonomy, and sound collateral basis—has prevented the other local governments to access borrowing, outside the scarce official financing provided by the Ministry of Finance itself.[27]

While still extremely small in absolute terms and as a share of GDP, capital expenditure of local governments in Moldova has actually been larger than that of central government, what may be explained by the severe budgetary constraints imposed by the urgent need of fiscal adjustments since independence. Nevertheless, capital outlay has absorbed almost 10 percent of the local governments resources, and may increase in the

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[25] Though, the weight of "energy cost" in Moldova tend to be particularly high as well.

[26] For example, estimates for the "material and services" to "wages " ratio for the middle-income and high-income countries are in the interval 1.4-1.0, respectively. See "Unproductive Public Expenditures", IMF/FAD, Pamphlet Series, no. 48, Washington, 1995.

[27] Amendment to the 2000 Budget Law (Law no.1410-XIV, December 8th, 2000) did write-off MDL 181 million of Local Government debt to the Ministry of Finance, which had been accumulated between 1994 and 1998. Apparently this bailout operation by the central government was justified in the context of the decentralization reform initiated in 1999, and to clean the books for the new local authorities. However, in order to keep a hard budget constraint in place, and to avoid moral hazard incentives, it would be important to make the local authorities realize a firm commitment by the central government of not repeating these bailout operations in the future. Currently, local governments are not prohibited to borrow in Moldova, and, for the time being, the regulation seems to be restricted enough to keep in place some discipline on the local government access to capital markets.

near future for three reasons: (a) the obvious need for the rehabilitation and expansion of basic urban infrastructures; (b) the continuation of central government budget constraints, that could not carry on financing local infrastructures; and (c) the need to place, for efficiency reason, at the same level of government the responsibilities for maintenance and replacement of the capital stocks.

Regional disparities in Local Expenditures

Disparities of total expenditure across local governments

A remarkable feature of local government expenditure in Moldova is its disparity across territorial units, exacerbated by the concentration in the City of Chisinau. In 2001, for instance, while the per capita expenditure in the City of Chisinau was Lei 907, in Edinet Judet it was only Lei 318. However, excluding the City of Chisinau, the average per capita expenditure falls from Lei 425 to Lei 381, with a maximum of Lei 516 (UTA Gagauzia); and the coefficient of variation falls from 0.38 to only 0.14. It is also interesting to observe that the disparities are much more concentrated at the Judets' administration level (second level government) than at the municipalities/ primarias level of administration (first level government); and, again, with large disparities mainly explained by the presence of the City of Chisinau in the data set. In 2001, the coefficient of variation for the Judets' administration (the second level) was as high as 0.91, while for the municipalities/ primarias it was 0.29; but excluding Chisinau these coefficients dropped dramatically to 0.22 and 0.15, respectively.

Table 2.4. Moldova: Total Local Gvt. Expenditure, per Judet (Lei per capita)

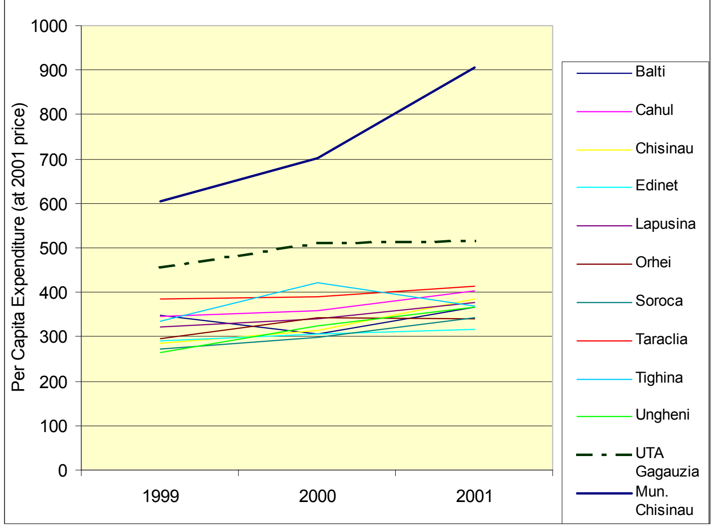
Judet	1999 executed			2000 executed			2001 executed		
	Local Total	Judet	Munic./ Primar.	Local Total	Judet	Munic./ Primar.	Local Total	Judet	Munic./ Primar.
Balti	244	84	160	281	138	144	367	175	192
Cahul	240	73	168	329	115	214	404	138	266
Chisinau	199	79	119	288	104	184	384	129	255
Edinet	202	95	107	282	147	135	318	132	186
Lapusina	225	86	138	312	144	168	377	169	208
Orhei	207	92	114	314	163	151	340	154	187
Soroca	191	77	114	274	145	129	343	166	176
Taraclia	268	136	132	357	162	195	413	185	227
Tighina	234	105	129	387	222	165	369	173	196
Ungheni	184	95	89	298	126	172	366	146	221
UTA Gagauzia	317	192	126	469	262	207	516	263	253
Mun. Chisinau	423	400	23	643	613	30	907	865	41
Total	264	159	105	382	248	134	486	312	175
Descriptive Statistics:									
Maximum Value	423	400	168	643	613	214	907	865	266
Minimum Value	184	73	23	274	104	30	318	129	41
Average	245	126	118	353	195	158	425	225	201
Stand. Deviation	67	92	37	107	139	49	160	205	58
Coef.of Variation	0.28	0.73	0.31	0.30	0.71	0.31	0.38	0.91	0.29
Descriptive Statistics (Excl. Mun. Chisinau):									
Maximum Value	317	192	168	469	262	214	516	263	266
Minimum Value	184	73	89	274	104	129	318	129	176
Average	228	101	127	327	157	169	381	166	215
Stand. Deviation	39	35	23	59	46	29	52	37	31
Coef.of Variation	0.17	0.34	0.18	0.18	0.30	0.17	0.14	0.22	0.15

Source: MIF

These conclusions are basically the same when the analysis is extended back to the years 2000 and 1999, showing a consistent regional pattern of spending, with most of the disparity highly influenced by the concentration of local public expenditures in the capital city (and to a certain extent at Judets' administration level), and much less disparity across the rest of the country (particularly at the first level of administration). Moreover, a similar conclusion can also be drawn over time, i.e., *disparities in real per capita expenditure across regions have increased substantially* over the last three years, with the concentration of spending increase in the capital city (Table 2.4 and Figure 2.3).

Many factors can explain this pattern of concentration of local public expenditures across regions and overtime in Moldova; the most important being: (a) the differential needs for and supply costs of the services in the capital city metropolitan area (e.g., urban infrastructures, mass transportation services, pollution control); (b) the availability of larger own tax basis, and the distortions of the current tax-sharing system—which, by being based on the derivation principle tend to assign most of the tax collection to the larger centers where the enterprises are registered rather than where the economic activities are generated (see Chapters 3 and 4); (c) the higher creditworthiness of the capital city and its easier access to the capital market, which gives it the opportunity to incur debt in order to finance capital expenditures; (d) the political clout of the capital city which, apart from UTA Gagauzia, is the only territorial unit with a representative seat in the Parliament; and (e) the lack of formal regulation of fiscal relations between the second (Judets) and the first (primarias) levels of government, which ends up subordinating the first level to negotiate with the Judets the necessary resources to finance their spending priorities. The latter tends to dissipate municipalities'/ primarias' fiscal autonomy. Therefore, if unchecked, the current system of intergovernmental fiscal relations in Moldova tends to perpetuate and even exacerbate the per capita local expenditures disparities across territorial units and levels of government in the near future. Probably a more equitable distribution of expenditures across the territorial units and government levels will need a reform of the fiscal relations, particularly the tax-sharing and the transfer systems (see Chapters 3 anfd 4).

Figure 2.3 Moldova-Evolution of Local Gvt. (real) Per Capita Expenditure, 1999-2001



Disparities in functional and economic composition of expenditures across local governments

Usually, disparities of per capita functional expenditures tend to reflect jurisdictional differentials in needs, preferences and government priorities. Moldova is not an exemption to this rule. Per capita local public expenditures vary substantially according to function across territorial units. But, disparities in per capita expenditures are apparently bigger in functions where local governments tend to be on average less involved. In these areas, while the well-off judets may have had some interventions, the poorest judets could have not afford it. For example, in the areas of "services related to economic activities" and "industry and construction" only the City of Chisinau and UTA Gagauzia, and to a much lesser extent, Orhei, Taraclia, Tighina, Ungheni, and Soroca judets, have made some expenditures, but the rest of the territorial units have not intervened at all. As "fuel and energy" are essentially attributions of the State, the data show that the autonomous unit Gagauzia was the only territorial unit to intervene in this function directly in the last three years.

Table 2.5 Moldova: Disparities on Local Expenditures, by Functional Categorias
Descriptive Statistics (average 1999-2001)

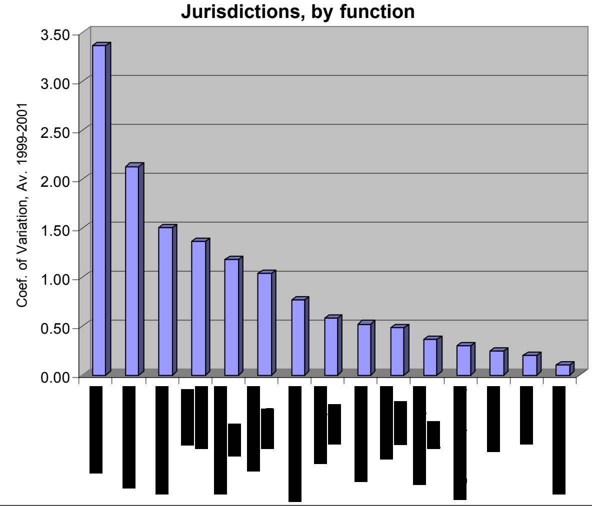
Functional Classification	Maximum value (per capita Lei)	Minimum Value (per capita Lei)	Average Value (per capita Lei)	Stand. Deviat.	Coeff.of Variat.
Total Expenditure	663.3	267.3	337.2	111.7	0.33
Current Expenditures	532.6	253.6	314.0	78.1	0.25
General Public Services	39.4	27.7	33.8	3.4	0.10
Mantenance Publ. Order & Nat.Sec.	27.2	7.0	10.9	5.3	0.48
Education	211.4	108.4	143.6	28.9	0.20
Culture, art,sport & youth actions	17.9	6.3	9.6	3.5	0.36
Health Care	117.3	51.1	72.9	18.0	0.25
Social Assistance	25.8	5.2	10.1	5.3	0.52
Agr., Forestry, Fish. & Water Mgt.	10.1	3.2	6.8	2.0	0.30
Environ.prot.& Hydrometeorology	0.2	0.0	0.1	0.0	0.58
Industry and Construction	1.8	0.0	0.5	0.6	1.36
Transp,RoadMgt.,Com.& Inform.	13.3	0.7	3.0	3.5	1.18
Complex for Fuel and Energy	0.8	0.0	0.1	0.2	3.37
Public Utilities and Housing	50.8	3.9	13.2	13.7	1.03
Serv.related to Economic activity	1.4	0.0	0.2	0.4	2.13
Other current expenditures	28.5	2.6	9.3	7.1	0.76
Capital Expenditures	130.7	5.5	23.1	34.8	1.51
Capital investments	130.7	5.5	23.1	34.8	1.51

Source: Ministry of Finance

Disparities are also high in transportation services, utilities and housing, social assistance, environment, and public order (about 0.50 or higher). And, again in these areas, not every judet can afford providing these services to its population on the same standard. For instance, "public utility and housing" and "social assistance" are important activities where every local government in Moldova is involved, but with considerable per capita spending variations. While on average they were, during 1999-2001, Lei 51 and Lei 26 in City of Chisinau, respectively, they barely reached Lei 4 and Lei 5, in Edinet and Cahul judets.

On the other hand, the coefficient of variation for the per capita local expenditures in "general public services," "education," and "health care" are the lowest (lower than 0.25). From the equity point of view, the smaller disparities on these priority functions across territorial units, are a highly desirable feature of the local governments in Moldova (Table 2.5 and Figure 2.4). Since these are labor intensive sectors, this result may have been more a consequence of the central government-controlled wage and employment policies across the country, rather than any deliberate choice of individual local governments in delivering standard services. Nevertheless, as observed above, these lower disparities in coefficients of variation of the

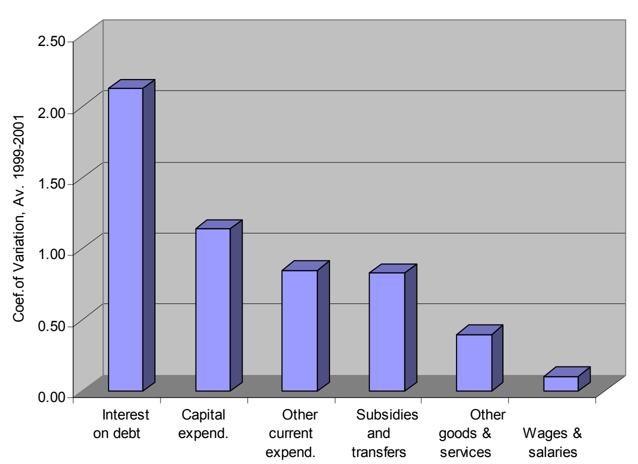
Figure 2.4 Moldova: Disparities in Expenditures Across Jurisdictions, by function



per capita local expenditures do not have any direct correspondence with efficiency. On the contrary, one could infer that, if anything, the local governments in Moldova are equally inefficient in the production of those services (see below).

The interface of what was presented in the previous paragraph is reproduced in Figure 2.5. The economic expenditure categories with the highest disparity are "interest on debt" and "capital expenditures", where the City of Chisinau, and to some extent ATU Gagauzia and Balti judet, are higher than the others. But these expenditures actually are minor items in the local budgets. On the most relevant items, "other goods and services" and "wages and salaries", the disparities are much smaller. This is especially the case with per capita expenditures on "wages and salaries" (i.e., wage bill expenditures) because, as pointed out previously, they reflect a uniform national policy on wage rates and, to certain extent, the employment "norms" regulated by the central ministries (particularly on education and health). As also observed before, though, these very same "fixed coefficients" imposed from above to the local governments, may be contributing to *less disparities in the delivery* of basic public services across jurisdictions, but at the same time are also contributing to *less technical efficiency in production* of these services. Affecting the latter, there is a very skewed distribution in the O&M to wages bill cost ratio across jurisdiction—only the city of Chisinau is actually above the national average (0.63, which is very low for international standards), Tighina judet is around the average, and all the other judets are below the average, between 0.39 and 0.58.

Figure 2.5 Moldova: Disparities in Per Capita Expenditures Across Jurisdictions, by Economic Categories



C. MAIN ISSUES AND OPTIONS

Fiscal decentralization in Moldova has been characterized as a spasmodic process; considerable initial effort to put in place the foundations of a sensible legislative framework, followed by an absence of complementary regulation and poor implementation, and again followed by reactions against the ineffectiveness of decentralization, including actions for rolling back some important aspects of the initial reforms. A detachment between the intended policy (legislation) and the actual practice (implementation) is an outstanding feature of fiscal decentralization in Moldova. Lack of follow-up regulations and poor implementation are the critical problems related to this decentralization, which is reflected in the assignments of responsibilities and expenditure performance at the three levels of government, and explain the confusion of functions and competences which rendered, to a large extent, the initial reforms ineffective.

The main expenditure responsibility issues identified above include:

(a) too broad and vague assignment of responsibilities and competences both between the central and local governments, and especially between the second level (judets) and the first (municipalities/ primarias) level local governments. There are not yet clear-cut definitions of the delegated competence (as for regulation, financing and/or delivery of services) between the central and the local government. The lack of definition has contributed to certain reluctance from central bureaucracy (specially line ministries) to relinquishing powers to local governments. Also shared/ concurrent responsibilities are not clearly assigned, especially at local level between the judet and the municipalities/ primarias. The latter has led to great confusion and conflicts at local government level, contributing for ineffective policies and inefficient service deliveries. Major misunderstandings still exist on: (i) the responsibilities for the financing of capital expenditures, which has been pushed to local governments, but the majority of Judet Councils and Mayors argues that this is impossible to implement for lack of corresponding local revenue capacity; (ii) social assistance has also been pushed downwards, but apparently without a proper reviewing of affordable entitlements—which has led to an unfunded mandate and accumulation of arrears; and (iii) education has been assigned as shared function, but specific competences are not entirely defined, especially between the second and first level of governments.

(b) unequal administrative and technical capacities at the local government level, a factor that has contributed to the weak implementation of policies and prevented delivery of quality services efficiently. While these capacities may be adequate at the larger urban centers, this does not seem to be the case in the large majority of judets, municipalities, primarias and villages.

(c) perverse incentive inducing local government to inefficient use of scarce public resources. Central government still has exercised excessive and undue interference in areas already of exclusive responsibility of local governments, by retaining the power of, inter alia, controlling and approving tariff policies of utilities, wage rates and employment "norms". These interventions have distorted local resource allocation and created inefficiencies in the production and delivery of public services (social and utilities). One possible effect of this is the extremely low O&M to "wage bill" expenditure ratio for the majority of territorial units, which may be reflecting an inefficient combination of inputs (too little maintenance of structures and facilities and too much employment). Also, except for the autonomous territorial unit Gagauzia (which receives lump-sum allocations in the budget for specific purposes), the combined use by the central government of "expenditure norms" with "gap-fill transfers" has introduced a perverse incentive mechanism to local budget management. Fixed expenditure norms (even if based on national average and capitation) tend to discourage local administration to economize on expenditures if the gain are perceived as been clawed back by a lower "gap-fill transfer";

(d) inefficient management of the public properties by placing the ownership and the responsibility for maintenance and capital replacement at different levels of government. Most of the public asset ownership of both the social sectors (health and education) and the technical services (utility companies) has still been kept at the State level, while the responsibilities for maintenance and replacement has been shifted to the local budgets. This is a highly inefficient management system, which tends to lead to low maintenance of equipment, faster depreciation of the capital stock, and a premature depletion of the asset basis, contributing to a permanent deterioration in the production capacity and the quantity and quality of services provided to the citizens.

(e) de-capitalization and deplorable financial situation of the local utility companies, which does not augur well for provision of public services in the near future. The current situation is not sustainable in the long-run, since costs have not been recovered either owing to unrealistic tariff policies or a too low collection ratio of the utility bills. In face of the local budget constraints, increasing compensatory subsidies for the companies can hardly be maintained, so that the utility companies are currently "cannibalizing" their own capital basis while their financial and economic situations in the long-run are unsustainable. The current practice of utilizing a dual-tariff system that some utility companies have been allowed to use in order to deal with their financial situation in the short-run is an artificial and inefficient policy. This policy provokes distortions in the allocation of resources on the rest of the economy, is non-transparent from the public resource management point of view, and is highly regressive from the equity point of view (since the beneficiaries of the implicit subsidy are not targeted).

(f) considerable disparities in per capita local expenditures, especially between the capital city and the rest of the country, which runs against nation-building and may feed a feeling of unfairness, discontent and political instability.

To restore local government expenditure autonomy and ensure an efficient delivery of public services, the government of Moldova may consider reforming expenditure responsibilities by:

(i) decentralizing adequate decision-making powers on public expenditures asymmetrically, by reviewing and re-assigning well specified responsibilities and competences to local governments, and assuring adequate financing on the delegated functions. Areas of responsibility and specific competences should be properly regulated also for the second and first level of local governments, aiming at minimizing negotiations on attributions and resources. Specific responsibilities by function and competences (on regulation, financing and/or delivery) to each level of local government should follow the principle of subsidiarity, and be assigned asymmetrically, by taking into consideration the local relative technical and administrative capacities. Being of particular national interest, the financing of "basic education", "public primary health care package" (plus some essential functions like vaccination campaigns, preventive medicine, combat of contagious diseases), and "social assistance to the poor" should be re-assigned to the State budget, while decisions on the delivery of services should be kept as delegated competence to the local governments, who are better positioned for selecting and targeting beneficiaries.

(ii) defining a new strategic direction for the provision public services (including utilities) aiming at making it affordable and sustainable in the long term. The current dual price/tariff mechanism practiced by some utility companies should be banned outright in order to eliminate a source of inefficiency provoking distortions to the rest of the economy. Any subsidy policy (including utility, housing, transportation and others) should be tested against affordability and directly targeted to the needy, and always explicitly approved in the environment of the budget. The participation of the private sector both on financing and on provision of public services should be encouraged, and outsourcing public services to private providers should also be encouraged and become a common practice in Moldova. Privatization policy should continue and be embraced by the public utility and social sectors to the extent possible under a reformed regulatory framework. In the meantime, the utility tariff policies should be redesigned aiming at full cost recovery, and the existing utility companies should be administratively re-structured aiming at substantially increasing the ratio of collection of utility bill. A successful implementation of this new strategic direction for the provision of public services will require the following reforms:

- *transferring of the property rights on the assets (both social assets and of utilities) to the local governments* aiming at placing the ownership of the service delivery facilities in the same level of government where the responsibility for their maintenance is. This will tend to improve the maintenance of the assets, increase the necessary investments, and increase efficiency in the use of the capital. Although Moldova has approved general rules on property rights of the local governments, in practice the ownership of enterprises and service facilities has not being effectively transferred by the State. Identification of the assets, and their effective transfer and registration to the respective local governments are critical at this stage.
- *adopting utility tariff policy based on the principle of full cost recovery*, without disregarding the social condition of the population. This requires a separation of the two policy instruments: (a) the recovery of the cost of service delivered by the providers, on the basis of prices/tariff solely determined on technical and financial ground and implemented as such—which would help rationalize the consumption and the allocation of scarce resources, and sustain production in the long term; (b) the social objectives associated to the condition of the population being served, addressed by distinct and more adequate policy instruments at the local government budget, such as, *explicit* current "grants" to the targeted population (e.g., the poor);
- *regulating the specific sectors to facilitate and encourage cooperation* among local government units for a joint provision of services (either public or private companies, or an association among them), in order to explore economies of scale (by merging or associating existing companies), consider externalities among jurisdictions;
- *enforcing each local public utility company to submit its annual business plan* and previous year report for the approval of the local Council. The companies' Chief Executive Officers should be given full autonomy to perform, but be made personally

accountable before the law and the local representatives for the outcomes of their plans and actions.

(iii) promoting civil service reform, including local governments, to increase productivity of local public sector and efficiency in the delivery of public services. The reform should aim at a synchronized restructuring of careers on the basis of merit recruitment and promotion systems, with the promotion of improvements in the compensation system, and an optimization of the public employment by retrenching surplus labor. Also flexibility in wage and employment policies should be pursued at the extent possible.

(vi) reviewing the system of "expenditure norms", the shared-tax system, and the "transfer mechanism" to eliminate perverse incentives and unfairness. These reforms should be carried out simultaneously, since they impinge on each other. Once removed the imperfections and decided upon the new criteria, these instruments should be defined in *organic laws*, only sporadically reviewed on the basis of technical reasons, treated as purely technical mechanisms, and immune to from bureaucratic or political influences. This approach would aim to restore credibility in the intergovernmental fiscal relations, to provide predictability to the policy makers to all levels of government, and to the extent possible effectively contribute to converge per capita expenditure differentials across jurisdictions to the needs differentials (see also Chapters 3 and 4).

(v) promoting administrative and technical capacity building (including interpretation of the legislation and general regulation; uniform accounting procedures; monitoring and reporting systems; input, output and outcome indicators of performance) both for local government officials and also for those in the central government working in related areas. The promotion of capacity building is sine qua non to proceed with a sustainable implementation of a decentralized fiscal system in Moldova.

CHAPTER 3: REVENUE ASSIGNMENTS

The most important step in the reform of revenue assignments has been the enactment of the Law on Local Public Finance (Law # 167, of 1999). However, the revenue assignment scheme designed by this law is still unsatisfactory, since it falls short of:

(a) disengaging from the previous system of annually negotiated revenue assignments, because it only sets minimum sharing rates between the central government and the intermediate level of government (judets) for the most important taxes, such as VAT, CIT, PIT, and road taxes. It leaves for the annual budget execution laws to "regulate the specific ratios of tax-sharing;"

(b) providing subnational governments (judets/districts and primarias) with any measurable increase in formal tax autonomy; and

(c) establishing any explicit revenue assignments, not even minimum sharing rates, between the intermediate level (judets/districts) and the local level (primarias) of governments.

Therefore, Moldova has yet to put in place a stable and predictable system of revenue assignment for the subnational governments, including explicit regulation for the relations between primarias and judets/districts.

A. CURRENT ASSIGNMENTS OF REVENUES

The 1998 Tax Code only distinguishes between the national (or state) taxes and the local taxes and fees. State taxes and fees are those entirely regulated by the Parliament, while local taxes and fees are those over which Local Councils exercise some competences in conformity with the law. Regardless whether the taxes and fees are finally allocated to the state or to the local budget, all taxes and fees are administered by two central agencies—the Customs Control Department and the State Tax Service, accordingly. Box 3.1 presents and overview of the tax structure and tax assignments in Moldova in 2001.

Total revenues of the consolidated public sector have been decreasing in recent years, budgeted as 23 percent of GDP for 2001 as compared to 33 percent executed in 1997 (Table 3.1) The major sources of budget revenues are tax revenues, of which the most productive taxes have been the VAT and excises, respectively budgeted for 2001 at 37 percent and 19 percent of consolidated total revenues. The share of subnational governments in total consolidated revenues was budgeted to increase in 2001 to 33 percent form 29 percent in 2000 (Table 3.2)

State Taxes and Fees

Article 6 of the Tax Code specify the following as state taxes and fees: income tax; value-added tax, excise tax and fees (including stamp duties); “private” tax; customs duty and fees; and Road Fund fees (Box 3.1). [28] Out of these state taxes and fees, revenue proceeds from customs duty, excises, and value added tax (VAT) on imported goods are entirely allocated to the state budget, while the proceeds of personal income tax (PIT), corporate income tax (CIT), the VAT on domestic goods, and Road Fund taxes are shared in varying proportions with the intermediate level of governments (judets/districts, ATU Gagauzia, and the municipality of Chisinau). VAT and excise are the most important taxes, and in 2000 they represented about 40 percent and 20 percent of the tax revenue, respectively. Since the late 1990s between three-fourths and two-thirds of the total tax collection has been allocated to the state budget (Table 3.2).[29][30]

Shared taxes and fees

State shared taxes and fees are the most important source of revenue of sub national governments in Moldova (estimated in 57 percent in the 2002 budget—see Table 3.5). Tax sharing in Moldova is allocated on a derivation basis, meaning that each territorial unit of government shares the tax collected within its respective jurisdiction. The revenue sharing arrangements are regulated by the 1999 organic Law on Local Public Finance and the annual budget execution laws. The organic law established the following criteria for the tax sharing between the state budget and the judets/districts, ATU Gagauzia and Chisinau municipality:

. 100 percent of the PIT;
. At least 50 percent of the CIT;
. At least 10 percent of the VAT on domestic transactions;
. At least 50 percent of the Road Tax.

As a result of annual negotiations among levels of governments, the budget execution laws “regulates” the actual sharing ratios to prevail in a particular year. In general, very broad tax capacity and needs concepts have guided the final regulating ratios among Chisinau municipality, ATU Gagauzia and the judets. However, in fact the

[28] The “private tax” is a one-time charge levied on privatization transactions (Box 3.1).

[29] See also *Economic Trends*, quarterly issue (Table 4.1), Moldova, January-March 2001, TACIS-European Union, May 2001.

[30] There are also the payroll *social security contributions* (for pension and social assistance) of 31% (paid by the employers) and 1% (paid by the employees), plus the 10% of the gross revenue of unincorporated businesses, but these are resources, which flow directly as revenue of the Social Insurance Fund budget. Together with the State budget and the Local budget, the Social Insurance Fund budget form the national Consolidated budget.

sharing ratios have been highly unpredictable and continued changing substantially in the recent years as they used to change in the mid-1990s.[31]

The tax sharing rates between the central government and the judets for 2000 and 2001 are presented in Tables 3.3 and 3.4, respectively.[32] In 2000 all judets and also the ATU Gagauzia and the municipality of Chisinau received a 50 percent share of the revenues from the road tax. The same was also true for revenues from the CIT, but with the exception here of the ATU Gagauzia, which got a sharing rate of 100 percent. The bulk of the revenue sharing "regulation" took place through the varying sharing rates for VAT revenues. These varying rates ranged from 10 percent for the Balti judet and the municipality of Chisinau to 100 percent for ATU Gagauzia. All other judets got in the year 2000 a sharing rate of 30 percent of VAT revenues, with the only exception of Edinet, whose sharing rate for VAT was only 20 percent.

While the sharing rates for revenues from the road tax continue to be the same, at 50 percent, in 2001, the sharing rates for VAT and income tax changed radically. All judets plus the ATU Gagauzia received the maximum sharing rate of 100 percent for these two taxes. The only exception was the municipality of Chisinau, which had sharing rates of 10 percent for VAT and 50 percent for the CIT. The sharing arrangements in the proposed 2002 budget are the same as those for 2001.[33] Table 3.5 shows the effective sharing rates for all local governments by type of local revenue source in the 2002 budget. Among shared taxes, the central government reserves for itself 35 percent of the income tax on entrepreneurial activities (CIT), 62 percent of the VAT, and 50 percent of the road tax.

There is no direct tax sharing arrangement between the central government and the primarias. In principle, the above annual negotiation process on the shares of the "regulating taxes" (CIT and VAT) between the central government and the judets/districts, are supposed to be replicated at the subnational level of governments between the judets/districts and their respective primarias. (Although included in the category of shared taxes, PIT has traditionally being allocated 100 percent directly to the primarias on a derivation basis.) The outcome has been an asymmetric, unpredictable tax sharing system, with the primarias highly dependent on these negotiations of the

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[31] For the mid-1990, see also "Intergovernmental Fiscal Relations in the Republic of Moldova", prepared by KPMG for USAID, 1994; also Monika Huppi, "Fiscal Decentralization", background paper for PER (World Bank), 1996.

[32] Prior to the enactment of the Law on Public Finance, the central government also regulated its sharing rates with local governments. See Table A.3.1 in the Appendix for the sharing rates in 1999, as a recent example of past practices.

[33] Possible reasons explaining these recent changes in revenue assignments may include: (a) the unfunded mandates—especially the substantial responsibilities for the social protection area transferred to local governments with the 1999 reform—may have triggered increasing political pressures on the central government in the following years for the releasing of additional resources; (b) the argument (although not relevant in the Moldova context) that local governments would be more committed with the tax effort to reduce tax evasion if they were entitled to a larger share of the VAT and CIT; and (c) the special "concessions" made to the ATU Gagauzia on tax assignments, and the mounting political pressures by the other territorial units in the following years to equalize the "privileges".

“regulating” sharing ratios with the judets/ districts.[34] The 2002 budget estimates an overall 59 percent share of the state shared-taxes (PIT, CIT, VAT and Road Taxes) will flow into the subnational governments’ budgets, which will correspond about three-fourths of their total tax revenue (Table 3.5).

Local “own” taxes and fees

Local “own” sources of revenues includes taxes and fees over which local governments have some discretion in setting rates, and those completely controlled by the center but whose proceeds have been assigned 100 percent to local governments. The latter has been the case with the PIT, entirely assigned to primarias, and with the local tax on natural resources (water, mineral and forestry), entirely assigned to the judets/ districts. Nevertheless, excluding PIT, the overall contribution of the “own” taxes and fees to the aggregate subnational governments’ budget is estimated to be only about 24 percent in 2002 (Table 3.5).

Actually, the intermediate level governments (the judets/district), apart from taxes on natural resources, have not been assigned any other significant source of “own” revenues. (Their revenues are fundamentally composed by shared taxes with the central government.) All the other local taxes and fees (including land tax, real estate tax, and local fees), have been assigned exclusively to primarias, and follows the definition of those taxes in the Tax Code. Differently from the shared-taxes, on the framework of these local taxes and fees, the Law on Local Finance protects primarias against the discretion by judets. For instance, the new law on property taxes—land and real estate—to be effective in 2004, only establishes ceiling rates for the taxes, and primarias will have the discretion to decide on the rate more appropriate for their own individual jurisdiction.[35]

The current Tax Code still maintain the same list of the locally regulated fees established by the 1994 Law on Local Fees.[36] This means that local governments do not have freedom to introduce their own taxes and fees, but the Government plans to add to the Tax Code a new title, which would regulate the updated list of local fees. Local fees can only be imposed by primarias and not judets.[37] Primarias have an option to use any or all of the fees in the list. They make their choices by introducing the list of fees that

[34] These “regulating” sharing ratios are only one component of the budget “gap-fill” approach which still prevail in Moldova; the other being the “transfers” (see Chapter 4). This renders the assignment system overdetermined and cumbersome.

[35] Though there still is a long way to go in order to properly explore the potentials of the property taxes in Moldova. To start with, as a reliable cadaster of properties does not yet exist, the plans are to have one in place by end 2003, and shifting for market value of properties as for early 2004 (probably based on “mass valuation” approach). See more on this below.

[36] This is Law No. 186-XIII of July 19, 1994. The Law on Territorial Administration (# 191/98), the Law of Public Administration (# 186/98), and the Law on Local Public Finance reaffirm the right of local governments to choose from the list of local fees, and what rates to charge, as long as the maximum rates provided in the law are respected.

[37] Including municipalities, towns, communes, and village councils. Chisinau, although having the status of a judet/district, can, in its authority of municipality, impose local fees. ATU Gagauzia also is autonomous to impose its own fees from the authorized ones.

will be collected the following year in their annual budget. Primarias have discretion on the actual tariff rates used by choosing between maximum and minimum rates set in the law for each of the fees. Currently primarias are authorized to impose local fees on:

- territorial organization
- local auctions and lotteries
- hotel accommodation
- advertising
- use of local symbols
- business licensing and location
- market stalls
- car parking
- resorts
- domestic pets
- right to shoot films
- border crossing
- right to sell in a customs zone
- transportation services.

Although marginally important, fees are not a very significant source in the composition of subnational governments' revenues—less than 10 percent of the judet consolidate revenues. One exception is Chisinau municipality, which has been exploring well the potentials of this source, and where fees are already representing close to one-fifth of all revenues.

B. REVENUE PATTERNS[38]

The relative importance of total sub national government revenues, including grants, consolidated at the judet level has been planned at around 7 percent of GDP over the 2000-2002 period (Table 3.6.A). By source of revenue and leaving aside transfers, the PIT is most important, representing between 1.3 and 1.6 percent of GDP.[39] Transfers to local governments represent about 2 percent of GDP in the 2000-2002 period. Other important sources of revenue are the land tax, and shared revenues for the VAT and the income tax on entrepreneurial activities (CIT). Roughly speaking, according to this classification of the taxes, own revenues represent a little above 3 percent of GDP, while shared revenues and transfers each represent around 2 percent of GDP. For 2000 at least, actual (or executed) sub national government revenues exceeded those planned (Table 3.6.B). While planned total revenues represented 7.4 percent of GDP, actual revenues were as high as 8.9 percent of GDP. The comparison between planned and executed

[38] This section discusses only data after 2000. This is the first year for which the territorial reform introducing the judets became operational. The comparable data for the three years (2000-02), are only "planned" or budgeted data. Actual, executed budget data for 2000 were available only in a different format, as reported in separate tables in this section.

[39] Although according to the Tax Code PIT is considered a "shared" tax, it is classified in Table 3-6 as "own" local revenue.

budget data for 2000 shows considerable variation across sub national governments and by type of revenue (Table 3.6.C). Nevertheless, in the aggregate actual revenues exceeded planned revenues in most categories, the only exception being land and real estate taxes.

In 2000, PIT revenues amounted to 21 percent of total revenues, and the land tax 13.5 percent (Table 3.7.) Revenues from sharing the income tax on entrepreneurial activities (CIT) and the VAT were 8 percent and 7 percent, respectively. By comparison, planned revenues for 2002 show an increased importance of CIT and VAT shared revenues, with 11 and 15 percent, respectively. The planned land tax would fall to 10.6 percent of revenues in 2002, and the PIT 18.7 percent. Planned transfers are also down from 33 percent in 2000 to 28 percent in 2002. These changes would reflect trends in revenue basis but also discretionary measures by the central government for revenue sharing and transfers. As discussed in the next section, under the current "regulating" approach to revenue assignments, the distinctions between the different sources of revenues are not very meaningful, especially those involving revenue sharing and transfers.

These consolidated judet figures, however, mask significant variation among these jurisdictions in the relative importance of different revenue sources. These differences are shown for 2000 in Table 3.8.A (planned revenue) and Table 3.8.B (actual revenue).[40] For example, the relative importance of "own" revenues varies quite significantly. Seventy-two percent of planned revenues in Chisinau municipality were from "own" revenue sources (including PIT) and in Edinet 61 percent. At the low end, Ungheni was planned to raise 30 percent in "own" revenues and Chisinau judet only 27 percent. There is also substantial variation across judets on the relative importance of other revenues sources as well. The relative importance of shared revenues also reflects differences in economic bases and the current rules for the apportionment of these taxes. On transfers, for example, Tighina and Chisinau judets , at one end, actually received 60 and 63 percent of their revenues, respectively, in the form of central government grants in 2000. At the other end, Chisinau municipality, which was planned to receive no transfers in 2000, received 5 percent of its revenues in the form of transfers.

There was also significant variation in per capita revenues across judets in 2000 (Table 3.9.A and Table 3.9.B).[41] The main reason for these variations are the different sizes of tax bases due to different levels of economic development across the national territory. These disparities are quite high for some revenue sources. In the case of the PIT, Chisinau municipality was planned to collect 196 Lei in 2000 versus 17 Lei in Tighina judet. In reality, Chisinau municipality collected 239 Lei per capita and Tighina 21 Lei. The coefficient of variation for actual per capita PIT revenues was over 1.38. Because of the lower dispersion in other revenue sources in combination with the equalizing effect of transfers, overall disparities in per capita total revenues are not very

[40] To allow comparison with 2001-02 (Tables A.3.2 and A.3.3 in the appendix) table 3.8.A also present the planned figures.
[41] For variation in per capita planned revenues for 2001 and 2002 see Tables A.3.4 and A.3.5 in the appendix

pronounced. The range in total per capita revenues after transfers in 2000 was planned at 436 Lei for Chisinau municipality and 260 Lei for Balti judet (Table 3.9.A).[42] In reality, the range in total per capita revenues went from 655 Lei for Chisinau municipality to 284 Lei for Edinet judet (Table 3.9.B). The coefficient of variation for per capita total revenues in 2000 end up being 0.3—about one-fourth of the coefficient of variation for per capita PIT, CIT and VAT—showing a considerable equalization impact of the transfers, subsidies and grants over the sub national governments' total revenue.

C. MAIN ISSUES IN REVENUE ASSIGNMENTS AND PATTERNS

Unpredictable Revenue Assignments

Moldova still lacks explicit and stable revenue assignments. Moldova still uses a "regulating" approach to revenue assignments, which is intrinsically not different from that practiced in the former Soviet Union. The sharing rates for major taxes between the center and the judets and then between the judets and the local governments or primarias change by jurisdiction and from year to year according to what is dictated in the annual budget laws of the central and judet governments

During the transition period, revenue assignments have been ever changing and individually customized for each sub national government in each year's budget.[43] The main feature of the approach to revenue assignments has been to use different combinations of the main taxes, most importantly VAT and income taxes, to "regulate" the revenues of sub national governments. The sharing rates of sub national governments in those taxes have been customized so that the sub national government has just enough revenues to finance its "minimum expenditure budget."[44] In this approach, the forecast of sub national government "own revenues" are subtracted from the minimum expenditure budgets to arrive at the gap to be financed with revenue sharing. For poorer jurisdictions with a small tax base, where the retention of 100 percent of practically all collected taxes

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[42] The final position of Balti judet, probably the second richest jurisdiction in the country, possibly reflects the roughness of the regulation process through sharing rates and transfers. But it also tells an important story about the negative incentive to revenue mobilization now in Moldova's system.

[43] The process of revenue assignments in Moldova, for the most part, has continued to parallel the nested structure of budgeting in the former Soviet Union. The center determined the revenue assignments for the regional governments in its budget, and in turn the regional budgets determined the revenue assignments for local governments. Revenue assignments for local governments also included "own revenues," shared taxes with customized or "regulated" rates, and in some cases subventions from the regional governments. The determination of sharing rates and subventions for local governments mirrored the process followed between the center and the regional governments.

[44] In the early years of the transition this minimum expenditure budget was negotiated with the upper-level government authorities and, at least notionally, it was based on a large number of expenditure norms. Later in the transition, the elements of negotiation and norm-based budgeting have given way to a minimum expenditure budget primarily determined by the Ministry of Finance and based on very few norms. These norms earlier were based on previous-year expenditures adjusted for inflation, and more recently, on per capita expenditure norms. However, negotiation and bargaining, often around the use and the interpretation of the norms, continue to be basic features of Moldova's budget process. See the discussion in Chapter VI.

is not enough to finance the minimum expenditure budget, the remaining gap is financed trough a lump-sum transfers from the upper-level government.

Although considerable time and effort have been dedicated each year during budget preparation in Chisinau and in the judets' (and before 1999, in the rayons') capitals to bargaining the sharing rates for particular taxes, it is unclear whether this bargaining yielded any advantages to either side. The key variables in the bargain have always been the size of the minimum expenditure budget and the forecast of sub national government own revenues. The upper-level government always has had the last word for those two. It has been much less important which shared taxes or transfers are used to finance the budget gap. In fact, given the fact that sub national governments are to have just and only the amount of funding needed to cover the minimum expenditure budget, revenue assignments per se would have seemed irrelevant. As in other transition countries, the central government in Moldova has used mainly the VAT, but also the enterprise income tax, as the regulating instrument with the regions. Some other taxes (eg, the water tax or the forestry tax), most of them representing minor sources of revenue, have been allocated 100 percent to judet governments.

The two main advantages of the regulating approach to revenue assignments are, first, that it provides the central government (or the more generally upper-level governments) with budget flexibility, and second, that it can allow for high levels of equalization, which may be hard to reach with other revenue assignment approaches.

However, the regulating approach also has imposed significant costs on sub national governments. First,, the regulating approach deprives sub national governments of any measure of revenue autonomy. Revenue autonomy and "regulation" of taxes are intrinsically contradictory concepts. The lack of tax autonomy diminishes the efficiency and fiscal accountability gains associated with fiscal decentralization. Second, it deprives sub national governments of revenue certainty and predictability, which makes budgeting and planning over time much less efficient. In addition, the system can be unfair since it is subject to the influence of both lower and upper level government officials. Third, it creates perverse incentives for the sub national governments to increase tax collections, either through their own taxes and fees or by contributing to the better enforcement of shared taxes with the central government. Any increase in tax effort by local governments faces either a cut in the "regulated" sharing rates and/or, as the case may be, with a reduction in transfers. In essence the discretion (or , the lack of rules) leaves it open to upper level governments to claw back any increased revenues or even enhanced expenditure efficiency by local governments. Fourth, it has been a source of political friction and dissatisfaction between regional and local governments. Intermediate level governments, indeed, appeared to have routinely clawed back any additionally raised revenues by local governments. Although this practice is not supposed to happen, central government pronouncements have not been enough to take care of this problem. Local governments have reacted by lobbying against the budgetary authority of judet governments. Fifth, although recently less of a problem in Moldova, sub national governments are also given incentives to hide funds from the upper-level authorities through the use of extra-budgetary funds which detracted from the transparency and accountability in public budgets.

An alternative paradigm in revenue assignments, which by now, has been adopted by the Russian Federation, Ukraine, the Baltic states, and several other former soviet republics and Eastern European Countries, is to establish stable and uniform sharing rates between the central government and the judets and between the judets and the local government. These sharing rates would be established in organic laws (either Law on Public Finance or Law Budget System), in lieu of the annual budget laws, and only changed when justified by objective reasons, supported by technical study and after intense debate and consideration by the parliament. In this way, revenue assignments would not be subject to change every year, but rather would remain stable for a longer period of time, such as three or more years. This system can improve fairness, predictability, and introduce the right incentives for revenue mobilization at the local level. It should also address one of the most contentious sources of friction among different levels of government. But it needs to be acknowledged that making the sharing rates stable for periods of three years or longer may also be a challenge in Moldova because of the macroeconomic instability and policy uncertainty Moldova has faced during most of the transition years. It also needs to be acknowledged that establishing uniform rates in Moldova is made quite difficult because of the economic dominance of the capital Chisinau in the national economy. However, these two sources of difficulty are not unique to Moldova. In fact, most transitional countries have undergone macroeconomic uncertainty, although this may have been higher in Moldova than in many other transitional countries. However, the use of more rules throughout the economy tends to reduce uncertainties and may become a stabilizing factor. Moldova's concentration of economic activity in the capital city is also problem common to other countries, including several transition countries, such as Estonia or Latvia.

Of the two problems, lack of stability and lack of uniformity in revenue assignments, there is little doubt that the first carries more powerful negative implications. The lack of stability allows upper level governments to claw back and causes the negative perverse incentives. Introducing uniform revenue assignments is important for having a non-discriminatory and transparent revenue assignment. However, implementing uniform sharing rates for the major taxes such as the VAT and the enterprise profit tax is admittedly difficult given the unevenness in the territorial distribution of tax bases. Part of the solution may be the centralization of the VAT and the enterprise profit tax. The case for centralization is further explained below. If the centralization of the these majors taxes is not implemented, then uniform revenue assignments will require that none of the jurisdictions have higher sharing rates than Chisinau municipality.[45] Of course, this will require also higher transfers for most jurisdictions.

[45] This would follow the conventional rule that in the presence of fiscal disparities, revenue assignments in general and tax sharing rates in particular are to be set at a level that guarantees or nearly guarantees full revenue adequacy for the richest subnational jurisdiction.

Insufficient Local Tax Autonomy

The current system of revenue assignments provides subnational governments with little meaningful revenue autonomy.[46] In reality, judets do not have any own revenues since all funding (except for the taxes on natural resources) comes from shared taxes with the central government and transfers. Local governments do have their "own" revenues sources.[47] They can set rates for some local taxes, such as the land tax and the real estate property tax, and can choose among a list of local fees and also set rates for those fees up to a maximum legislated level. However, these sources of revenue are for the time being quite limited and on the whole provide local governments with only limited revenue autonomy.

More importantly, the current system of incentives leads local governments to make little use of the revenue autonomy with which they are granted. This is so because the current budgeting system provides upper level governments (the judets vis-à-vis mayorias but ultimately also the central government vis-à-vis judets) with the means to claw back any additional revenues collected by local governments that increase their tax effort by exercising their tax autonomy. Local governments that choose to use higher tax rates for the property tax, make use of a higher number of local fees, or charge higher rates for those fees are faced in the next budget period with lower revenue sharing rates and transfers from the judet government.[48] Similarly, if a higher number of local governments in a particular judet realize a higher tax effort in the current period, current budget practices imply that in the next budget period the Ministry of Finance may reduce transfers or even revenue sharing rates to the entire judet. Thus, the current arrangement for revenue assignments and transfers creates powerful negative incentives for revenue mobilization at the local level. Besides the fiscal pressure it imposes on the central government budget, the current arrangement ultimately leads to an atmosphere of soft budget constraints and lack of efficiency and accountability of local officials.

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[46] Despite the reality of a lack of financial autonomy at the local level, the national Constitution and several laws protect and guarantee local government self-governance and fiscal autonomy. For example, the Law on Local Public Finances articles 4 and 89 develop the concept of local autonomy. However, these pronouncements seem to be mostly rhetorical given the reality of lack of revenue autonomy.

[47] There is still some confusion in the current legislation about what is a local government own tax and what is a central government tax shared at 100 percent with local governments. This is the case, for example, for the PIT. In substance, the PIT should be considered in its current incarnation as a central government tax (shared with local governments), since local governments have no authority to change rate or base and its collections is carried out by the central authorities. One criterion sometimes used in Moldova to differentiate between central and local taxes is to take as central all taxes addressed in the Tax Code. But clearly this criterion is not foolproof since the real estate property tax is a local tax but it is also regulated in title VI of the Tax Code. Even for the local fees, that are now regulated by a separate law from 1994, the plans are to update and incorporate them eventually as Title VII of the Tax Code. In reality, the Tax Code does not determine the destination of taxes. This is done in the annual Budget Law, although the minimum sharing rates are set in the organic Law on Local Public Finance.

[48] Chisinau municipality is immune to this claw back, since it does not depend on any intermediate government. Moreover, it "negotiates" its tax shares with the state independently. Chisinau also have a privileged access to the central power. The Chisinau municipality mayor is a member of the Government, access not shared by any other local government in the country.

One test of the severity of the negative incentives for revenue mobilization is to analyze the extent to which local governments have exercised the tax autonomy they now have. In particular, how much use local governments have made of the local fees that they are currently allowed to introduce. Local governments currently have the right to use (or not) a number of fees from a list provided in the Law on Local Taxes and Fees, and they have as well discretion for setting rates for those fees up to a maximum established in the law. Aggregate information exists on the number of municipalities that have made use of the different fees, although no information is available on the rates actually used.[49] Table 3.10 shows the number of municipalities using different fees as of January 2001.[50] Only three of the 15 available fees are widely used: the fee on territorial development (81 percent of the municipalities use it), the business license and location fees (70 percent), and the market stalls fee (54 percent).[51] Way down in its frequency of use, but fast rising, is the fees on passenger transportation services (15 percent). All other fees are very infrequently used. Their lack of use reflects no doubt also lack of opportunity; for example, not many municipalities may have the opportunity to use the resort fee or the fee on crossing the State border. However, overall it would appear that municipal governments have been less than eager to make use of their autonomous revenue raising powers by using local fees.[52] Several reasons may explain the low use of local fees, including that many mayors lack previous experience in public finance issues. Finding low usage of local fees is not surprising given the fact that directly or indirectly the current budget system allows upper-level governments to claw back local revenue increases. The surprise may actually be that the local fees are actually used at all. The fact that Chisinau municipality uses local fees far more intensively than any other territorial unit is consistent with the fact that it is more immune to revenue claws back, since it does not depend on the transfers from the central government. Nevertheless, claw back for Chisinau still can take the form of lower tax sharing rates.

The benefits of fiscal decentralization arise only if local governments are accountable and able to respond to the needs of taxpayers. The most effective way to provide budgetary accountability and responsiveness is by granting local governments a meaningful degree of tax autonomy. Through local tax autonomy taxpayers become more aware of the costs of services and local officials' actions are subject to closer scrutiny by taxpayers.

One implication of the lack of explicit revenue sharing rules is that they vary from judet to judet. This informal approach provides judet governments with budget flexibility and it may even facilitate revenue equalization among local governments (municipalities

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[49] It appears, however, that once municipalities have decided to use a fee, the tendency is to use it at the maximum rate allowed.
[50] Actually, each municipality makes a decision in December each year on what fees and rates to adopt. Thus, it is possible for a municipality to stop using some fees that has used in the past.
[51] If we assume that any municipality making use of their right to introduce fees would first introduce the most popular one, the fee on territory development, then about 20 percent of the municipalities in Moldova still use no fees at all.
[52] Some of the fees, such as the fee on domestic pets and the fee on filming, are not used by any municipality. The municipality of Chisinau has been using 11 of the 15 available fees, and it clearly has more opportunities to implement several of these fees.

and primarias) within each judet. However, the current approach deprives local governments of revenue autonomy and reduces intergovernmental accountability. The lack of a formal assignment also reduces revenue predictability of local governments, diminishing their ability to plan and budget expenditures and it also provides local governments with negative incentives for revenue mobilization, at the same time that it encourages local governments to hide resources in extra-budgetary funds. The costs implied by the lack of formal revenue sharing arrangements between judets and primarias depend on the actual policies followed by the judet governments. The more unstable and unpredictable the revenue assignments are, the higher the costs imposed. The practices appear to vary from judet to judet, some keeping arrangements more or less stable from year to year and others changing sharing arrangements markedly every year.

There is little question that overall efficiency and equity of the system of intergovernmental fiscal relations in Moldova would significantly improve with the adoption of open formal revenue assignments between the judets and local governments. The choice for the central authorities is whether to put these assignments into law directly, without giving judets any choice or just to legislate mandatory principles or guidelines for how judets need to organize revenue assignments within their jurisdictions. The former option is more common among unitary countries, which may by-pass entirely the role of intermediate level of government in structuring revenue assignments for local governments. But whatever approach is used, it would need to be recognized that the reform of revenue assignments in Moldova should be accompanied by the reform of other aspects of intergovernmental fiscal relations, including expenditure assignments, equalization transfers and conditional grants, and the budget process.

Inadequate Tax Sharing Mechanism (VAT, CIT, and PIT)

Revenue sharing on a derivation basis is the most important source of revenues at the sub national level. This continues the budgeting tradition of the former Soviet Union. However, the high reliance on revenue-sharing arrangements may bring potential problems. Revenue sharing (as opposed to the assignment of own revenues) breaks the link between the benefits and costs of public spending.[53] This may be a factor promoting general fiscal irresponsibility, as local governments have incentives to under-utilize their own tax bases at the expense of national sharable revenues. Generalized fiscal irresponsibility arises because the burden of providing public goods and services can be exported or shared across jurisdictions, whereas the benefits of public sector spending are internalized and generate a political payoff to local governments. In contrast, the use of own revenues internalizes within the jurisdiction the costs of providing public services. In short, excessive reliance on tax sharing (and inter-governmental transfers) as the funding mechanism for local governments can discourage revenue mobilization and encourage overspending, leading to arrears, higher sub national deficits if they are allowed, and ultimately more pressure on the central government budget.

[53] The same argument applies to transfers. In reality, tax sharing on a derivation basis (whereby taxes are actually collected) or on any other form, such as per capita, is nothing else than another form of transfers.

Using the principle of "derivation" for revenue sharing, that is the splitting of revenues between the central government and the subnational jurisdiction where revenues are actually collected, introduces several additional problems. These are particularly acute for some taxes, such as the VAT and the enterprise profit tax (CIT).

The Value Added Tax (VAT). Even when the distribution of VAT revenues among local governments is fair, that is, when each level of government shares the revenues generated in its jurisdiction and not others, the process tends to lead to increased fiscal disparities across jurisdictions. This is because economic activity is unevenly distributed and the VAT is a large revenue producer. But in general the use of the derivation principle leads to an unfair distribution of resources since the VAT can be credited and debited in other local jurisdictions. For example, if the enterprise has production facilities (not independent units) in other jurisdictions, VAT in Moldova is paid exclusively in the jurisdiction where the headquarters of the enterprise is located. In more concrete terms, these problems have led the municipality of Chisinau to believe that their contribution to the public finances of the country may be too high and unfair when the fact may very well be that Chisinau actually benefits from the arbitrary results of the current sharing arrangements for the VAT.[54]

The use of the derivation principle for sharing VAT revenues also can lead to perverse market protectionism by subnational governments. The sharing of the VAT on a derivation basis is in fact equivalent to a provincial VAT system on an origin basis—the VAT is levied where production takes place, but with completely harmonized bases and rates as defined in the national law. A VAT system on an origin basis will typically lead to protectionist policies by local jurisdictions attempting to maximize their share of the VAT. This should encourage local governments to get further involved in market activities, offer special advantages to business and create artificial barriers to internal domestic trade.[55]

To make the VAT neutral with respect to the spatial allocation of production inputs as well as consumption, it is generally agreed that the VAT should operate according to the destination principle. This means that VAT should be levied and received by the local government where consumption takes place (destination basis), as opposed to where the goods are produced (origin basis). This would require the very undesirable introduction of internal borders to tax commodities being imported into the jurisdiction and zero-rate those that are being exported. These difficulties have led other countries to centralize VAT revenues, as most recently has been the case in Russia,

[54] It must be noted that in recognition of the fact that VAT is paid at the place of registration, Chisinau municipality is, for example in 2001, allowed to retain only 10 percent of the domestic VAT while other judets are allowed to retain 100 percent of the collections in their territories. However, this has been called a "crude" method, that end up confusing the matter of revenue allocation: causing resentment both in Chisinau, that may feel accessing less revenue than it collects, and in other judets, that may see enterprises operating in their territories but paying taxes exclusively in Chisinau.

[55] For instance, as evidence for their tax-raising effort, some judets' authorities reported that they have been conducting regular meetings with local businessmen (particularly local public enterprises) in order to discover ways and means that the judet government could help promoting local sales (that pay shared VAT locally) *as opposed to exports* (that does not bring to them any tax revenue!).

Ukraine and Kazakhstan. These countries now distribute VAT and other central government revenues through a formula-based system of equalization transfers and other grants (see Chapter 4). Other countries have used instead a direct formulary approach to the sharing of VAT with local governments, as in Germany, on a per capita basis, and in Canada with the Maritime Provinces, on the basis of statistical estimates of the final consumption of taxed items in each jurisdiction.[56]

The Corporate Income Tax. Similarly, the sharing of the CIT on a derivation basis also presents several problems. But, there are several reasons why the CIT is less than an ideal tax to share with local governments. The CIT tends to be an unstable source of revenue and for that reason less suitable for local governments, since local governments have less ability to borrow and are (quite appropriately) not supposed to run budget deficits. The tax burdens from the CIT are also more likely to be exported to taxpayers in other communities, a feature which detracts from political accountability and responsible local governance. The tax base of the CIT is also less evenly distributed than are most other taxes, which tends to increase horizontal fiscal disparities at the local level. Besides these concerns, the sharing of the CIT with local governments is further complicated by how apportionment of the revenues is carried out in practice.

Until last year, the effective sharing of the CIT by the central government with judets was by the place of registration or the headquarters of the enterprise.[57] This has been a source of relative unfairness since enterprise activities, and consequently the consumption of local public services, many times take place in jurisdictions other than the one where the enterprise is registered. However, finding a remedy to this unfairness is not an easy task.

A first best solution to the problem is simply the centralization of all revenues from the CIT. This may not be politically feasible, so a second best solution is to share the revenues from the CIT proportionally across local governments where the business operates. An acceptable approach to the sharing of the CIT among all jurisdictions in which the enterprise operates is to use an apportionment formula. The formulas used in other countries typically approximate the share of the enterprise income in a locality by a weighted average of several factors, which include the enterprise's share of labor, sales, and even assets in that locality vis-à-vis the entire country. Giving heavier weights to origin-based factors, such as labor and capital, favors producing jurisdictions while giving more weight to destination-based factors, such as sales, favors consuming jurisdictions. There is no exact way to arrive at an apportionment formula and practically the final choice is the result of a political compromise.

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[56] A third alternative is the creation of regional VATs. Long thought to be unworkable, several approaches have now been suggested in the public finance literature which in theory would allow for the functioning of subnational VATs. The introduction of regional VATs in Moldova, however would not be advisable, given the many difficulties still present with the administration of the central VAT. Thus, this alternative will not be discussed any further in the report.

[57] The Tax Code does not address the issue of apportionment of the EPT. Article 87 states that the place of payment shall be regulated by the State Tax Service through instructions. Some regulations on apportionment have been approved recently, and they are just starting to be used.

Recently (2000-2001) the State Tax Service introduced two formulary approaches to the apportionment of CIT revenues: according to the number of employees, and in proportion to the profits derived. Enterprises can decide which approach to use. Not surprisingly, given the inherent difficulties of dividing profits, the apportionment approach that appears to be used is the number of employees. It must be noted that as a national agency, the State Tax Service will have little interest in seeing that the right apportionment between jurisdictions is produced. For this to happen it would be necessary to let subnational jurisdictions claim with the State Tax Service and in the courts, if necessary, their right share by using clear and homogenous (across subnatational jurisdictions) nexus rules issued by the State Tax Service. Thus if the Government of Moldova decides to keep sharing CIT revenues with local governments, there is still room for improving how these revenues are actually shared.

The Personal Income Tax. Although the personal income tax (PIT) is a much more appropriate tax to be shared with local governments, the apportionment of the PIT at the local level also presents problems. This is because the PIT withheld by enterprises on wage income is paid at the place of work rather than at the place of residence of taxpayers where consumption of local public services occurs.

Weak property tax system

A modern improved real estate property tax is one of the most promising alternatives to introduce revenue autonomy at the subnational level and to promote local revenue mobilization in Moldova. The new Title VI of the Tax Code, "Tax on Immovable Property " was approved in June of 2000 and came into effect January 1, 2001. The reformed tax is based on territorial cadastres for registration and a mass appraisal approach for property valuations. It has a ceiling tax rate of 0.5 percent of the property assessed value and the actual tax rate is set by the local governments. The actual rate cannot be lower than 50 percent of the ceiling tax rate (or 0.25 percent). The reformed tax shall be computed on an annual basis by tax collectors within the mayor's office based on the assessed value of the property on January 1 of that year.

The problem is that the fiscal cadastre is not scheduled to be completed until the end of 2003, thus the complete property tax reform will not be in place until 2004. Until then, the valuation and rates will be annually determined by the Councils of municipalities and primarias (including communes, village, and town) in the process of adopting their annual budgets and in compliance with the limits in Law no 1056-XIV of June 16, 2000 on Implementation of Chapter VI of the Tax Code. As of the fall of 2001 serious doubts have arisen that the fiscal cadastre will be completed by the end of 2003. According to the Office of the Cadastre, so far only half of the properties have been registered, mostly for agricultural land. Registration in urban areas has been going much more slowly. One alleged reason is the lack of adequate financing of the cadastre activity. Several pilot projects are supposed to be introducing, in the interim, mass-appraisal techniques.[58] The process of land (only) assessment has started, but obtaining market values has proved to be quite difficult.

These developments threaten the effective implementation of the property tax reform. For as long as the assessment basis remains the old arbitrary criteria—based on unadjusted book values, location, "quality" and use of the assets—the property tax will remain without much relevance as a source of revenue autonomy for local governments. The Government needs to accelerate the implementation of the fiscal cadastres and the introduction of market-based assessment. If indeed the main obstacle to achieving these goals is the lack of adequate financing, increased funds should be allocated to this activity.

Outdated local fees user charges

One of the strengths of Moldova's intergovernmental finance system is the existence of a law on local fees, which regulates this important aspect of local revenue mobilization and also provides municipalities with some degree of revenue autonomy. The government is in the process of reforming the structure of local fees, which will become part of the Tax Code (the new Title VII). The thrust of the reform is to provide local governments with more discretion on rates, and better means also to enforce compliance. Some of the new fees being proposed have noticeable revenue potential. This is a worthwhile initiative, which will contribute to the strengthening of revenue assignments in Moldova. However, there is a potential problem in the proposed reforms. This is the introduction of a new sanitation fee, based on business turnover as the base and with rates between zero and 0.5 percent. Although it has a very small rate, this particular proposal for a sales tax equivalent needs to be evaluated carefully, since in the presence of a national VAT, it could increase business tax compliance costs quite significantly. In addition, since this will be a tax on business turnover, it will have also undesirable cascading effects.

A different aspect of revenue mobilization at the local level is the need to normalize user charges at the local level. Local spending agencies, including those involved in providing health and education services, have been making increased use of cost recovery charges for the services they provide. The growth in the use of cost recovery fees in fields such as health and education needs to be interpreted as a rational response from subnational authorities to cope with severe budget under-funding and limited revenue autonomy. In addition, revenues from fees are likely the only revenues protected from claw-back by upper level governments. Even though the extensive and unregulated use of these fees may have undermined accountability and efficient budget and expenditure management and carried negative equity implications for the poor, the practice also has contributed to increasing revenue mobilization at the local level. These additional revenues have helped to varying degrees fund the delivery of basic services that otherwise may have never been provided in Moldova's communities. In addition, the use of fees also has fostered cost recovery practices in some areas of public services,

[58] These activities are being supported by technical assistance projects from USAID and the World Bank.

which has the potential to improve the overall efficiency of local government expenditures.

The rationalization of user charges will need to be accompanied by the reform of revenue assignments at the local level to increase tax autonomy. This rationalization needs to separate between necessary and desirable fees and those that are not. In particular, cost recovery practices, i.e., fees that are charged to users of public services and which are commensurate with the cost of providing these services, should be kept. In fact, local governments need to increase their reliance on user charges to finance public utility services such as water and sewerage services, and in particular, public housing.

Peculiarities of the Autonomous Jurisdictions

The ATU of Gagauzia is currently demanding from the Moldovan government a special treatment in revenue assignment, which amounts essentially to a "single channel" arrangement whereby all taxes, levies, and payments would go to the budget of Gagauzia. These payments would include those paid on the border of the Republic of Moldova by business entities, which are registered in the territory of Gagauzia.

These claims are similar to—and actually go beyond what concerns border taxes—those demanded by some ethnic regions in other countries, such as in the case of the Russian Federation by Tatarstan and Bashkiria during the early years of the transition.[59] Gagauzia has based these claims on what appear to be a stretched interpretation of article 18 of the Law on the Special Legal Status of Gagauzia. Regardless of the validity of those claims, what is clear is that Gaguazia is demanding an asymmetric treatment within the system of intergovernmental fiscal relation in Moldova. The need and merits of those demands can be interpreted only from a political perspective.[60] It may be feasible to adopt certain concessions in revenue assignments to Gagauzia, but those should also be accompanied by increased expenditure responsibilities and/or exclusion from other types of central government transfers. Over time these demands may settle, as has been mostly the case in other countries, such as Russia.

There has also been some debate in Moldova regarding the appropriate treatment of the municipality of Chisinau in its special role as the capital of the country. This

[59] These demands for a single channel in Russia involved a claim to retain all revenues raised in the territory of the region, and were similar in one way and distinct in another from those being raised by Gagauzia. They included an agreement for a single payment from the region to the federal government to contribute to national expenditures at the federal level, such as defense, the judicial system or the repayment of the national debt. But, the demands of certain regions in the Russian Federation did not include border taxes, as is the case for Gagauzia. Even in the few countries where the constitution allows for an asymmetric assignment of revenues, such as for the Basque Country in Spain, these arrangements do not include border taxes. Some other national taxes such as excises are also excluded.

[60] From a technical or efficiency point of view, an asymmetric treatment could be justified if for example Gagauzia were a more institutionally developed region, ready to assume more fiscal responsibilities than other regions. But clearly this is not an applicable argument to Gagauzia. At any rate, asymmetric treatment based on an efficiency argument can only be temporary until other regions also reached an adequate level of institutional development.

debate has been complicated by the fact that a high level of economic activity and the headquarters of most Moldovan enterprises are concentrated in Chisinau. The concentration of tax revenues in Chisinau has led the government to “regulate” tax sharing for Chisinau at lower rates than those used for other subnational governments. In response, the municipality of Chisinau has continued to decry this “discrimination” and asked for more funding. In a reformed revenue assignment regime, as is being proposed here, the municipality of Chisinau would be treated on an equal basis with all other subnational governments. That is, own taxes and tax sharing rates would be the same as those of other local governments. In that reformed framework of revenue assignments, the city of Chisinau may be entitled to a specific grant from the central government to help with the costs imposed on the municipality that are associated with playing its role of capital city.

Deficient Tax Administration

Tax administration and enforcement is entrusted in Moldova to the State Tax Service, which has deconcentrated offices or tax inspectorates throughout the national territory. Each judet has a tax inspectorate office in the judet capital and several additional offices within the judet territory. For example, Balty judet has four other offices besides the one in Balty itself. Current arrangements are that the local tax inspectorates of the national tax administration are in charge of also collecting all local taxes and fees. The only exception is for the land tax and the property tax to be paid by physical persons, which are collected by local tax collectors.[61] These local tax collectors are hired and fully paid by the local governments and are not subordinated to state tax inspectorate authorities.[62]

Some potential problems exist with current arrangements. First, the allegiance of tax inspectors (who are employees of the national tax administration) with local authorities may compromise tax collections and enforcement objectives. The evidence is that tax inspectors of the national State Tax Service, even though appointed by the central authorities, receive some kinds of fringe benefit payments from the local authorities, such as housing and other amenities. Because of the importance for some municipalities of the economic viability of enterprises, the danger in Moldova is, as experienced in other countries in transition with similar institutional arrangements, that local authorities may put pressure on tax inspectors to go easy with particular taxpayers, especially for taxes that are mostly assigned to the central government. However, this issue may play a smaller role in Moldova because under current arrangements most local governments are allowed to retain most of the taxes collected in their territories. A second issue is whether tax inspectors, who are in charge of collecting all national taxes and practically the totality of local taxes and fees, are always going to exercise the same effort in collecting national and local taxes.

[61] Depending on their population size, some locality may not have their own tax collectors.
[62] The only exception if for procedures and general methodology.

There appears to be significant consensus in Moldova that in the future it would be desirable to convert the role of the local collectors into local tax administrations. Before designing a strategy to develop local tax administrations it may be wise to strengthen the central tax administration.[63] The role of any future local tax administrations should be significant in the administration of the new real estate property tax and all local fees. Other taxes possibly assigned to the local level, such as a piggyback personal income tax, still could be more efficiently administered by the state tax administration, which will have comparative advantages in audit and enforcement of these taxes.

D. OPTIONS AND POLICY RECOMMENDATIONS

Reforming Revenue Assignments

The reform of revenue assignments needs to be compatible in terms of vertical balance or overall level of funding for judets and primarias with the reform in expenditure assignments, transfers, and budgeting institutions. For example, it must be realized that with the budgeting system still in use based on minimum expenditure budgets, negotiation and gap-filling transfers, it would not be effective just to reform revenue assignments. Evidence that just the reform of revenue assignments will not do is provided by the spotty use of fees by local governments, even though local governments need the additional revenues.

The reform in revenue assignments also needs to be coordinated with tax policy and tax administration reform. For example, introducing more revenue autonomy at the local level would need to be done without increasing overall tax burdens in the economy. Until quite recently tax burdens in Moldova were as high as one-third of GDP, but tax effort has decreased significantly in the last years (Table 3.1).

Four major reform thrusts summarize the more detailed recommendations that will follow below:

(a) ***Providing judets/districts with a proportional rate of PIT piggybacking the nation PIT.*** In order to increase genuine revenue autonomy of local governments judets should be provided with proportional PIT piggybacking the national PIT, with maximum and minimum rates specified in the law;

(b) ***Accelerating the implementation of the real estate property tax at the primarias level.*** The property tax would still provide primarias with

[63] There is a significant agenda for reform in tax administration at the national level. In July 2001, Parliament approved the tax administration chapter of the Tax Code. The goal of this legislation is to improve tax and customs administration. Current plans include the establishment of a large taxpayer unit, the integration of the financial guard in the regular tax administration. In addition, the State Tax Service has continued to work on eliminating tax offsets, in-kind collections of current taxes and arrears.

discretion for setting rates within a band also fixed in the national law. Providing local governments with the ability to increase revenues at the margin by using their own taxes—as in (a) and (b)—would increase accountability and efficiency of judets and primarias.

(c) ***Centralizing the VAT and the CIT.*** In order to adequately fund equalization grants, conditional grants for education and health (if so decided), and other types of grants (for capital infrastructure and social assistance, for example), the VAT and the CIT would be retained by the central government, thus discontinuing the sharing of these taxes on a derivation basis as is now the case.[64] This reform would also address the current inequities inherent in the poor apportionment of these taxes among local governments.

(d) ***Sharing the progressive national PIT:*** There are several feasible options for sharing revenues from the progressive PIT. The sharing could be by formula (e.g. per capita), or by using the funds as part of an equalization pool, or on a derivation basis; depending on whether the government intends to strengthen the equalization process or leave more revenues where they are produced. If revenue sharing on a derivation basis is the selected option, then it would appropriate to use uniform (or identical) sharing ratios across local governments. In addition, these sharing ratios should be made stable for a period of time, say three or more years.[65]

Increasing revenue autonomy

One of the first priorities in the reform of revenue assignments in Moldova should be granting local governments a higher degree of tax autonomy. This will be the best way to address existing vertical imbalances and to increase efficiency and accountability of local budgets. Tax autonomy at the local level can take the form of having discretion to introduce new taxes, discretion to define and change the tax base of existing taxes, or discretion to vary the rates for existing taxes. The least costly of these options, in terms of compliance and administration costs and interference with the central government's ability to maintain macroeconomic stability, is to confine local tax autonomy to choosing the tax rate levels of a closed list of local taxes with common tax bases throughout the national territory.[66] In this regard the taxes assigned to the local level should exhibit

[64] This policy option is often considered in Moldova as one that would reduce the autonomy of local governments. Revenue sharing on a derivation basis is just another form of transfer, since local governments have no control over their amounts. Its substitution for equalization transfers would not reduce the autonomy of local governments since both transfers are unconditional. However, this substitution would have an impact on the territorial distribution. If conditional grants are used in substitution of revenue sharing there would be some reduction in local autonomy. This may be considered as the cost of ensuring the national priorities pursued with the conditional grants. (Chapter 4)

[65] One way to help stabilizing the sharing tax revenue for the local governments is to adopt a new methodology for the computation of the revenue allocation which is based on moving averages of tax collection, instead of the actual current collection.

[66] In the case of Moldova, increased local tax autonomy should be made revenue neutral by reducing the rates of existing taxes or eliminating some of the existing taxes.

several properties. First, local taxes should encourage the link between payment and benefits received in order to improve political accountability and help match the demand and supply for public services at the local level. Second, local taxes should tend to be more equally distributed geographically to avoid creating large horizontal disparities. Third, they should not be exportable, in order to encourage responsible fiscal behavior. They should have immobile bases in order to minimize the distortions created by their impact on factor location. Finally, local taxes should be quite stable over time and in particular exhibit low sensitivity to the business cycle because of the lower ability of local governments to finance deficits.

There are probably no taxes that can completely exhibit this list of desirable characteristics and at the same time provide adequate revenue for local governments. But it needs to be clear that not all taxes are created equal for their assignment to local governments. There are better and worse choices that can be made in the assignment of local taxes in the face of these desirable features. In the actual international experience, the PIT and property taxes are the two most frequently used taxes to provide revenue autonomy to local governments. Some countries also rely, but much less so, on the taxation of consumption at the local level in the form of sales and excise taxes.

A Piggyback Personal Income Tax: The most obvious choice to provide judet governments with some degree of tax autonomy is to develop a piggyback flat rate PIT. Larger local governments could also be allowed to join in with a piggyback rate of their own. However, the current progressive PIT is wrongly assigned at the local level of government on a derivation basis. The main justification for a progressive rate structure is to redistribute income. But if the tax is shared with local governments at 100 percent on a derivation basis, all redistribution would be localized and richer jurisdictions will get more funds, and the allocation scheme would be regressive instead. A reformed PIT could be split into two different taxes. First, a progressive PIT would be assigned to the central government. This progressive part could be shared with local governments in different ways, including using the revenues to partly fund equalization grants. Second, a proportional flat rate PIT piggybacking the national (progressive) PIT would be assigned to the local level. This tax would be (eventually) paid by the place of residence and would give local governments discretion to set rates between minimum and maximum bands legislated by the Parliament. Also as just mentioned, the flat rate PIT can be assigned to one single level of government (say, judets) or can be split in a pre-arranged legislated way among different subnational levels of government (say, among judets and primarias).

***A Real Estate Property Tax*:** The best choice to develop local tax autonomy in Moldova is to give full financial support and accelerate the introduction of a modern real estate property tax. However, from the viewpoint of revenue yield, the property tax will take some time to produce noticeable results. The key to the successful introduction of the new property tax will be the completion of the fiscal cadastre, the introduction of efficient market-based mass appraisal methods, and a fair and transparent administration of the tax, including efficient appeals procedures. Given the difficulties involved in completing the cadastre and introducing mass appraisal, the government may consider assessment procedures, for an interim period, that are less complex and sophisticated. Updating some of the presumptive methods now used for the land and property tax could yield significant improvements in tax revenues. Another way to enhance local tax autonomy associated with the real estate tax is to regulate the voluntary introduction by municipalities of "betterment" or improvement levies. These are surcharges to the property tax that municipalities may approve within their jurisdictions, as one time or multi-year charges, for improvement directly benefiting certain homeowners, such as improvements in street lighting, sidewalks and so on. These levies have become common in many developing countries and in some cases represent a significant source of revenue.

Other options: Other less obvious options exist for enhancing revenue autonomy at the local level in Moldova. One of these options is to allow large municipalities to introduce local surcharges on the central government excise taxes on alcohol, tobacco and petroleum products. This may not be a feasible innovation given the small size of jurisdictions and therefore small distances to other jurisdictions' borders in Moldova. This raises the possibility of "smuggling" the taxed products from other jurisdictions. This policy would also require the strict use of stamps at the factory or point of importation for the product to be sold in each jurisdiction. Another possibility for increasing local tax autonomy is the introduction of a surcharge in the VAT as a final local sales tax. This tax would have the same base and structure as the VAT and would be paid exclusively on final sales.[67] A conceptually superior choice would be the introduction of a destination-based regional VAT, with discretion to set rates, and implemented side by side with the national VAT. In practice, there is little international experience with this type of tax and it requires a very well developed tax administration and enforcement apparatus of the VAT. The regional VAT is also much better suited for large federative countries than for small countries like Moldova.

Introducing predictable revenue assignments

The lack of stable revenue assignments (from year to year) not only contributes to the lack of revenue autonomy at both the judet and the primaria levels[68], but it also deprives these local governments of any minimum degree of budgetary certainty to plan their expenditure programs over time. Local governments' inability to predict their revenues leads to poor planning, rushed decisions, and the inefficiency of public expenditures.

One of the most important steps to improve revenue assignments in Moldova is to introduce uniform and stable revenue assignment (for a period of three years or more), including sharing rates at the judet and primaria levels. There is a clear need to move the

[67] The weakness of this proposal is that it may lead to avoidance and evasion by final consumers representing themselves as intermediate producers and the latter making purchases for final consumers. The advantage of this option of a surcharge over a separate local final sales tax is that the latter is more likely to increase compliance costs among merchants and make enforcement much harder for the tax authorities.

[68] Without stability of revenue assignments upper level governments can always change revenue assignments next year to claw back any additional revenues raised by lower level governments.

entire system of revenue assignments to a system that is stable over time and that is uniform, to the largest extent possible. Explicit and stable revenue sharing rules between the judets and primarias should be directly stated in central government legislation.[69] Revenue assignments, including sharing rates between different levels of government should be established in the organic laws—e.g., the Law on Local Public Finance (instead of annual budget laws as is currently done)—which should be changed less frequently and only under technical, sound justification.

The provision of stable and uniform revenue assignments at the judet and primaria levels is crucial for an accountable and efficient system of decentralized government. However, the establishment of stable revenue assignments will require a careful exercise quantifying the expenditure responsibilities of different levels of government. Given the significant disparities in revenue basis between Chisinau and the rest of the country, the establishment of uniform assignments may require a more extensive use of direct transfers and less use of revenue sharing on a derivation basis, as it is now the case. Although difficult to implement, these tasks are doable, as has been shown by other countries in transition in similar circumstances to Moldova, such as Estonia, Latvia, and Lithuania.

Nevertheless, revenue uncertainty and the negative incentives toward revenue mobilization will not be simply eliminated by introducing stable and uniform revenue assignments. These goals will also require neutralizing other avenues upper-level governments can use to claw-back lower-level governments' revenues. This will require, among other things, a system of transfers based on formulas and objective and predictable criteria and the adherence to a hard budget constraint culture for all dealings between different levels of government. Getting rid off the current negotiated "gap-fill" transfer mechanism and putting in its place a more effective, properly funded, formula-driven system of transfers is discussed in the next chapter.

Apportioning Shared Taxes Adequately

There are two possible solutions to problem of sharing the VAT. The first is to completely centralize revenues from the VAT. This is the solution adopted in recent years by many other transition countries, including Russia, Ukraine and Kazakhstan. The centralized revenues could be used by the central government to finance conditional grants for education and health or to increase the pool funds available for equalization under a new formula-driven approach. The second solution is to apportion the VAT revenues, now shared with local governments on a derivation basis, by using one of several fairer and more transparent alternatives. These include the sharing on an equal per

[69] An alternative approach is to legislate general principles of revenue assignments that the intermediate levels of government must follow vis-à-vis municipal governments. These principles would spell out how to structure revenue assignments at the sub-judet level and would need to be fixed for a period of several years. This latter approach may be less relevant to Moldova, as a unitary country of rather small size. However, the approach may help Moldova deal its subnational complexities, such as ATU Gagauzia and Transnistria.

capita basis or the sharing in proportion to estimates of final consumption in each jurisdiction. In any cases these significant changes in policy should be carried out in the context of a wider set of reforms, to insure horizontal fairness and an adequate vertical balance among the different levels of government.

Revenue allocations of CIT were often unrelated to where actually economic activity took place, leading to a mismatch between the demand for public services and the availability of budget resources. In response to this problem, the government recently introduced a formulary approach to the apportionment of CIT revenues based on the geographical distribution of the enterprise's payroll. If this formula is in effect applied in the future, the apportionment of CIT revenues will become better balanced and fairer. However, the use of an apportionment formula only mitigates rather than resolving the problem of an arbitrary distribution of revenues. For example, CIT revenues could also be apportioned according to the geographical distribution of assets or sales. Actually there is no perfect formula to distribute CIT revenues fairly. The use of a formula is a second best approach. The best solution to this issue is to centralize the revenues from the CIT and use these revenues to fund either conditional or equalization transfers to local governments.

Whether the PIT is reformed along the lines recommended above or it continues to be shared (without structure changes) with local governments, the government should consider adopting the principle of sharing PIT with local government according to the place of residence of workers. The proper sharing of the PIT is an issue only for those situations where individuals may live and work in different local jurisdictions. In these cases, the residence criterion tends to yield a fairer distribution because individuals tend to consume more services in their places of residence.

Rationalizing the Current System of Fees

The government should proceed with the reform of the system of local fees and make it part of the Tax Code (the new Title VII). This initiative will contribute to promoting local revenue autonomy in Moldova. However, it is not desirable to introduce a turnover sales tax by the back door with these measures. This is a tax with many problems and one that will conflict in terms of administration and compliance with the current VAT.

There is a need to normalize user charges at the local level. These practices may be quite justified for some services as desirable cost recovery and they may be further justified in an era of budget stringency, when local budgets are not providing sufficient funding for basic services. However, there are two main concerns that need to be addressed by the government. First, the use of user charges may exclude from service consumption the poorest groups of citizens. This would be counter productive and could severely undermine the government objectives for income redistribution and fighting poverty. One solution is to use, where feasible, lower fees for the poor. A more general and preferable solution is to rely in income support programs for the poor that include need arising from higher services fees. Second, these user charges need to be brought into the open, made official and be regulated and controlled.

Streamlining Tax Administration

The first priority in this area is for the government to continue the modernization and strengthening of the national tax administration, the State Tax Service. In the medium term at least, local governments need to continue to rely on the state tax administration to collect their taxes. There are, however, three issues that need to be tended to.

First, the *de facto* subordination of tax administrators to local authorities can still create conflicts of interest now or in the future. It would be desirable to make it illegal for local authorities to provide any direct or indirect compensation or payments to state tax inspectorate employees, including housing, bonuses. For this measure to be effective, the central government needs to fund adequately the budget needs of the state tax administration.

Second, central government tax administrators may not have as a priority now, or in the future, collecting local taxes and fees. The best way to address this problem is to arrange for a formal payment from the local governments to the central tax administration, by drawing incentive compatible contracts between the two parties. For example, the payment may be a small percentage of collections, with increased payments for increased collections.

Third, now is the time to start thinking about and preparing for the creation of local tax administrations in the future. The objective should be to develop the role played now by the tax collectors into full fledged local tax administrations in charge of collections of all local taxes and fees, with the exception of those that piggyback on national taxes. This could be done on a pilot basis in some larger primarias. There will also be a need to address the problem of inefficient scale of operations in the case of small local governments. Where local governments are too small to operate their own tax administration at a minimum level of efficient scale, the option would be for those local governments to contract with an upper level government for the administration and collection of their taxes. These contracts need to be incentive compatible so that the upper level tax administrators have an interest and responsibility to collect local government taxes.

Table 3.1: Consolidated Fiscal Revenues By Major Source (Annual)

	1997	1998	1999	2000bdgt	2000 prel	2001bdgt
			Nominal, Lei million			
Tax Revenues	2,298.5	2,205.8	2,422.8	2,976.9	3,065.8	3,700.8
o/w Profit Tax	244.1	178.6	233.4	262.2	275.2	348.4
Income Tax	281.9	234.0	218.7	234.5	264.6	271.0
VAT	948.9	1,124.0	940.2	1,293.3	1,332.6	1,627.0
Excises	401.1	374.6	444.5	612.4	657.6	834.0
External economic activity	127.4	109.4	230.8	216.0	222.4	263.0
Non-Tax Revenues	643.2	516.1	566.0	958.3	866.0	739.0
Profits from National Bank	131.1	187.8	159.7	384.0	387.3	250.0
Grants			111.5	128.0	132.4	
Total Revenues	2,941.7	2,721.9	3,100.3	4,063.2	4,064.2	4,440.0
			% of Total Revenue			
Tax Revenues	78.1	81.0	78.1	73.3	75.4	83.4
o/w Profit Tax	8.3	6.6	7.5	6.5	6.8	7.8
Income Tax	9.6	8.6	7.1	5.8	6.5	6.1
VAT	32.3	41.3	30.3	31.8	32.8	36.6
Excises	13.6	13.8	14.3	15.1	16.2	18.8
External economic activity	4.3	4.0	7.4	5.3	5.5	5.9
Non-Tax Revenues	21.9	19.0	18.3	23.6	21.3	16.6
Profits from National Bank	4.5	6.9	5.2	9.5	9.5	5.6
Grants			3.6	3.2	3.3	
Total Revenues	100.0	100.0	100.0	100.0	100.0	100.0
			% of GDP			
Tax Revenues	25.8	24.2	19.7	18.7	19.2	19.2
o/w Profit Tax	2.7	2.0	1.9	1.6	1.7	1.8
Income Tax	3.2	2.6	1.8	1.5	1.7	1.4
VAT	10.6	12.3	7.6	8.1	8.3	8.4
Excises	4.5	4.1	3.6	3.9	4.1	4.3
External economic activity	1.4	1.2	1.9	1.4	1.4	1.4
Non-Tax Revenues	7.2	5.7	4.6	6.0	5.4	3.8
Profits from National Bank	1.5	2.1	1.3	2.4	2.4	1.3
Grants	0.0	0.0	0.9	0.8	0.8	0.0
Total Revenues	33.0	29.8	25.2	25.6	25.4	23.0
GDP, lei million	**8917**	**9122.1**	**12321.6**	**15900**	**15980**	**19300**

Source: World Bank Resident Mission, Ministry of Finance

Table 3.2
Share of Subnational Revenues in the Consolidated Total Revenues
(Budgeted figures. Nominal Lei million)

	2000	2001
Consolidated Fiscal Revenues in the public sector	4,063	4,440
Total Revenues at the Subnational Level	1,182	1,477
Subnational Revenues as a Percent of total	29.1%	33.3%

Source: Ministry of Finance

Table 3.3
Tax sharing rates between the Central and Judet Governments for 2000

Administrative territorial unit	Sharing rates in percent		
Judets	Income tax on entrepreneurial activity	VAT on domestically produced goods	Fee for travel on roads of Moldova by vehicles registered in the Republic of Moldova
Balti	50	10	50
Cahul	50	30	50
Chisinau	50	30	50
Edinet	50	20	50
Lapusna	50	30	50
Orhei	50	30	50
Soroca	50	30	50
Taraclia	50	30	50
Tighina	50	30	50
Ungheni	50	30	50
Autonomous territorial unit			
Gagauzia	100	100	50
Municipality Chisinau	50	10	50

Source: Ministry of Finance

Table 3.4
Tax sharing rates between the Central and Judet Governments for 2000

Administrative territorial unit	Shared revenues, in percent		
Judets	from the income tax on entrepreneurial activity	from the VAT on domestically produced goods*	from the fee for the use of roads, levied on owners of vehicles registered in the Republic of Moldova
Balti	100	100	50
Cahul	100	100	50
Chisinau	100	100	50
Edinet	100	100	50
Lapusna	100	100	50
Orhei	100	100	50
Soroca	100	100	50
Taraclia	100	100	50
Tighina	100	100	50
Ungheni	100	100	50
Autonomous territorial unit			
Gagauzia	100	100	50
Municipality Chisinau	50	10	50

***Except for VAT on phytotechnical products, cattle breeding and horticulture in kind, alive and slaughtered cattle delivered by its producers.**
**The amount of VAT on goods produced and services provided on the territory of Chisinau municipality to be collected in the year 2001 above the sum of 319.7 million lei shall be distributed equally between the state budget of Chisinau municipality.
Source: Ministry of Finance

Table 3.5
Local Government Revenue Sharing in Total Collections in the 2002 Budget

	Total Collections	Sub-national Share	Sub-national Budgets
CIT	326 100	65%	211 100
VAT	760 300	38%	292 300
Road Tax	28 946	50%	14 473
SHARED TAXES	1 115 346	46%	517 873
PIT	356 250	100%	356 250
Land Tax	201 949	100%	201 949
Subsoil Tax	10 301	100%	10 301
State Duty	11 670	100%	11 670
Property Tax	28 759	100%	28 759
Revenues from Privatization	20 359	100%	20 359
Local Taxes	67 402	100%	67 402
Fees	109 914	100%	109 914
Other Taxes	45168	100%	45 168
Revenues, pre-transfers	1 967 118		1 369 645
Transfers			540 300
Total Revenues, post-transfers			1 909 945

Table 3.6.A

PLANNED REVENUES OF JUDETS' CONSOLIDATED BUDGETS

(Share of GDP, 2000-2002)

	2000		2001		2002	
	Million Lei	As Share of GDP, %	Million Lei	As Share of GDP, %	Million Lei	As Share of GDP, %
PIT	249	1.6	270	1.3	356	1.3
Land Tax	160	1.0	202	1.0	202	0.8
Subsoil Tax	12	0.1	12	0.1	10	0.0
State Duty	12	0.1	12	0.1	12	0.0
Property Tax	35	0.2	33	0.2	29	0.1
Privatization Revenue	17	0.1	20	0.1	20	0.1
Other Local Taxes	111	0.7	92	0.4	222	0.8
Total Own Revenues	596	3.7	640	3.1	852	3.2
CIT	96	0.6	181	0.9	211	0.8
VAT	84	0.5	239	1.2	292	1.1
Road Tax	17	0.1	17	0.1	14	0.1
Total Shared Revenues	197	1.2	437	2.1	518	1.9
Transfers	388	2.4	401	1.9	540	2.0
Total Revenues after Transfers	1 182	7.4	1 477	7.1	1 910	7.1
GDP Estimate	15 980	100.0	20 724	100.0	26 876	100.0

Table 3.6.B
Revenue of Judets' Consolidated Budgets as Share of GDP
(Executed 20002)

	Revenue Source	Million Lei	Share of GDP
	Total Revenues before Transfers, Subsidies and Grants	944.8	5.9
	PIT	*263.9*	*1.7*
Of Which	*Property Tax (Land & Real Est.)*	*186.9*	*1.2*
	CIT	*139.6*	*0.9*
Of Which	*VAT*	*98.3*	*0.6*
	Transfers, Subsidies and Domestic Grants	484.1	3.0
	Total Revenues after Transfers, Subsidies and Domestic Grants	1 428.9	8.9
	GDP Estimate	15 980.0	100.0

Table 3.6.C
Executed Data for Year 2000 as a percent of Planned 2000 Data for Judets' Consolidated Budgets

	CIT	VAT	PIT	Property Tax (Land & Real Est.)	Total	Other Revenues before Transfers, Subsidies and Grants	Total Revenues before Transfers, Subsidies and Grants	Transfers, Subsidies and Domestic Grants	Total Revenues after Transfers, Subsidies and Domestic Grants
1. Balti	102.0	74.1	87.3	117.4	99.7	176.1	115.0	117.5	115.8
2. Cahul	174.4	95.9	93.0	107.0	106.2	205.3	122.2	113.7	117.4
3. Chisinau	170.8	67.7	107.0	101.2	101.3	169.7	113.2	106.8	109.0
4. Edinet	167.0	42.8	49.4	96.3	80.1	113.6	85.5	168.4	107.7
5. Lapusna	149.2	118.9	74.9	83.6	88.5	200.1	104.9	109.8	107.4
6. Orhei	80.2	49.1	114.7	78.9	79.1	149.6	90.0	107.8	99.9
7. Soroca	95.3	124.0	61.7	91.3	85.9	173.1	95.5	114.6	103.1
8. Taraclia	320.8	131.2	136.7	64.9	99.3	215.2	113.2	123.6	117.9
9. Tighina	186.2	143.7	117.7	95.7	108.5	178.6	118.6	111.6	114.3
10. Ungheni	131.1	58.1	76.3	88.7	84.5	206.4	100.2	106.1	103.6
11. UTA Gagauzia	97.1	183.2	59.4	106.9	121.5	146.2	125.0	359.2	159.4
12. Mun. Chisinau	158.7	160.8	121.8	97.1	132.4	253.1	153.9	-	162.0
TOTAL	145.0	117.1	105.8	95.8	110.3	206.5	126.2	124.7	125.7

Table 3.7
Structure of Judets' Consolidated Budget
(Planned 2000-2002)

	2 000		2 001		2 002	
	Thousand Lei	Share of Total Revenues after Transfers, %	Thousand Lei	Share of Total Revenues after Transfers, %	Thousand Lei	Share of Total Revenues after Transfers, %
PIT	249 400	21.1	269 850	18.3	356 250	18.7
Land Tax	160 000	13.5	202 485	13.7	201 949	10.6
Subsoil Tax	12 000	1.0	11 645	0.8	10 301	0.5
State Duty	11 640	1.0	11 500	0.8	11 670	0.6
Property Tax	35 000	3.0	32 775	2.2	28 759	1.5
Revenues from Privatization	17 330	1.5	19 960	1.4	20 359	1.1
Other Local Taxes	110 750	9.4	91 725	6.2	222 484	11.6
Total Own Revenues	596 120	50.5	639 940	43.3	851 772	44.6
CIT	96 250	8.1	180 985	12.2	211 100	11.1
VAT	83 968	7.1	239 270	16.2	292 300	15.3
Road Tax	17 000	1.4	16 755	1.1	14 473	0.8
Total Shared Revenues	197 218	16.7	437 010	29.6	517 873	27.1
Transfers	388 200	32.9	400 548	27.1	540 300	28.3
Total Revenues after Transfers	1 181 538	100.0	1 477 498	100.0	1 909 945	100.0

TABLE 3.8.A
Planned 2000 Composition of Local Revenues by Judet
(as % of Total Revenues after Transfer)

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	18.1	15.5	1.5	1.8	3.4	1.5	10.3	52.2	7.4	5.0	1.4	13.8	34.0	100.0
2. Cahul	9.2	17.6	0.6	0.2	2.0	0.5	7.4	37.5	2.3	4.9	1.3	8.5	54.0	100.0
3. Chisinau	7.1	11.7	0.5	0.8	1.7	0.7	4.1	26.6	2.4	6.1	1.1	9.6	63.8	100.0
4. Edinet	14.8	27.9	1.7	1.4	4.7	2.2	8.0	60.8	2.9	8.8	1.8	13.5	25.8	100.0
5. Lapusna	9.9	21.7	0.3	0.9	2.6	0.8	6.4	42.6	2.4	3.6	1.2	7.2	50.2	100.0
6. Orhei	6.7	14.8	0.7	0.5	3.5	0.8	5.4	32.5	4.0	7.9	0.7	12.7	54.8	100.0
7. Soroca	15.9	24.1	1.2	0.4	2.7	1.1	4.7	50.2	4.4	5.2	1.1	10.8	38.9	100.0
8. Taraclia	9.2	28.6	0.8	0.3	2.6	0.4	6.2	48.1	2.8	3.3	1.2	7.3	44.6	100.0
9. Tighina	4.9	20.7	0.5	0.2	2.0	0.5	4.8	33.7	1.5	3.6	0.7	5.8	60.5	100.0
10. Ungheni	9.2	12.4	0.8	0.7	2.8	0.7	3.8	30.3	4.3	7.2	0.9	12.4	57.3	100.0
11. ATU Gagauzia	17.9	16.2	0.5	0.4	2.3	0.6	11.6	49.6	9.1	26.0	1.0	36.1	14.4	100.0
12. mun. Chisinau	45.0	2.5	1.3	1.4	3.3	2.6	16.2	72.4	18.1	7.3	2.2	27.6	0.0	100.0
Coefficient of Variation	0.766	0.414	0.502	0.681	0.299	0.708	0.497	0.303	0.906	0.826	0.34	0.655	0.476	0.00

TABLE 3.8.B

	Some Own Revenues		Some Shared Revenues		Total Some Own Revenues and Some Shared Revenues	Other Revenues before Transfers, Subsidies and Grants	Total Revenues before Transfers, Subsidies and Grants	Transfers, Subsidies and Domestic Grants	Total Revenues after Transfers, Subsidies and Domestic Grants
	PIT	Property Tax (Land & Real Est.)	CIT	VAT					
1. Balti	14.2	20.0	6.8	3.3	44.4	19.6	64.0	36.0	100.0
2. Cahul	7.5	18.4	3.5	4.1	33.5	12.5	46.0	54.0	100.0
3. Chisinau	7.1	12.5	3.8	3.8	27.2	9.6	36.8	63.2	100.0
4. Edinet	7.0	30.2	4.6	3.6	45.5	12.6	58.2	41.8	100.0
5. Lapusina	7.1	19.4	3.4	4.1	34.1	13.2	47.2	52.8	100.0
6. Orhei	7.8	14.7	3.3	3.9	29.7	10.3	40.0	60.0	100.0
7. Soroca	9.7	24.3	4.2	6.4	44.7	11.1	55.8	44.2	100.0
8. Taraclia	11.0	17.6	7.9	3.7	40.1	11.9	52.0	48.0	100.0
9. Tighina	5.2	19.2	2.5	4.6	31.4	8.8	40.2	59.8	100.0
10. Unghei	6.9	13.2	5.5	4.1	29.6	10.8	40.4	59.6	100.0
11. UTA Gagauzia	6.8	12.7	5.7	30.5	55.7	11.3	66.9	33.1	100.0
12. Mun. Chisinau	36.5	3.8	19.1	7.9	67.2	27.8	95.0	5.0	100.0
Average	10.6	17.2	5.9	6.7	40.3	13.3	53.5	46.5	100.0
Coefficient of Variation	0.805	0.386	0.762	1.141	0.298	0.400	0.306	0.352	0.000

Table 3.9.A
Planned 2000 Per Capita Local Revenues

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	47.1	40.4	3.8	4.8	8.9	4.0	26.9	135.9	19.3	12.9	3.7	35.9	88.6	260.4
2. Cahul	27.5	52.6	1.8	0.7	5.8	1.4	22.3	112.1	6.8	14.7	3.9	25.5	161.8	299.4
3. Chisinau	20.7	33.9	1.4	2.2	5.0	2.0	12.0	77.1	6.9	17.7	3.3	27.9	185.5	290.5
4. Edinet	40.5	76.3	4.6	3.9	12.8	6.1	21.9	166.2	7.9	24.0	4.9	36.8	70.5	273.5
5. Lapusna	30.0	65.6	1.0	2.6	7.8	2.6	19.2	128.8	7.3	10.9	3.5	21.7	151.9	302.4
6. Orhei	22.0	48.9	2.5	1.8	11.7	2.6	17.7	107.2	13.3	26.1	2.5	41.9	180.9	330.0
7. Soroca	45.1	68.3	3.5	1.2	7.7	3.2	13.2	142.2	12.6	14.8	3.2	30.7	110.2	283.1
8. Taraclia	28.2	87.6	2.5	1.1	7.9	1.1	19.1	147.4	8.6	10.0	3.7	22.3	136.6	306.4
9. Tighina	17.5	73.3	1.8	0.9	7.0	1.8	17.1	119.2	5.3	12.8	2.4	20.5	214.3	354.1
10. Ungheni	26.9	36.2	2.5	1.9	8.1	1.9	11.0	88.5	12.6	21.0	2.7	36.2	167.6	292.4
11. ATU Gagauzia	55.0	49.7	1.7	1.3	7.0	1.9	35.6	152.2	27.9	79.7	3.1	110.8	44.1	307.0
12. Mun. Chisinau	196.1	11.1	5.8	5.9	14.4	11.5	70.7	315.6	79.0	32.0	9.4	120.4	0.0	435.9
Average	68.5	43.9	3.3	3.2	9.6	4.8	30.4	163.6	26.4	23.0	4.7	54.1	106.5	324.3
Coefficient of Variation	1.047	0.402	0.527	0.704	0.327	0.876	0.679	0.431	1.183	0.827	0.484	0.771	0.510	0.149

Table 3.9.B
Executed 2000 Per Capita Local Revenues
(Lei per capita)

		Some Own Revenues		Some Shared Revenues						
		PIT	Property Tax (Land & Real Est.)	CIT	VAT	Total Some Own Revenues and Some Shared Revenues	Other Revenues before Transfers, Subsidies and Grants	Total Revenues before Transfers, Subsidies and Grants	Transfers, Subsidies and Domestic Grants	Total Revenues after Transfers, Subsidies and Domestic Grants
1.	Balti	41.2	57.9	19.7	9.6	128.3	56.5	184.8	104.1	288.8
2.	Cahul	25.6	62.5	11.9	14.1	114.1	42.5	156.6	183.9	340.5
3.	Chisinau	22.1	39.3	11.8	12.0	85.2	30.0	115.2	198.0	313.3
4.	Edinet	20.0	85.8	13.2	10.3	129.2	35.8	165.1	118.7	283.8
5.	Lapusna	22.5	61.4	10.8	13.0	107.7	41.7	149.4	166.8	316.2
6.	Orhei	25.2	47.8	10.7	12.8	96.6	33.5	130.0	195.0	325.1
7.	Soroca	27.8	69.4	12.0	18.4	127.6	31.8	159.4	126.3	285.7
8.	Taraclia	38.6	61.9	27.7	13.1	141.3	41.7	183.0	168.9	351.9
9.	Tighina	20.6	76.8	9.9	18.4	125.7	35.2	160.8	239.1	400.0
10.	Ungheni	20.5	39.3	16.5	12.2	88.4	32.1	120.5	177.9	298.4
11.	UTA Gagauzia	32.7	60.6	27.1	146.1	266.5	53.9	320.4	158.3	478.7
12.	Mun. Chisinau	238.9	24.7	125.3	51.5	440.4	182.1	622.5	32.8	655.3
	Average	44.6	57.3	24.7	27.6	154.2	51.4	205.6	155.8	361.5
	Coefficient of Variation	1.379	0.298	1.306	1.411	0.659	0.818	0.688	0.346	0.299

TABLE 3.10: Application by Local Governments of the 1994 Law on Local Taxes and Levies

Judet	No. of municipalities per judet	Fee on territory Development	Fee on the right to organize local auctions	Hotel fee	Fee on advertising placement	Fee on the right to apply the local symbolism	Fee on the placement on commercial units	Market fee
Chisinau municipality	22	22	1	4		5	1	11
Balti	82	68	12	2	15	13	59	37
Cahul	54	34	2	3	5	4	26	20
Chisinau	91	87	1	2	10	11	83	52
Edinet	73	41		1	3		32	38
Lapusna	64	52	2	2	5	4	50	40
Orhei	72	46	1	2	1		43	36
Soroca	62	53	2	3	5	2	53	40
Tighina	47	42	1		3	3	35	27
Ungheni	55	53	2	1	3	5	53	29
UTA Gagauzia	26	26	1	2	2	1	20	17
Total	648	524	25	22	52	48	455	347
Percent		80.86%	3.86%	3.40%	8.02%	7.41%	70.22%	53.55%

Judet	Fee on vehicle parking	Resort fee	Fee on dog owners	Fee on filming	Fee on crossing the State Border	Fee on the right to sell in the customs area	Fee on the right to provide transportation services for passengers
Chisinau municipality		1					1
Balti	4		3	1	1		19
Cahul	2	1	1	3	2		6
Chisinau	4		1	1			14
Edinet	6		1		8	5	5
Lapusna	5		1				4
Orhei	4						1
Soroca	3		2	2	1	2	12
Tighina	4		1	1	2	2	11
Ungheni	4		2		1		17
UTA Gagauzia	1						7
Total	37	2	12	8	15	9	97
Percent	5.71%	0.31%	1.85%	1.23%	2.31%	1.39%	14.97%

Table A.3.1
Tax Sharing rates between the central and local governments in 1999

Administrative territorial unit	Sharing rates (in percent)		
DISTRICT	From the income tax on business activity	from the value added tax on domestically produced goods	from the land tax on legal entities
Anenii Noi	50	30	100
Basarabeasca	50	30	100
Briceni	50	20	100
Cahul	50	30	100
Camenca	50	30	100
Cantemir	50	30	100
Cainari	50	30	100
Calarasi	50	30	100
Causeni	50	30	100
Cimislia	50	30	100
Criuleni	50	30	100
Donduseni	50	20	100
Drochia	50	20	100
Dubasari	50	30	100
Edinet	50	20	100
Falesti	50	20	100
Floresti	50	20	100
Glodeni	50	20	100
Hincesti	50	30	100
Ialoveni	50	30	100
Leova	50	30	100
Nisporeni	50	30	100
Ocnita	50	20	100
Orhei	50	30	100
Rezina	50	30	100
Riscani	50	30	100
Singerei	50	30	100
Soroca	50	30	100
Straseni	50	30	100
Soldanesti	50	30	100
Stefan-Voda	50	30	100
Taraclia	50	30	100
Telenesti	50	30	100
Ungheni	50	30	100
Vulcanesti	50	30	100
ATU Gagauzia	70	30	100
Municipalities			
Chisinau	40	10	100
Balti	40	10	100

Table A.3.2
Plan 2001 Composition of Local Revenues by Judet
(as % of Total Revenues after Transfers and Withdrawals)

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	11.9	14.6	2.2	0.7	2.0	1.2	5.5	38.0	10.5	39.5	1.1	51.0	10.9	100.0
2. Cahul	6.0	20.1	0.4	0.5	1.8	0.7	5.1	34.6	4.8	14.5	1.0	20.3	45.2	100.0
3. Chisinau	6.4	12.5	0.3	0.7	1.6	0.6	2.3	24.3	4.8	12.7	0.8	18.4	57.3	100.0
4. Edinet	6.8	27.7	0.6	0.6	2.8	0.6	5.3	44.3	6.8	19.2	0.9	26.9	28.7	100.0
5. Lapusna	5.4	21.2	0.2	0.7	2.2	0.5	4.6	34.7	5.1	13.4	0.8	19.3	46.0	100.0
6. Orhei	6.2	22.2	0.3	0.5	2.0	0.6	3.0	34.8	8.2	12.5	0.8	21.5	43.7	100.0
7. Soroca	11.1	25.8	0.5	0.5	1.8	0.4	4.1	44.2	8.5	19.4	1.2	29.1	26.7	100.0
8. Taraclia	8.7	29.5	0.5	0.4	2.4	0.6	4.0	46.0	13.2	12.4	1.1	26.6	27.3	100.0
9. Tighina	4.3	27.7	0.2	0.3	2.3	0.5	3.6	38.8	4.6	13.0	0.8	18.4	42.7	100.0
10. Ungheni	6.3	12.9	0.3	0.7	1.9	0.3	3.1	25.7	8.4	11.7	0.7	20.8	53.5	100.0
11. UTA Gagauzia	10.1	20.3	0.4	0.8	2.1	1.0	9.9	44.5	10.1	32.6	0.9	43.7	11.7	100.0
12. Mun. Chisinau	39.3	1.9	0.9	1.1	2.6	2.7	9.7	58.2	21.7	6.6	1.6	29.9	11.9	100.0
Coefficient of Variation	0.928	0.409	0.980	0.310	0.165	0.804	0.487	0.239	0.546	0.548	0.242	0.383	0.489	0.00

Table A.3.3
Plan 2002 Composition of Local Revenues by Judet
(as % of Total Revenues after Transfers and Withdrawals)

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes and Fees	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	12.9	14.3	1.9	0.4	1.6	0.7	10.8	42.5	11.1	35.5	0.9	47.4	10.0	100.0
2. Cahul	5.9	15.7	0.2	0.6	1.2	0.4	11.9	35.7	6.9	11.7	0.5	19.1	45.2	100.0
3. Chisinau	6.6	9.0	0.2	0.5	1.0	0.1	5.3	22.7	7.5	12.7	0.5	20.8	56.5	100.0
4. Edinet	6.2	20.7	0.5	0.4	1.8	0.4	7.0	37.0	6.7	16.9	0.6	24.2	38.7	100.0
5. Lapusna	5.0	14.9	0.1	0.5	1.2	0.2	9.4	31.3	5.1	11.6	0.5	17.2	51.5	100.0
6. Orhei	6.1	14.7	0.2	0.4	1.3	0.6	6.8	30.0	5.9	11.8	0.6	18.3	51.7	100.0
7. Soroca	7.7	18.6	0.3	0.4	1.2	0.4	8.3	36.9	6.9	20.2	0.9	27.9	35.2	100.0
8. Taraclia	8.0	21.4	0.2	0.3	1.3	0.3	9.1	40.6	10.7	8.0	0.8	19.4	40.0	100.0
9. Tighina	4.4	18.7	0.1	0.4	1.4	0.3	7.6	32.8	5.1	12.2	0.5	17.8	49.3	100.0
10. Ungheni	4.8	9.3	0.2	0.6	1.3	0.3	6.8	23.2	6.0	12.1	0.4	18.6	58.2	100.0
11. UTA Gagauzia	8.4	14.2	0.2	0.7	1.2	0.6	7.7	33.1	7.2	28.3	0.8	36.3	30.6	100.0
12. Mun. Chisinau	44.1	1.4	0.6	0.9	1.9	2.5	19.3	70.7	19.5	8.8	1.0	29.3	0.0	100.0
Coefficient of Variation	1.097	0.393	1.315	0.349	0.197	1.139	0.401	0.340	0.489	0.525	0.293	0.374	0.464	0.000

Table A.3.4
Planned for 2001 Per Capita Local Revenues
(Lei Per Capita)

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	49.5	60.7	9.1	3.0	8.3	4.9	22.7	158.3	43.6	164.1	4.5	212.2	45.5	416.0
2. Cahul	21.0	70.6	1.5	1.8	6.3	2.4	17.8	121.5	16.8	50.8	3.6	71.3	158.8	351.5
3. Chisinau	20.9	40.4	0.8	2.2	5.2	1.8	7.3	78.8	15.7	41.2	2.7	59.7	186.2	324.7
4. Edinet	21.1	86.0	1.9	1.8	8.6	1.8	16.4	137.5	21.1	59.6	2.8	83.5	89.1	310.1
5. Lapusna	18.4	72.5	0.6	2.5	7.4	1.8	15.8	119.0	17.4	46.1	2.7	66.1	157.7	342.9
6. Orhei	19.8	71.2	1.0	1.7	6.4	1.8	9.6	111.5	26.4	40.0	2.5	68.9	139.8	320.2
7. Soroca	37.2	86.5	1.8	1.8	5.9	1.4	13.8	148.5	28.4	65.1	4.0	97.6	89.6	335.8
8. Taraclia	30.2	102.8	1.7	1.5	8.3	2.2	13.8	160.5	46.0	43.1	3.8	92.9	95.3	348.6
9. Tighina	14.1	90.3	0.7	1.0	7.4	1.5	11.8	126.8	15.0	42.4	2.7	60.2	139.6	326.6
10. Ungheni	21.2	43.3	1.0	2.5	6.4	1.2	10.4	86.0	28.2	39.4	2.3	69.9	179.4	335.3
11. ATU Gagauzia	37.2	74.4	1.3	2.8	7.7	3.7	36.3	163.5	37.2	119.8	3.4	160.5	43.1	367.0
12. Mun. Chisinau	243.4	11.5	5.4	6.7	16.3	16.8	60.1	360.2	134.5	41.0	9.6	185.1	73.5	618.7
Average	74.1	55.6	3.2	3.2	9.0	5.5	25.2	175.6	49.7	65.7	4.6	119.9	109.9	405.5
Coefficient of Variation	1.43	0.38	1.12	0.59	0.36	1.26	0.75	0.49	0.92	0.62	0.53	0.52	0.43	0.23

Table A.3.5
Planned for 2002 Per Capita Local Revenues
(Lei Per Capita)

	PIT	Land Tax	Subsoil Tax	State Duty	Property Tax	Revenues from Privatization	Other Local Taxes	Total Own Revenues	CIT	VAT	Road Tax	Total Shared Revenues	Transfers	Total Revenues After Transfers
1. Balti	57.4	63.8	8.6	1.6	7.1	3.2	48.3	190.1	49.5	158.4	4.0	211.9	44.8	446.8
2. Cahul	28.8	77.3	0.8	2.8	5.8	1.8	58.6	176.1	34.1	57.7	2.4	94.1	222.5	492.7
3. Chisinau	29.8	40.6	1.0	2.4	4.6	0.5	24.0	102.8	34.0	57.6	2.4	93.9	255.7	452.5
4. Edinet	25.6	86.1	2.1	1.8	7.6	1.7	29.1	154.0	28.1	70.2	2.6	100.9	161.2	416.1
5. Lapusna	24.5	72.7	0.6	2.5	6.0	1.1	45.8	153.1	24.8	56.7	2.5	84.0	252.2	489.2
6. Orhei	27.0	65.5	0.8	2.0	5.6	2.7	30.1	133.7	26.4	52.7	2.5	81.6	230.1	445.4
7. Soroca	34.4	83.0	1.4	1.8	5.4	1.6	37.2	164.8	30.6	89.9	4.0	124.5	156.8	446.0
8. Taraclia	38.8	103.9	0.9	1.3	6.4	1.5	44.3	197.0	51.7	38.8	3.9	94.4	194.0	485.4
9. Tighina	21.2	90.1	0.5	1.8	6.6	1.6	36.9	158.7	24.7	58.9	2.5	86.2	238.2	483.1
10. Ungheni	23.2	44.4	0.8	2.9	6.2	1.2	32.5	111.2	29.0	57.9	2.1	89.0	278.6	478.8
11. ATU Gagauzia	43.5	73.3	0.9	3.7	6.4	3.0	39.9	170.7	37.2	145.9	4.0	187.2	157.7	515.5
12. Mun. Chisinau	333.0	10.3	4.6	6.9	14.4	19.2	145.8	534.2	147.3	66.6	7.7	221.6	0.0	755.8
Average	97.8	55.4	2.8	3.2	7.9	5.6	61.1	233.8	57.9	80.2	4.0	142.1	148.3	524.2
Coefficient of Variation	1.53	0.38	1.25	0.58	0.37	1.56	0.68	0.60	0.79	0.50	0.46	0.43	0.47	0.18

CHAPTER 4: THE SYSTEM OF TRANSFERS

This chapter examines vertical and horizontal fiscal imbalances in Moldova, how the current system of transfers has worked so far, and suggests options for improving the design and performance of the transfer system.

A. FISCAL IMBALANCES

Fiscal imbalances are a common feature in most fiscally decentralized countries, and Moldova is not an exception. These imbalances are a consequence of the local economic conditions, the low mobility of population and production factors among regions, and inadequate intergovernmental fiscal relations. The latter, when properly designed, can help compensate for financial insufficiencies and disparities between expenditure responsibilities and revenue sources at different levels of governments and across jurisdictions.

Vertical imbalances

There is no unique definition of vertical imbalances. Broadly, a vertical imbalance exists when the revenue sources assigned to each level of government do not correspond to their expenditure responsibilities. Several approaches have been used to measure the existence and the size of vertical imbalances. Although this is not a trivial exercise, the two most frequently used practical measures are: (i) the existence of structural (i.e., persistent) budget deficits at a particular level of government, and (ii) the ability of different levels of government to finance expenditures from their own sources of revenues.

Usually the actual budget deficit measure tends to indicate an imbalance against the central government, since budget deficits have been consistently higher at the central level than among subnational governments over the transition years. In many countries, as is the case also in Moldova, subnational governments are not as free as the central government to run budget deficits and borrow to finance their expenditures. Particularly, the central government is the only one allowed to borrow from abroad (which usually requires sovereign guarantee), although they may on-lend or transfer to lower tiers afterwards. In any case, even though the central government has control over the most important sources of revenue—ultimately because it shares some of those revenues with subnational governments and because it spends on many central government responsibilities—the central government may only be able to get by borrowing against future tax revenues. Apart from borrowing directly from the central government (particularly the Ministry of Finance—see Chapter 5) and incurring in arrears on wages, subnational governments in Moldova do not have enough creditworthiness to access commercial borrowing.[70]

Typically all levels of government appear to have expenditure responsibilities and needs that exceed their financing means (Box 4.1). In this regard, the measurement of vertical imbalances is

[70] Although off-budget public utility (and other) companies have had access to different forms of commercial borrowing, including foreign.

made difficult by the ambiguity of the expenditure levels (quantity and quality of services) that can be associated with the assignment of responsibilities at each level of government. One way to dealing with this ambiguity is to prepare an exhaustive listing of standards (or norms) for provision, and conduct an accounting of the expenditures required for explicitly stated and agreed upon levels and quality of public services and, finally, compare them to available resources for each level of government. This is a very costly and time-consuming exercise, and requires a great deal of intergovernmental consensus and communication. Nevertheless, without the latter, the listing and costing of expenditure norms can lead to intergovernmental friction and poor budgeting practice.

A simpler and more effective guarantee against vertical imbalance is to provide each level of government with enough revenue autonomy so that they can make their own decisions regarding what services to cover and at what level. In practice, this approach to measuring vertical fiscal imbalance is to compute the share of local government expenditures that cannot be financed with sources of revenues over which local governments have discretion or autonomy [71]:

Coefficient of vertical imbalance = 1 - (total subnational resources under subnational control / total subnational expenditures)

This coefficient quantifies the share of the subnational government expenditures that are not financed from sources of revenues that are controlled by the subnational government—i.e., the share that the subnational government does not have revenue raising powers—i.e., they do not have discretion or authority to change tax rates, tax bases, or even to use or not particular taxes. By construction, the coefficients of vertical imbalance take values between zero and one, with values closer to zero indicating a smaller vertical imbalance, and values closer to one indicating larger vertical fiscal imbalance. There is typically disagreement on the definition of the concepts applied to the formula. Total subnational expenditures include exclusive, shared and delegated expenditures, but the concepts of revenues that are controlled and revenues that are not controlled by subnational governments are subject to more controversy. For example, lump sum or unconditional transfers may also be interpreted as resources controlled by subnational governments, although, in any case, conditional transfers would be resources not controlled by subnational governments. In this respect, extra care has to be exercised in comparing measures of vertical imbalances across countries, because the level of central government control and the definition of subnational "own revenues" may varies from country to country.

By this definition, there is a vertical imbalance in Moldova against local governments. As we saw in the previous two Chapters, subnational governments in Moldova have little tax autonomy. Local own revenues, excluding the personal income tax and other shared revenues, finance a little above one-fourth of the subnational budgets.[72] Thus, the lack of revenue autonomy at the subnational level is a main cause of the existence of vertical imbalances against subnational governments in Moldova.

[71] By autonomy it is meant the ability to adopt or not certain taxes, or change their structure, base and rate.

[72] Own revenues (excluding PIT) represented 29 percent of total revenues in 2000 and 25.9 percent in 2002 (Table 3.7). Note, however, that the importance on own revenues varies significantly across subnational jurisdictions. For example, for 2002, Soroca judet was budgeted to raise 32 percent of its total revenues from own sources (excluding PIT) while Chisinau judet was budgeted at half that or 16 percent (See Table A.3.3).

Box 4.1
Vertical Imbalances and Revenue Adequacy

One common problem when a decentralization policy is implemented is determining the level of resources that is “adequate” for the delivery of subnational government services. Determining the adequate level of funding is often a cause for contention between the central and subnational levels of government.

Given the scarcity of economic resources, revenue adequacy and vertical balance should be interpreted within the context of the overall public sector budget constraint. Therefore, it is advisable to define what constitutes ”adequate resources” on the bases of a national dialogue with participation of all stakeholders. Although perfect consensus is unlikely to be reached, the dialogue can protect subnational governments from the central governments using decentralization as a way to push down responsibilities just to solve its own fiscal shortcomings, and also as a way to facilitate the role of the central authorities by increasing solidarity and making subnational governments more aware of the existing national, overall fiscal constraints.

Horizontal imbalances

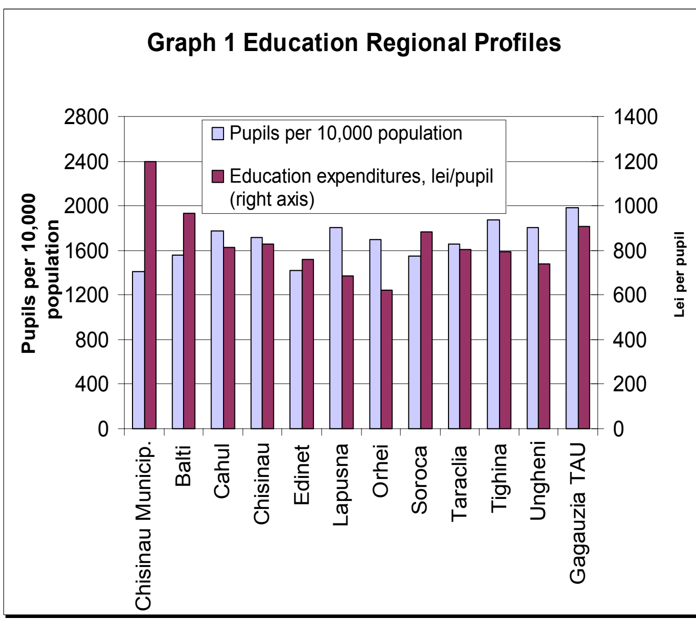
Horizontal imbalances arise from existing fiscal disparities across subnational jurisdictions. Subnational governments generally have different tax capacities or abilities to raise revenues through their assigned taxes at standard rates because they differ in their economic bases. Differences in economic base across regions are a common and natural occurrence. Regional variations in economic conditions tend to encourage labor and capital to move from less productive regions towards more productive regions. Some of this migration enhance the more productive use of national resources and, therefore, excessive fiscal equalization may thwart overall economic growth in the country.

In Moldova there exist substantial disparities in tax collections per capita across judets (Chapter 3). Tables 4.1 to 4.3 show planned tax collections per capita for different taxes for 2000 trough 2002, respectively.[73] Total per capita collections from shared revenues in Chisinau municipality in 2002 was planned to be 11.5 times larger than in Orhei judet and, for PIT per capita revenues, the difference between Chisinau municipality and Tighina judet was 15.7 fold (Table 3.3). Notice that the existence of fiscal disparities in Moldova is largely caused by the differences between Chisinau municipality and the rest of the country. However, excluding Chisinau municipality some disparities, although in a much lesser extent, still remain. For example, in 2002, total per capita collections from shared revenues in Balti judets were planned at over 2.5 times those in Orhei judet, and per capita PIT revenues in Balti judet were planned at 2.7 times those in Tighina judet.[74] Tax disparities may arise for reasons other than economic differences. For instance, differences in the density of population in combination with value assessments—still not based on market prices—may lead to disparities in per capita property tax and land tax revenues.

[73] Note that the column heading in these tables referring to “collections” (the first four columns) includes all revenues collected on that tax in the judet regardless of the level of government that eventually got the tax revenues. All the other columns in these tables refer to revenues actually appropriated by the local governments.

Horizontal fiscal imbalances may also exist because of disparities across subnational jurisdictions in expenditure needs. The differences in needs may arise from either different prices or costs of service provision or different shares of the population with special needs. For example, it is likely that the unit costs of provision are higher in the larger cities than in rural areas. In 2000, the 20 percent share of elderly population in Edinet judet was twice the level in Chisinau municipality; the infant mortality rate in Cahul judet is twice that ATU Gagauzia; and the average monthly salary is 2.4 times that in Tighina judet (Table A.4.1 in the Statistical Appendix). The most recently available data for 2000 shows that there are still significant disparities in needs, infrastructure and expenditures per capita across judets in education and health, the two most important expenditure categories at the subnational level. . See Graphs 1 and 2.

In summary, there are both vertical and horizontal fiscal imbalances in Moldova. Although the direction of the vertical fiscal imbalance seems uncertain (if against the central or the subnational governments)— because it depends on the measurement criterion utilized—it is clear however that the inadequate level of revenue autonomy can leave local governments unable to fulfill all the expenditure responsibilities (on the quantity and standard) that they are assigned with. The need to improve revenue assignments in Moldova to provide subnational governments with more tax autonomy was discussed in the previous Chapter. There are multiple sources of horizontal imbalances in Moldova. The paragraphs below, concentrate on how the current system of fiscal decentralization addresses the problem of horizontal imbalances through equalization transfers, how effective these have been, and how they can be reformed to improve the system.



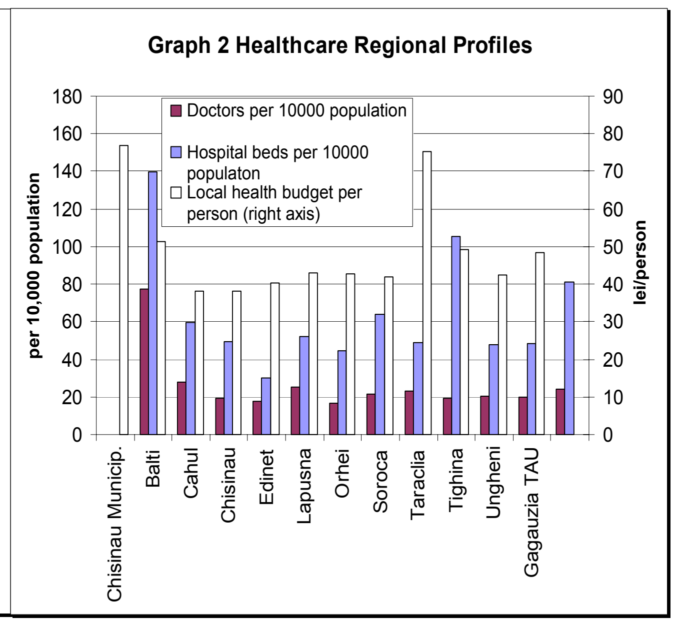


Table 4.1
Equalization Effect of Revenue Sharing and Transfers Distribution,
Per Capita Collections and Revenues According to Plan 2000

	Collections from Shared Revenues			Total Collections from Shared Revenues	Local Budget Revenues from Shared Taxes	PIT	Other Local Own Revenues	Local Budget Revenues from Transfers	Revenues of Local Budgets after Transfers
	CIT	VAT	Road Tax						
1. Balti	38.6	129.1	7.3	175.0	35.9	47.1	88.7	88.6	260.4
2. Cahul	13.6	49.0	7.9	70.6	25.5	27.5	84.6	161.8	299.4
3. Chisinau	13.9	59.0	6.5	79.4	27.9	20.7	56.5	185.5	290.5
4. Edinet	15.8	119.9	9.8	145.6	36.8	40.5	125.7	70.5	273.5
5. Lapusna	14.5	36.4	7.1	58.0	21.7	30.0	98.7	151.9	302.4
6. Orhei	26.7	87.0	4.9	118.6	41.9	22.0	85.2	180.9	330.0
7. Soroca	25.2	49.5	6.5	81.1	30.7	45.1	97.1	110.2	283.1
8. Taraclia	17.2	33.3	7.5	58.0	22.3	28.2	119.2	136.6	306.4
9. Tighina	10.6	42.7	4.8	58.1	20.5	17.5	101.7	214.3	354.1
10. Ungheni	25.1	69.9	5.4	100.4	36.2	26.9	61.7	167.6	292.4
11. UTA Gagauzia	27.9	79.7	6.2	113.9	110.8	55.0	97.2	44.1	307.0
12. Mun. Chisinau	157.9	320.2	18.8	496.9	120.4	196.1	119.4	0.0	435.9
Average	32.3	89.6	7.7	129.6	44.2	46.4	94.6	126.0	311.3
Coefficient of Variation	1.252	0.881	0.484	0.937	0.771	1.047	0.226	0.510	0.149
Correlation with per Capita Total Collections from Shared Revenues	0.978*	0.994*	0.916*	1.000*	0.750*	0.966*	0.357	-0.730*	0.717*
Correlation with per Capita Local Own Revenues, Excluding PIT	0.328	0.356	0.512	0.357	0.267	0.426	1.000	-0.555	0.334
Correlation with per Capita Local Revenues from PIT	0.981*	0.939*	0.935*	0.966*	0.795*	1.000	0.426*	-0.780*	0.748*

* Correlation is statistically significant at 5 percent level.

Table 4.2
Equalization Effect of Revenue Sharing and Transfers Distribution,
Per Capita Collections and Revenues According to Plan 2001

	Collections from Shared Revenues			Total Collections from Shared Revenues	Local Budget Revenues from Shared Taxes	PIT	Other Local Own Revenues	Local Budget Revenues from Transfers	Revenues of Local Budgets after Transfers
	CIT	VAT	Road Tax						
1. Balti	43.6	164.1	9.0	216.7	212.2	49.5	108.8	45.5	416.0
2. Cahul	16.8	50.8	7.3	74.9	71.3	21.0	100.5	158.8	351.5
3. Chisinau	15.7	41.2	5.5	62.4	59.7	20.9	57.9	186.2	324.7
4. Edinet	21.1	59.6	5.6	86.3	83.5	21.1	116.4	89.1	310.1
5. Lapusna	17.4	46.1	5.4	68.9	66.1	18.4	100.6	157.7	342.9
6. Orhei	26.4	40.0	4.9	71.4	68.9	19.8	91.8	139.8	320.2
7. Soroca	28.4	65.1	8.1	101.6	97.6	37.2	111.3	89.6	335.8
8. Taraclia	46.0	43.1	7.5	96.7	92.9	30.2	130.3	95.3	348.6
9. Tighina	15.0	42.4	5.4	62.9	60.2	14.1	112.6	139.6	326.6
10. Ungheni	28.2	39.4	4.6	72.2	69.9	21.2	64.8	179.4	335.3
11. UTA Gagauzia	37.2	119.8	6.8	163.9	160.5	37.2	126.2	43.1	367.0
12. mun. Chisinau	269.0	409.5	19.2	697.7	185.1	243.4	116.8	73.5	618.7
Average	47.1	93.4	7.5	148.0	102.3	44.5	103.2	116.5	366.5
Coefficient of Variation	1.502	1.142	0.529	1.212	0.517	1.426	0.216	0.430	0.229
Correlation with per Capita Total Collections from Shared Revenues	0.983*	0.993*	0.972*	1.000	0.702*	0.992*	0.294	-0.471	0.988*
Correlation with per Capita Local Own Revenues, Excluding PIT	0.259	0.308	0.361	0.294	0.452	0.250	1.000	-0.787*	0.271
Correlation with per Capita Local Revenues from PIT	0.995*	0.971*	0.973*	0.992*	0.615*	1.000	0.250	-0.392	0.975*

* Correlation is statistically significant at 5 percent level

Table 4.3
Equalization Effect of Revenue Sharing and Transfers Distribution,
Per Capita Collections and Revenues According to Plan 2002

	Collections from Shared Revenues			Total Collections from Shared Revenues	Local Budget Revenues from Shared Taxes	PIT	Other Local Own Revenues	Local Budget Revenues from Transfers	Revenues of Local Budgets after Transfers
	CIT	VAT	Road Tax						
1. Balti	49.5	158.4	8.0	215.9	211.9	57.4	132.6	44.8	446.8
2. Cahul	34.1	57.7	4.7	96.4	94.1	28.8	147.2	222.5	492.7
3. Chisinau	34.0	57.6	4.7	96.3	93.9	29.8	73.0	255.7	452.5
4. Edinet	28.1	70.2	5.3	103.5	100.9	25.6	128.4	161.2	416.1
5. Lapusna	24.8	56.7	4.9	86.4	84.0	24.5	128.6	252.2	489.2
6. Orhei	26.4	52.7	4.9	84.0	81.6	27.0	106.7	230.1	445.4
7. Soroca	30.6	89.9	7.9	128.4	124.5	34.4	130.4	156.8	446.0
8. Taraclia	51.7	38.8	7.8	98.3	94.4	38.8	158.2	194.0	485.4
9. Tighina	24.7	58.9	5.0	88.7	86.2	21.2	137.4	238.2	483.1
10. Ungheni	29.0	57.9	4.2	91.2	89.0	23.2	88.0	278.6	478.8
11. UTA Gagauzia	37.2	145.9	8.1	191.2	187.2	43.5	127.3	157.7	515.5
12. mun. Chisinau	294.6	666.1	15.4	976.0	221.6	333.0	201.2	0.0	755.8
Average	55.4	125.9	6.7	188.0	122.4	57.3	129.9	182.7	492.3
Coefficient of Variation	1.369	1.384	0.461	1.339	0.430	1.527	0.252	0.469	0.178
Correlation with per Capita Total Collections from Shared Revenues	0.990*	0.998*	0.924*	1.000	0.722*	0.997*	0.698*	-0.771*	0.938*
Correlation with per Capita Local Own Revenues, Excluding PIT	0.712*	0.685*	0.770*	0.698*	0.508	0.704*	1.000*	-0.689*	0.710*
Correlation with per Capita Local Revenues from PIT	0.998*	0.990*	0.915*	0.997*	0.674*	1.000	0.704*	-0.742*	0.943*

* Correlation is statistically significant at 5 percent level

B. THE CURRENT SYSTEM OF EQUALIZATION TRANSFERS

Gap-filling transfers

After independence, Moldova has continued to use a version of the gap-filling transfers in combination with "regulating" tax revenues that were used in the former Soviet Union to address horizontal and vertical fiscal imbalances. This system, as most recently incorporated in the Law on Public Finance, is used for the financial relationships between the central and the intermediate level governments (i.e., judets, or districts), and between these latter and local governments (i.e., municipalities/primarias). The essence of this approach is to provide gap-filling transfers to those lower-level jurisdictions which show a budget gap between estimated expenditures and forecasted revenues from own and shared sources.[75] The planned transfers for 2000 and 2001 are shown in Tables 4.4 and 4.5, respectively. All intermediate level governments, except Chisinau municipality, receive an equalization transfer. As there are significant fiscal disparities between Chisinau municipality and the rest of the country, fiscal equalization in Moldova means shifting collected resources from Chisinau municipality towards the other jurisdictions.

Table 4.4
Transfers from the State Budget to Judet Budgets in 2000 (planned)

Administrative territorial unit	thousand lei
Balti	44,760
Cahul	30,870
Chisinau	70,880
Edinet	27,100
Lapusna	42,860
Orhei	54,890
Soroca	30,630
Taraclia	6,340
Tighina	36,370
Ungheni	43,400
ATU Gagauzia	7,100
Total	**388,200**

Source: 2000 Budget Law, Ministry of Finance

[75] For the computation of transfers, the Ministry of Finance develops expenditure estimates for each judet based on an explicit methodology that incorporates expenditures per capita and demographic information, such as the number of students. On the revenue side, the Ministry of Finance also makes estimates of shared taxes and own revenues, and discusses them with the judets governments. When revenue estimates exceed expenditure estimates, the Ministry of Finance regulates (ex-ante) revenue sharing by providing subnational governments with a smaller share of state taxes. (This has been the case of Chisinau municipality over the last several years.) Also, ex-post, territorial units whose *actual* per capita revenue exceeds by 20% the per capita expenditure average norm, looses the excess in favor of the ***"Fund for the Financial Support of the Territories."*** (Law on Local Public Finance, # 491/99, Arts. 8a. and 9.1.b) When estimated revenues are less than estimated expenditures, the subnational government gets a transfer from the state budget. Judets are supposed to follow the same methodology with their municipalities/primarias.

Table 4.5
Transfers from the Fund for Financial Support of Territories to the Budgets of Administrative-Territorial Units in 2001 (planned)

Administrative territorial unit	thousand lei
Cahul	30,300
Chisinau	71,160
Edinet	25,400
Lapusna	44,510
Orhei	42,410
Soroca	24,920
Taraclia	4,420
Tighina	23,690
Ungheni	46,450
ATU Gagauzia	6,940
Total	**320,200**

Source: 2001 Budget Law, Ministry of Finance

The main problem with the system of gap-filling subventions, also shared by the "regulating" approach to revenue sharing, is the potential negative incentives created for subnational revenue mobilization. Clearly, if any subnational government increases its effort to mobilize revenues, the result is reduced gap-filling transfers or reduced tax sharing rates in future years. Similarly, if any subnational government makes an effort to reduce the costs of delivering public services, thereby reducing expenditures and the budget gap, in the future the budget would likely include reduced transfers or reduced revenue sharing. In either case, the benefits of higher tax effort or the frugality and efficiency on the expenditure side of the budget would not be entirely internalized by those territorial units that exercised those efforts, but instead shared with the inefficient ones. Clearly, the system of incentives provided by the current system of equalization transfers in Moldova is inadequate and should be reformed. The government and the rest of the stakeholders are quite aware of the problem. For example, the methodology employed by the Ministry of Finance leaves out collections from *local fees* in the computation of the fiscal gap. This is an explicit acknowledgement of the negative incentive effects of the system. But this is not enough, since collections from *local taxes* are indeed included in those computations. Moldova needs an objective, formula-driven transfer system to go with the reform of revenue assignments that address horizontal and vertical imbalances, and at the same time does not discourage local optimization of expenditure and mobilization of revenue.

It must be noted that the norms used nowadays in the calculation of expenditure needs are structured mostly on a per client basis—number of students, population etc. (See Chapter 2). This methodological approach avoids, for the most part, the inefficient incentives caused in the past by the use of norms based on capacity, such as number of schools or number of hospital beds.

Another problem with the gap filling equalization transfers in Moldova is that they have not been used as lump sum or unconditional grants, as is the rule with all equalization grants in decentralized systems and, it appears, is the nature of these transfers in Moldova's organic laws.

Rather, these transfers have been used as conditional grants. For example, the Budget Law for 2001 clearly states that the "fund for financial support of territories to the budgets of administrative-territorial units," i.e., the equalization grants shall be used "…70 percent for the payment of salaries in the area of education, health care and culture, and transfers into the social security budget and 30 percent for the payment of used energy resources and other expenses made by financial institutions from the corresponding budgets." It would appear that many subnational governments did not respect the conditionality imposed on these funds on the basis of the general principle that these transfers should be unconditional. These conflictive views of the transfers led to friction between the parliament and the central authorities with judet councils and were ultimately behind the removal of budget execution authority for the judet councils in 2001 (Law 496, June 2001) and, quite likely, behind the elimination of the judets and re-introduction of the rayons in 2002.

Performance of the Equalization Transfers

At least on the basis of planned data, it seems that the intentions of the Ministry of Finance have been to use the gap-filling transfers to equalize expenditures per capita across judets (Tables 4.1 to 4.3). Disparities in the availability of fiscal resources in 2000, 2001 and 2002 would have been significantly reduced via transfers and "regulation" in revenue sharing. The first four columns in Tables 4.1 to 4.3 present per capita tax collection by judet for the CIT, VAT and roads and their sum, regardless of the level of government to which they will be appropriate. Therefore, these figures represent the potential extent of fiscal disparities coming from these tax sources. The coefficients of variation are relatively high for VAT, CIT and "total collections from shared revenues," at, for example, 1.3 in 2002. The fifth column ("local budget revenues from shared taxes") shows the impact of the tax assignment policy. During the period, there was a significant drop in the coefficients of variation for local revenues from shared taxes (from 0.77 to 0.43) vis-à-vis that for the CIT or VAT. This means that the regulation of taxes in Moldova has had an equalizing effect.

More interesting to us here is the equalizing impact of the gap-filling transfers. First, as shown in Tables 4.1 to 4.3, the correlation coefficient between planned transfers to the judets from 2000 to 2002 and shared revenues, own revenues, and separately PIT revenues is in all three cases negative, quite large, and most of the time statistically significant. The larger the availability of other sources of revenue the smaller the size of the equalization transfer. This means that there is a policy of trying to equalize the availability of funds across local governments Second, the coefficient of variation for subnational revenues after transfers is much smaller, for example, 0.15 in 2000 or 0.18 in 2002, than the coefficient of variation for all other sources of revenues, including PIT revenues, at 1.5 in 2002, and shared revenues, at 0.43 also in 2002. This means that the government equalizing intentions should be effective in achieving results. At least on the bases of planned data, and despite the negotiations involved and the risk that the central authorities may be influenced or swayed by the politically more powerful jurisdictions, the impact of the gap filling transfers appears to be equalizing. Therefore, even though the current system of transfers faults on several accounts, it is not failing to equalize per capita revenues and expenditures across territorial units.

C. MAIN ISSUES

The current transfer system in Moldova tends to be ineffective, since it lacks a simple, sound paradigm to encourage local tax effort and efficiency in public expenditures. The current mechanism still embodies undesirable features, such as negotiation and discretion in the determination of the size and distribution of transfer funds, negative incentives represented by the claw-back of "excess" revenue, a "fraternal" approach that generates dissatisfaction among territorial units, confusing conditionality attached to the equalization grants, absence of complementary regular special purpose transfer mechanism, and unregulated transfers from judet to the primarias.

Negotiation and discretion

Despite the methodology expanded in the Law on Local Public Finance, in practice, as expected from the actual financial constraints, the system has worked in a discretionary manner, with the Ministry of Finance indirectly limiting transfers by "regulating" the expenditure norms and tax sharing rates and "negotiating" individually with each judet the "gap-fill" transfer. Consequently, the system of transfers has lacked transparency and objectivity. It should be emphasized that the problem does not necessarily lie in the amount of funds available for transfers, but rather in the manner in which this amount is adjusted and distributed. The entire process should rest on rules, both for the determination of the overall pool of funds to be distributed and for how the funds will be distributed. Admittedly, better data availability, and macroeconomic and overall budget balance conditions may demand sporadic adjustments to the level of funding and in the distribution formula.

Negative incentives remain

Although the methodology currently used — the difference between expenditure needs based on per capita norms and forecasted revenues for shared and own taxes—is an improvement over past practices, it has not eliminated the negative incentives to revenue mobilization. Also, it has been argued that the negative incentives toward revenue mobilization are minimized because subnational governments, except for Chisinau municipality, share since 2001 all the major taxes (VAT, CIT and PIT) at 100 percent. However, this argument ignores that if the territorial unit collects more in shared or own taxes, then it may get less than the 100 percent of revenue sharing (and of transfers) in the future. Also the exclusion of local fees in the computation of the budget gap only partially deals with negative incentives, since those local governments that undertake a bigger effort to collect fees may end up receiving less transfers in future.[76]

Dissatisfaction with the "fraternal" system

Besides being subject to negotiation and entailing negative incentives to revenue mobilization, the current system of gap-filling equalization grants has had serious perception problems among subnational governments, such as:

[76] The evidence available appears to indicate that the higher the own local revenues per capita (excluding PIT) the lower the transfers per capita received by the judet budget. (See correlation coefficients for these two variables in Tables 4.1 to 4.3).

(i) Transfers are perceived as being too unstable from year to year, discouraging efficient planning by subnational governments;
(ii) The formal "fraternal" approach[77] to funding the pool of equalization funds has created political friction and lack of national solidarity. Fraternal funding may also have a negative impact on the overall collection effort because of the discontent it tends to generate among donor jurisdictions, from which revenues are explicitly taken away.
(iii) There continues to be a perception among subnational governments that the "virtual" expenditure norms used in the computation of the fiscal gap ought to be norms that are adequate for funding the expenditure responsibilities of the subnational governments. However, quite clearly the expenditure norms used by the Ministry of Finance could not under the present economic circumstances be anywhere near the level that subnational governments would consider adequate or else there would be a very significant budget deficit at the central level. Thus, the approach to determination of transfers based on expenditure norms continues to create a sense of insensitivity and injustice toward subnational governments.
(iv) There has been little clarity on whether amounts specified in the state budget for transfers to subnational governments are actually guaranteed to subnational governments. In reality, the actual transfer amounts are changed during budget execution according to the actual performance of the state budget. But it appears that subnational governments often have perceived these adjustments as cheating by the central authorities.[78]

Conditionality in equalization transfers

If equalization transfers in Moldova could be correctly conceived as unconditional (general funding) grants, their final use should conceptually be left to the discretion of local governments.[79] However, in practice, this principle has not been respected and /or its exercise by local governments has led to political problems. The use of expenditure norms in the computation of the transfers appears to have created the expectation at the central level that local governments (judets) would need to use the transferred funds to finance the expenditures represented in the expenditure norms. In recent years the annual state budget law has imposed priorities on judets for how to use the funds from equalization grants. However, there is little question that the best practice, and also the most common, is to ensure that equalization grants are general purpose or unconditional grants—i.e., grants provided to subnational governments without strings attached.

A formula is often used to allocate unconditional block grants among local governments. One main problem is that the central authorities may want to pursue multiple objectives with the current equalization grants. It will be more effective to use the equalization grants exclusively for equalizing fiscal disparities across regions, making it explicit what is to be equalized and how. The objective of

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[77] This has also been called the *Robin Hood* approach to funding transfers. The current methodology in Moldova explicitly takes from the richer judets, any amount that exceeds 20 percent of the difference between "normed" expenditure needs and forecasted revenues, and gives the funds to the poorer judets. This practice has meant that Chisinau municipality has contributed to practically all the rest of the other territorial units in the country.
[78] This is a common problem in decentralized systems. In some countries, for example Russia, the central authorities guarantee subnational governments the budgeted amounts for equalization transfers. More often, central authorities change actual amounts for transfers according to the actual performance of the executed budget. For example, the central government will distribute a fixed percentage of actually collected revenues as opposed to budgeted revenues. At any rate, it is important that subnational governments understand the rules and plan their own budgets accordingly.
[79] The Law on Local Public Finance seems ambiguous in this case. See, for instance, Arts. 8 and 9.

closing vertical imbalances in resources and responsibilities between different levels of governments should be pursued via improved revenue assignments. Although revenue sharing and other forms of transfers can be used to reduce vertical imbalances (Chapter 3), the most effective way to address vertical imbalances is by providing subnational governments with an adequate measure of tax autonomy. The special status of some regions, such as ATU Gagauzia, should continue to be addressed outside the general framework of equalization grants. The same is true for any special treatment due to Chisinau municipality as capital city.

Absence of other transfer instruments

A significant feature of Moldova's system of transfers is the dominance played by the gap-filling equalization transfers and the practically non-existence of other types of transfers. Some special budget allocations, which could be considered conditional transfers, do exist. For example, some judets assign budget resources to isolated local governments on an individual basis for public work projects, such as water services. The central government may also assign sporadically similar funds to the judets. However, in practically all cases these are small and typically done on an *ad hoc* basis. An important task ahead for the system of transfers in Moldova is the development of conditional matching and non-matching grants for both recurrent and capital expenditures. The introduction of a selective system of conditional grants—combined with an (on) lending window (Chapter 5)—can be quite effective to promote the financing of national priorities at local level. Funding for these conditional grants would have to come from the re-centralization of some taxes, but they could also come from funds now allocated to line ministries for development programs in the territory.

Unregulated transfers from judet to the primarias

This segment of the system of intergovernmental fiscal relations has not worked properly for the same reasons that the system of transfers between the center and the judets has flawed. But there is an additional element of complexity added here because of the history of mistrust and sometimes abuse between middle level and local governments. As discussed in Chapter 1, Moldova has preserved a highly hierarchical arrangement between the middle and lower level governments. As discussed in more detail in the next section, there are two possible approaches for addressing this issue. One approach would be to bypass the intermediate level government from any type of fiscal authority over local governments, and put in place direct revenue sharing rules and formula driven transfers from the central government to the local governments as well. Besides the obvious advantages in transparency and predictability, this approach (of direct sharing rules and formula) would avoid the nonsense of reintroducing a system that would involve negotiation between the Ministry of Finance officials and the over 600 local governments in the country. A second approach would keep the current hierarchical relationship between the intermediate level and local governments, but this relationship would be fully structured or mandated in the law with explicit revenue sharing rules and formula driven transfers.

In summary, although the current gap-filling system of transfers may have some advantages (flexibility and macroeconomic stability) it does not compensate for the flaws. The design of a system of equalization transfers, besides allowing for the central government policy flexibility and macroeconomic stability, should at the same time improve the incentives, predictability, transparency and objectivity for the adequate fiscal management of local governments. This will require a re-examination of current equalization transfers, and the government should consider developing a complementary system of conditional grants as well.

D. OPTIONS FOR THE REFORM OF THE TRANSFER SYSTEM

The thrust of the reform

The reform of the system of transfers should involve the following two fundamental thrusts.

a. ***The current system of gap-filling and negotiated equalization transfers should be abandoned for a formula-driven system of equalization grants.*** The latter would comprise an explicit and stable rule to establish the pool of equalization funds and a stable and explicit formula used to distribute those funds. The formula will equalize fiscal disparities among judets and primarias on the basis of differences in expenditure needs and fiscal capacity. The pool of funds available for equalization purposes will depend on whether or not, and the extent to which the central government introduces a system of conditional grants.
b. ***The introduction of conditional grants, especially for education and heath.*** The government should also consider the introduction of other conditional grants, with and without matching provisions, in other functional areas and to pursue other central government objectives. The latter would include the funding of programs of social assistance at the local level, grants for capital infrastructure, and others. The use of matching arrangements, whereby the central and local governments jointly participate in the financing of the program, are more conducive to the efficient use of resources because they introduce the right incentives for the local ownership of programs.

Unconditional equalization grants.

The government should give serious consideration to creating a Regional Equalization Fund, based on the set aside of the CIT and VAT revenues, as indicated in chapter 3. The fundamental steps the government would need to take to reform the system of transfers are summarized in Box 4.2. An advantage of a Regional Equalization Fund, based on effectively collected taxes, is that it would objectively establish a sustainable limit for the total amount of transfers to be distributed.[80] With regard to the distribution formula itself, it should be designed carefully, so that efficiency and equity are guaranteed in the system.

The essence of an equalization transfer system is to compensate for fiscal disparities across local governments. Fiscal disparities arise from differences in fiscal capacity and/or expenditure needs. On the one hand, tax capacity should ideally be measured by the size of the tax bases available

[80] In this case the determination of the degree of equalization would be automatically embodied in the system. At the beginning of the system's implementation, the desirable degree of equalization can also be calibrated by adjusting the ratios of the shared taxes entering the Fund, or by adding new sources of resources to the Fund.

to subnational governments or the revenue that these tax bases would yield under standard tax rates. A variety of methods are used around the world to measure fiscal capacity of subnational governments. These include per capita income, gross regional product, and statistical methods to calculate the amount of revenue that a local government would collect if it were to exert average fiscal effort by applying the average tax rate for the entire country to the respective standard tax base of the local government. On the other hand, the expenditure needs of a local government can be defined as the funding necessary to cover all expenditure responsibilities assigned to the region at a standard level of service provision. In practice, this can be measured from the bottom up with norms, but this method presents an array of problems. A simpler and more commonly used approach is to estimate some type of index of relative expenditure need as the weighted sum of demographic factors including population, special needs of the young and the elderly, the level of poverty and unemployment, and differences in the price level or cost of living.

In any case, simplicity and objectivity should guide the formulation of a feasible and lasting *Equalization Transfer Mechanism*. Thereby, the central government may consider discontinuing the current micromanagement and avoiding being intrusive in local matters. In this sense, equalization transfers should be made unconditional. This would allow the central government to use its scarce technical capacity more rationally for the macroeconomic management and the overall control of the system, and would give the opportunity to make the local authorities accountable (before the law and the citizens) for local issues. In this regard, the regular equalization transfer mechanism should be seen exclusively as an instrument for *fiscal equalization*, instead of being seen as an instrument to solve all sorts of intergovernmental fiscal issues. Indeed, even the size of the Regional Equalization Fund will essentially reflect the desired level of horizontal equalization across regions. Beyond that, issues related to vertical imbalances in general, sporadic regional fiscal problems, or delegation of specific central government competences to specific subnational governments should be managed through other special transfer/grants instruments.

All in all, the regular equalization transfer should always be treated as a *general purpose grant*, and be made on a *non-conditional basis*, leaving the final use of funds to be decided by the local authorities. Over time, under proper legislation and transparency rules, this criterion tends to encourage local authorities to be accountable to the local population. Other specific needs, in some ways reflecting national interest—e.g., special programs for encouraging expenditures in basic education, combating contagious diseases, for reducing absolute poverty, for assisting in local emergencies and calamities—should be treated by the central government *complementarily*, through different instruments such as matching or non-matching conditional grants. The remaining vertical imbalances issue should be resolved in the context of a sufficient degree local revenue autonomy.

Box 4.2
Fundamental Steps for Reforming the System of Transfers

The reform of the system of transfers in Moldova may require a series of steps, including to:

- Make clear that equalization transfers are unconditional grants, and that conditional grants will be used to pursue defined objectives of the central government, such as financing minimum levels of education and health services.

- Decide whether local governments should depend for their transfers on the intermediate level government, or if the transfers to local governments should be administered directly by the central authorities.[81]
- Explicitly identify how much equalization should be pursued. Should differences in expenditure needs and fiscal capacity be closed fully or should the system encourage revenue mobilization and keep some additional resources in faster growing regions?
- Determine the funding mechanism for conditional grants and equalization transfers separately, avoiding a "fraternal" mechanism (funded among the judets themselves). The Regional Equalization Fund and the funding for the conditional grants can be financed by centralizing (or setting aside) the proceeds (or a percentage) of several major taxes, including the VAT and the CIT.
- Consider the introduction of rules for the determination of the conditional grants and the equalization pool at both the judet and primaria levels. This can be done in an objective and stable basis as, for example, a percentage of central government tax revenue, or of certain taxes, with this percentage regulated by organic law and/or being computed as some moving average of actual collection of a number of years.
- Use formulas explicitly stated in the organic law for the division of the equalization funds among intermediate level and local governments. Equalization formulas should support a fair allocation of resources by providing more resources to local governments with lower tax capacity and greater fiscal needs. Equalization formulas should be stable over a period of years to promote revenue predictability, should be simple and transparent, should be understandable to all stakeholders, should be impermeable to political manipulation or negotiation in any of its aspects, and should provide the right incentives for revenue mobilization by local governments
- Consider whether to introduce reforms "cold turkey", or whether to introduce some sort of "hold harmless" provision. This is fundamentally a political choice, the former usually being a harder strategy to sell and sustain. Alternatively, a "hold harmless" provision would phase-in the new transfer system over a number of years to smooth out the transition to the new regime and typically make the changes in regional funding more politically acceptable. The international experience has shown that a "hold harmless" provision can smooth out the most significant political opposition to the reforms.

Special purpose conditional grants

A source of friction in the system of intergovernmental finances of Moldova in the recent past has been the different priority given to social sector expenditures by the central and sub national governments. Apparently, the central authorities have wished that judets and primarias had channeled more funds to the education and health sectors. Subnational governments have countered that they simply have exercised their constitutional rights to make their own decisions. Ultimately this has been a conflict between two important objectives: preserving local autonomy and giving (more) expenditure priority to areas of national importance. The creation of a system of *special purpose*

[81] While the former (i.e., the current system) simplifies tasks for the Ministry of Finance, its recent history of disappointments would suggest that an alternative direct system of transfers to the local governments, bypassing the intermediate level of government, may better ensure that the central government objectives are met.

conditional grants for health, education—and possibly other areas as well—from the central to sub national governments, may be a reasonable compromising solution between those two objectives.

These conditional grants should be computed on a "capitation basis" (i.e., per student and per inhabitant).[82] The use of per-client conditional grants for education and health would offer several other advantages. First, these grants would be inherently equalizing, thus addressing another major goal of the decentralization system. Second, because these would be *block grants*, local authorities still would be able to exercise budgetary autonomy in terms of expenditure priorities (within education and health) and the most efficient method of service delivery.[83] Given the massive importance of education and health expenditures in local budgets, the adoption of this system of conditional grants would have drastic implications for the rest of the system of intergovernmental fiscal relations. Therefore, this decision would need to be carefully weighted. Assuming the same overall allocation for social service provision, it will imply that revenue sharing of State taxes with local governments (and the equalization transfers) should be significantly reduced. This scenario is illustrated below in a series of simulations.

The use of conditional grants for education and health on a per client basis will not actually be a radical departure from current budgetary practices. Every year the Ministry of Finance already determines expenditure norms for education and health for the purpose of figuring out the level of equalization transfers to judet governments, and that the latter, in principle, should repeat the process with the primarias. Judets and primarias share most expenditure responsibilities for public education and health services (Chapter 2). However, the government should preserve the conceptual distinction between the *expenditure norms* and the *conditional grants*. Mixing them up invariably leads to major disagreements and disputes. The former are only virtual devices used to measures total needs on the basis of average "per client" expenditures, but should not be confused with the fact that the local governments are free to decide where and how to spend the funds that they are legally entitled to. Conditional grants, on the other hand, would conceptually obligate subnational governments to spend the funds in the areas designed by the central authorities, but contractually or legally delegated to local authorities to implement.

Administration of the new transfer system

The government is now facing a fundamental decision on the administrative organization of the intergovernmental fiscal relations: whether the reformed *equalization transfers* and the new

[82] The per-capita basis could be modified, if needed, by some adjustment coefficient to reflect different costs of provision or needs, but only as long as these adjustments can be made by formula and do not involve negotiation among central and local authorities. Preferably, the difference in needs arising, for example, from different levels and/or quality of infrastructure, would be addressed by sectoral ministries using separate grants disbursed using a formula or objective criteria. It should be emphasized that the presence of better and more modern facilities cannot be an acceptable argument to fund Chisinau municipality or other richer jurisdictions more than other poorer jurisdictions. Otherwise, the system would be adding the inequity of providing less operating funds to those jurisdictions with already more inadequate physical facilities.

[83] It is important to emphasize that the conditional grants should not be made for economic categories of expenditure, such as wages and salaries. This approach would eliminate any of the advantages of a decentralized delivery and implementation system and the full centralization of those services would produce the same results. Naturally, for local governments to be able to increase efficiency in the delivery of services, it would also be necessary to reduce, if not eliminate, central government norms and mandates *that interfere with their choices*.

conditional grants will flow directly from the State budget to the local governments' budgets (primarias and municipalities) or will still go through the judet budgets.

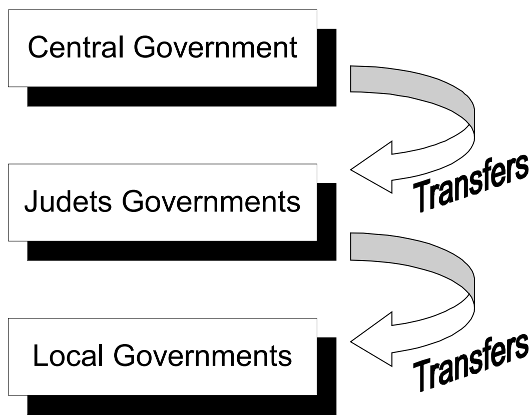
This decision should be congruent with the choice made on the overall approach to organizing intergovernmental fiscal relation in Moldova. The choice (see Chapter 3) is between: (i) *a hierarchical approach* where the central government continues dealing exclusively with the territorial units (i.e., judets, Chisinau municipality, and ATU Gagauzia), and these latter with local governments (municipalities and primarias), and (ii) *a bifurcated system* where the central government deals simultaneously with both territorial units and local governments(see illustration in Figure 4.3).[84]

[84] Actually, the role of the territorial units' governments changes when the administrative organization of the transfers changes from a hierarchical to a bifurcated transfer system. The justification for their controlling/ coordinating role tends to vanish in the latter system, while the justification for their very existence becomes more dependent on efficiency grounds, i.e. whether they can perform some functions (e.g., delivery of intermediate level of public goods and services) that require larger scale in operation.

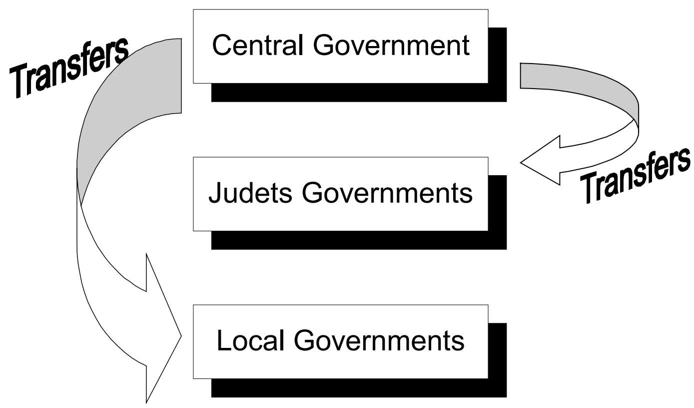
Figure 4.3

Approaches to transfers: Hierarchical versus bifurcated transfer schemes

Hierarchical transfer scheme



Bifurcated transfer approach



E. Illustration of a New System of Transfers

Assuming the reforms are in the direction of those suggested above, this section illustrates how a reformed system of transfers would look like. Given the data limitations and the still tentative assumptions, the results of the simulations presented in this Section are, for the time being, to be taken only as illustration of impacts of possible changes. Because of the lack of data for individual local governments at this point, the fiscal data are aggregated by subnational governments (territorial unit budgets and local budgets together).

Two basic scenarios

The simulations cover two basic scenarios and compare the results to those that would be obtained under the status quo (i.e., the "counterfactual"). The main assumptions behind the counterfactual and the two scenarios are summarized in Table 4.7. The counterfactual is simply the projection of how resources would be allocated in 2002 in Moldova using the policy rules proposed in the 2002 state budget law.

The first scenario (Simulation 1) assumes that revenue sharing for the VAT, CIT and road tax are completely eliminated and the revenues from those taxes set aside into a "Regional Transfer Fund." The rest of the revenue assignments stay the same as in the counterfactual, including 100 percent sharing of the PIT by local governments. Expenditure assignments stay the same as in the counterfactual. The money in the "Regional Transfer Fund" is used for two purposes: first, to introduce a system of conditional grants for education and health, and second to fund a reformed equalization system. The level of funding dedicated to the conditional grants in education and health (the Education account and the Health account, respectively) are chosen so that the conditional grants can finance 50 percent of the expenditures in education and health programmed for 2000 as local budget expenditures on these items in the counterfactual. The level of funding available to implement the reformed equalization transfers (the Equalization account) is equal to the remaining funds left from the previously shared revenues after the conditional grants (or The Regional Transfer Fund minus the Education and Health accounts) plus the funds already programmed for transfers in 2000 the counterfactual.

TABLE 4.7
Simulating Different Systems of Intergovernmental Fiscal Relations: Assumptions of the different scenarios

	Counterfactual	Simulation 1	Simulation 2
Own Source Revenues	• PIT, Land Tax, Subsoil Tax, State Duty, Property Tax, Revenues from Privatization, Other Taxes	• Same	• Same
Revenue Sharing	• CIT – 100 % • VAT – 100 % • Road Tax – 50 % • Mun. Chisinau gets 50% of CIT and 10% of VAT	• None	• CIT – 100 % (including for Chisinau Municipality) • VAT – 0 % • Road Tax – 50 %
Conditional Transfers	• None	• Education Account and Health Account provides 50% of aggregate sectoral need	• None
Equalization Transfers	• Negotiated Transfers	• Distributing the remaining funds on an equalizing basis	• Distributing the Regional Fund on an equalizing basis

The second scenario (Simulation 2) is quite similar to the first scenario except for a few additional assumptions. First, the only shared tax that is centralized is the VAT, with its revenues going into the "Regional Transfer Fund." The CIT and the road tax continue to be shared as in the counterfactual. However, the sharing rates for the CIT are assumed homogenous, i.e. identical across all territorial units, so that Chisinau municipality does not get singled out or "regulated" with a lower sharing rate for the CIT.[85] Second, the government decides not to introduce conditional transfers, but rather concentrates its efforts on a stronger equalization system. The size of the Equalization account (which now coincides with the size of the whole Regional Transfer Fund) in Simulation 2 is determined as the level of counterfactual VAT revenues plus the counterfactual transfers as programmed in the 2002 budget.

[85] Chisinau municipality does not get discriminated against or regulated in terms of the VAT in simulation 1 or 2, since in both cases the VAT is assumed to be not shared.

Allocations and sources of funding under alternative scenarios

The simulations are run under the assumption that the total level of funding for subnational governments remains the same in the two simulations and identical to the funding envelope in the counterfactual. The different scenarios have different implications on the vertical fiscal imbalance and on the control of revenues. Table 4.8 shows how much own source revenues, shared revenues, conditional transfers and equalization transfers contribute in each scenario (Counterfactual, Simulation 1, and Simulation 2).

Table 4.8

Allocations under Alternative Scenarios

	In millions of Lei			In percent of total		
	Counter-factual	Sim 1	Sim 2	Counter-factual	Sim 1	Sim 2
Own Source Revenues	674456	674456	674456	35.3	35.3	35.3
Revenue Sharing	517873	**0**	**340573**	27.1	0.0	17.8
Conditional Transfers	0	**665000**	**0**	0.0	34.8	0.0
Equalization Transfers	540300	**393173**	**717600**	28.3	20.6	37.6
Current Transfers	177316	177316	177316	9.3	9.3	9.3
Total revenues	1909945	1909945	1909945	100.0	100.0	100.0

Source: World Bank Staff estimates (see simulations below in this Section) based on budget data (Ministry of Finance)

The counterfactual estimates

The first step in the simulations is to state the base case (i.e., the counterfactual values). In the absence of the 2000 and 2001 executed budgets, the projected/ planned 2002 subnational revenues and expenditures were used as the counterfactual. This offers the advantage of giving more contemporary relevance to the analysis, but the disadvantage of using planned budget data as opposed to actual data. Tables 4.9 and 4.10 give a detailed breakdown of the estimated counterfactual revenue and expenditures by source for each judet, in total and in per capita terms, respectively. They show the breakdown of the counterfactual budgets by main revenues sources and main expenditure function/ categories, and also provide basic descriptive statistics.

Table 4.9: 2002 Sub national Budgets
Projection of counterfactual sources and allocation of resources
(in millions of Lei)

Territorial Unit	Own Revenues	*of which PIT*	Shared Revenues	*of which VAT (*)*	Total Revenues	Intergov. Transfers	Local Taxes	Fees	Total Revenues (incl. transfers)	Total Expend.	*of which education*	*of which health*	Budget Balance
Balti	77 202	*29 000*	107 025	*80 000*	184 227	22 630	6 485	12 314	225 656	206 849	*113 110*	*50 442*	18 807
Cahul	24145	*5500*	17950	*11000*	42095	42460	2438	7010	94003	84555.7	*49 984*	*18666*	9 447
Chisinau	31816	*11400*	35900	*22000*	67716	97730	1520	5963	172929	165437.7	*97 090*	*37118.5*	7 491
Edinet	38030	*7300*	28750	*20000*	66780	45950	3015	2850	118595	112726.3	*56 680*	*29598*	5 869
Lapusna	32404	*6900*	23693	*16000*	56097	71160	3739	7059	138055	127252.2	*73 968*	*27287.9*	10 803
Orhei	33108	*8200*	24750	*16000*	57858	69820	2517	4953	135148	127676.6	*72 894*	*29891.2*	7 471
Soroca	37037	*9550*	34600	*25000*	71637	43590	3040	5730	123997	115225.9	*61 760*	*28429.2*	8 771
Taraclia	7356	*1800*	4380	*1800*	11736	9000	462	1324	22522	20736.4	*11 511.2*	*4567.3*	1 786
Tighina	22057	*3600*	14625	*10000*	36682	40430	1476	3390	81978	77105.9	*42 975*	*16 717*	4 872
Ungheni	22548	*6000*	23050	*15000*	45598	72130	2355	3884	123967	117729.9	*69 564.2*	*25784.1*	6 237
Gagauzia UTA	22635	*7000*	30150	*23500*	52785	25400	1365	3500	83050	78186.2	*43 825.4*	*15 878.2*	4 864
Mun.Chisinau	326118	*260000*	173000	*52000*	499118	0	38990	51937	590045	499118	*223 077.6*	*120 788.9*	90 927
Total	674 456	*356 250*	517 873	*292 300*	1 192 329	540 300	67 402	109 914	1 909 945	1 732 600	*916 439*	*405 168*	177 345

Source: Consolidated budget projections for 2002, Ministry of Finance.

Table 4.10: 2002 Sub national Budgets
Projection of counterfactual sources and allocation of resources
(In Per Capita Terms, Thousands Lei)

Judets or municipalities	Own Revenues	*of which PIT*	Shared Revenues	*of which VAT (*)*	Total Revenues	Intergov. Transfers	Local Taxes	Fees	Total Revenues (incl transf.)	Total Expend.	*of which education*	*of which health*	Budget Balance
Balti	152.97	*57.46*	212.07	*158.52*	365.04	44.84	12.85	24.40	447.13	409.87	*224.13*	*99.95*	37.27
Cahul	125.71	*28.64*	93.46	*57.27*	219.17	221.07	12.69	36.50	489.43	440.25	*260.25*	*97.19*	49.19
Chisinau	82.86	*29.69*	93.50	*57.30*	176.36	254.53	3.96	15.53	450.37	430.86	*252.86*	*96.67*	19.51
Edinet	134.08	*25.74*	101.36	*70.51*	235.45	162.01	10.63	10.05	418.13	397.44	*199.84*	*104.35*	20.69
Lapusna	114.40	*24.36*	83.65	*56.49*	198.05	251.23	13.20	24.92	487.40	449.26	*261.14*	*96.34*	38.14
Orhei	108.93	*26.98*	81.43	*52.64*	190.36	229.71	8.28	16.30	444.65	420.06	*239.83*	*98.34*	24.58
Soroca	132.27	*34.11*	123.56	*89.28*	255.83	155.67	10.86	20.46	442.82	411.50	*220.56*	*101.53*	31.32
Taraclia	157.50	*38.54*	93.78	*38.54*	251.27	192.69	9.89	28.35	482.21	443.98	*246.46*	*97.79*	38.23
Tighina	129.49	*21.13*	85.86	*58.71*	215.35	237.36	8.67	19.90	481.28	452.67	*252.30*	*98.14*	28.60
Ungheni	87.20	*23.20*	89.15	*58.01*	176.35	278.96	9.11	15.02	479.44	455.32	*269.04*	*99.72*	24.12
Gagauzia UTA	137.87	*42.64*	183.64	*143.13*	321.50	154.71	8.31	21.32	505.84	476.22	*266.93*	*96.71*	29.62
Mun.Chisinau	422.03	*336.47*	223.88	*67.29*	645.91	0.00	50.46	67.21	763.58	645.91	*288.68*	*156.31*	117.67
Average	**148.78**	***57.41***	**122.11**	***75.64***	**270.89**	**181.90**	**13.24**	**25.00**	**491.02**	**452.78**	***248.50***	***103.59***	**38.25**
CoVariation	**0.60**	***1.54***	**0.43**	***0.49***	**0.48**	**0.47**	**0.91**	**0.60**	**0.18**	**0.14**	***0.10***	***0.16***	**0.69**
Minimum	**82.86**	***21.13***	**81.43**	***38.54***	**176.35**	**0.00**	**3.96**	**10.05**	**418.13**	**397.44**	***199.84***	***96.34***	**19.51**
Maximum	**422.03**	***336.47***	**223.88**	***158.52***	**645.91**	**278.96**	**50.46**	**67.21**	**763.58**	**645.91**	***288.68***	***156.31***	**117.67**

Source: Consolidated budget projections for 2002, Ministry of Finance.

The conditional transfers

The first policy move in Scenario 1 is the introduction of conditional transfers for education and health. Table 4.11 shows the formula used for the simulation of the allocation of the conditional funds available in the Education and Health accounts of the Regional Transfer Fund. These conditional grants use the most basic transfer formula since funds are allocated in proportion to one factor. Education transfers are allocated based on the number of school-aged children (using the number of pupils as a proxy), while health transfers are allocated based on the relative size of the "aging population" (using pension-aged population as a proxy). In the case of health total population size could have been used as an alternative indicator—the choice between the total and aging population depend on which indicator is a better proxy for expenditure needs in the health sector. There may not be much difference between the two approaches if the population pyramid looks approximately the same across jurisdictions. Also, for simplicity and lack of data, it was not investigated whether there would be a need to adjust the per student or per inhabitant transfers for differences in cost of provision. Here caution needs to be exercised to avoid taking better infrastructure for standard services as higher cost needs.

Table 4.11
Allocation of conditional transfers

$$\boxed{\text{Conditional Transfer}_i = (x_i / X) \cdot Y}$$

where $X = \Sigma x_i$

x_i = the number of school-aged children (for education), or the number of pensioners (for health), in judet i.

Y = the size of the Education (or Health) account in the Regional Transfer Fund

The equalization transfers

The measurement of expenditure needs. The main paradigm behind the proposed equalization system is to equalize across sub national jurisdictions in proportion to the fiscal imbalance between expenditure needs and fiscal capacity (i.e., potential resources). There exist several approaches to the measurement of expenditure needs in practice (Box 4.3).

Box 4.3
Approaches to Measuring Expenditure Needs

The expenditure needs of a sub national government may be defined as the funding necessary to cover all expenditure responsibilities assigned to the region at a standard level of service provision. In practice, there are several options to measure differences in expenditure needs across sub national governments.

First, expenditure needs can be measured from the bottom up, by costing the current expenditure obligations of local governments or costing a standardized basket of subnational government services. However, this approach is quite demanding of all sorts of information and it requires very explicit procedures for how to cost all aspects of the expenditure responsibilities of sub national governments. Another disadvantage of this approach is that there is no guarantee that the expenditure needs so derived are affordable within the overall budget resource envelope. The insufficiency of funds will require a downward adjustment of the computed budgets. This often can become a source of frustration for subnational government officials, if not cause voters' protests.

Second, a way to establish the expenditure needs of local governments is to rely on historical expenditure patterns. In this regard, expenditure levels would have to be adjusted over time for inflation and possible changes in expenditure responsibilities. But, in any case, it is not guaranteed that even the "adjusted historical expenditure patterns" would properly reflect the "actual" needs, since each jurisdiction may have exerted distinct efforts in terms of expenditure efficiency in the recent past.

Third, a more commonly used approach is to estimate some type of index of *relative expenditure need*. Implicitly, this is what is done when a weighted-factor mechanism is used for the purpose of allocating equalization grants. These indexes attempt to capture, from the simplest to more complex ways, the factors that determine cost differences in delivering a standard package of local government services. These factors include demographic variables reflecting, for example, the special needs of the young and the elderly, other factors such as the level of poverty and unemployment, and differences in the price level or cost of living. The list of criteria entering the index and the weight used need to be carefully assessed and also thoroughly discussed with all stakeholders to ensure that the main causes for substantial differences in the costs of public service delivery across jurisdictions are captured in the index.

Ultimately, the selection of factors and the weights are a political choice. However, the distribution formulas used to distribute equalization grants should be based on a relatively limited number of factors. Inclusion of too many variables reduces the transparency of the allocation scheme. It is also more costly and difficult to update a larger number of variables on a regular basis, and the use of many variables introduces more opportunities for political manipulation. Therefore, a balance has to be struck between simplicity and transparency, and the necessity to find factors that equitably reflect the true fiscal need of local governments. Variables used as factors should accurately reflect needs, come from an independent source, and be free of manipulation by either central government or sub national governments. For example, the use of "outputs" such as school buildings and hospital beds as allocation factors causes inefficiency by providing an incentive that could distort the preferred allocation of resources.

Here a four-step procedure to determine the expenditure needs of each region is used (Table 4.12):

(a) The 2002 counterfactual aggregate level of sub national expenditures is assumed to reflect the aggregate expenditure needs of all sub national governments.

(b) The factors that will be included in the computation of expenditure— population, school-aged population (as proxied by number of pupils) and the number of "aging population" (as proxied by pension-aged people)—are selected. (c)

It is computed, for each factor, the relative need of each jurisdiction. For instance, if jurisdiction A has 10 school-aged children out of a national total of 200, the relative need of jurisdiction A based on this factor is 10/200=0.05.

(d) Weights are assigned to the different factors according to the size distribution of the different categories of expenditure.[86] In the counterfactual, 53 percent of subnational expenditures is for education, so a relative weight of 0.53 is assigned to the factor "school-aged children." Likewise, health expenditures are 23 percent of the counterfactual budget, and thus "pension-aged pop" is weighted 0.23. The remainder (0.24) is assigned in proportion to population.[87]

(e) The weighted sum of relative needs is computed to determine a region's overall fiscal need.

Table 4.12
Computing a basic index of expenditure needs

Step 1.	Determine the **aggregate level of sub national expenditure needs** (SEN) *This may be based on historical data on sub national government expenditures*
Step 2.	Select **expenditure needs factors** *Expenditure needs factors may include population, land area, number of school-aged children, etc.*
Step 3.	Compute each **region's relative need** for each factor (x^j_i / X^j) *For instance, if a region has 10 school-aged children out of a national total of 200, the relative need of this region for this factor is 10/200=0.05.* (x^j_i is the size of factor j in jurisdiction i, and X^j is the size of factor j in all jurisdictions. I.e., $\sum_j x^j_i = X^j$)
Step 4.	Determine the relative importance of each **needs factor** (a^j) *For instance, if education is 25 percent of the aggregate local budget, the factor "school-aged children" may be assigned a weight of 0.25 in the expenditure needs formula.* (a^j *is the weight assigned to factor j, where* $\sum_j a^j$ *=1)*

[86] Lithuania used this approach.
[87] It is important to emphasize the illustrative purposes of this exercise. Clearly, there are other potential factors that could be used, such as poverty indexes or infant mortality rates, and the weights attached can also be selected in different ways. Regression analysis is sometimes used to derive the weights, but this approach assumes a high degree of local autonomy, which Moldova lacks at the present time.

Table 4.12 **Computing a basic index of expenditure needs**	
Step 5.	Determine the **expenditure need for jurisdiction *i*** as: $\boxed{\text{Need}_i = \sum_j (x^j_i / X^j) \,.\, a^j \,.\, SEN}$ where SEN = aggregate Sub national Expenditure Needs

The measurement of fiscal capacity. The next step in the computation of equalization transfers is to determine the level of fiscal capacity, i.e., the ability of each region to collect own source revenues. As in the case of expenditure needs, several approaches can be used to estimate fiscal capacity (Box 4.4).

Box 4.4
Approaches to Measuring Fiscal Capacity

Fiscal capacity of a sub national government may be defined as the potential revenues that can be obtained from the tax bases assigned to the sub national government if an average level of effort (by national standards) is applied to those tax bases. Thus, ideally, tax capacity should be measured by the size of the tax bases available to sub national governments or the revenue that these tax bases would yield under standard tax rates. Using the actual amount of revenue collections in a region as a measure of fiscal capacity should be avoided if local authorities can control tax rates, tax base, or administrative enforcement effort.

A variety of methods are used around the world to measure a state or region's fiscal capacity. First, a measure of fiscal capacity is the jurisdiction's lagged level of revenue collections**,** for example the revenues collected last year. Using past collections does not satisfactorily address the problem of negative incentives. Sooner or later sub national governments will "learn" that higher collections translate into lower transfers.

Second, a widely used measure is the per capita level of personal income. This tends to be a good proxy, which tends to be widely available and it is simple. Another widely used proxy measure is gross regional product (GRP), which is the sub national equivalent of Gross Domestic Product at the national level (GDP), can also be used as measure of fiscal capacity. GRP is a more comprehensive measure of the fiscal capacity than per capita income because GRP includes income generated within a region irrespective of the location of residence of the worker or producer.

Third is the Total Taxable Resources (TTR), a modified version of GRP, which excludes certain items such as central taxes and transfers from the measure of fiscal capacity since they do not provide a potential tax base.

Fourth, some countries (for example, Canada, Untied States, and more recently Russia) have used a multi-dimensional measure of fiscal capacity known as the Representative Revenue System (RRS). The basic idea underlying the RRS is to calculate the amount of revenue that a region would collect if it were to exert average fiscal effort. This is done by collecting data on revenue collections and tax bases for each of the taxes under consideration for every sub national region. Based upon information on all tax bases for every region as well as the national average fiscal effort for each of the taxes, one can compute the amount of revenues that each jurisdiction would collect under average fiscal effort. This amount is then considered to quantify the fiscal capacity of each jurisdiction. The main benefit of RRS is that computations are made at a disaggregated level and based on detailed knowledge of (proxies for) the statutory tax bases.

Overall, the RRS is a thorough and complete method to accurately measure the fiscal capacity of a region. It is based on disaggregated data and takes into account variations in effective tax rates among various tax components and non-tax revenue sources. As a result, fiscal capacity as measured by the RRS can be considered a more accurate representation of a region's true fiscal capacity. However, by the disaggregated nature of the computations, the measure is data intensive and, therefore, it is not always possible to use it.

For the purpose of the simulation, a simplified Representative Revenue System (RRS) approach was used. One of the most important objectives in measuring fiscal capacity is to avoid creating negative incentives to revenue mobilization. In this regard, a distinction between shared revenues and own revenues of sub national governments in Moldova needs to be made. First, shared revenues come from national taxes for which only central authorities can change rate or base. In addition, these national taxes are collected by a central government agency, the State Tax Inspectorate. In theory therefore there is nothing sub national governments can do to change the amount of revenue sharing they enjoy.[88] Thus, in the case of revenue sharing the actual revenues can be directly used in the measurement of fiscal capacity. Second, regarding to own revenues, sub national governments can impact the overall level of collections by either using or not some levies, by choosing higher or lower rates, and by exercising higher or lower diligence in collecting some of the levies. Therefore, in the case of own revenues, actual tax/fee collection cannot be used as a measure of fiscal capacity, since it can vary according to the effort exerted by the local authorities. Thus the "potential" own revenue has to be estimated. The simplified RRS approach can be instrumental for this.

The first step in the simplified RRS approach is to compute an *average effective tax rate* (AETR) as the sum of all own source revenue collections across all jurisdictions divided by a proxy for personal income; the latter being a measure of the tax base.[89] The AETR is computed to equal 0.198. The relatively high coefficient suggests that personal income may have been underestimated.[90] The second step is to define the fiscal capacity for each jurisdiction as the money

[88] However, there are in reality two potential sources of influence by subnational governments on collections from shared revenues. First, subnational governments may have some influence on the actual behavior of local tax officials because local governments cover some of the tax inspector expenses. Second, over the longer term, local officials may affect the level of economic development and therefore the tax bases for shared taxes.

[89] Since data on personal income were not available, the average monthly wages for 2000 and the number of employees across judets were used to come up with an estimate of personal income by judet. (This shows the priority the Moldovan government must give to developing reliable sources of data.)

[90] Because, in order to estimate personal income, only information on wages was possible to obtain. However, the underestimate will not have a serious consequence if the underestimate is proportionally constant across jurisdictions. This is likely the case across all judets. But, for Chisinau municipality the underestimate is likely to be larger than proportionally due to the higher occurrence of other sources of income, such as interest and profits. This means that the fiscal capacity measure for Chisinau municipality is likely to be biased downward or be less proportionally than those of other jurisdictions.

that it would collect if it were to apply a level of fiscal effort equal to the national AETR. In other words, Fiscal Capacity of a specific jurisdiction (i) equals the computed AETR multiplied by the Personal Income of the respective jurisdiction, or Fiscal Capacity in jurisdiction (i) = 0.198 * Personal Income in jurisdiction (i) (Table 4.13).

Table 4.13 **Computing a measure of fiscal capacity based on the idea of a Representative Revenue System (RRS)**	
Step 1.	**Select proxy measures for the tax base (T)** Select measures of a jurisdiction's own sources revenues (i.e., regional revenue collections) and a proxy for the region's tax base, such as aggregate personal income or gross regional product.
Step 2.	**Define the Average Effective Tax Rate (AETR)** The average effective tax rate can be defined as: AETR = $(\sum_i \text{Own source revenue}_i) / (\sum_i \text{Tax Base}_i)$ This coefficient reflects the average share of the own tax (in relation to the tax base) that is collected across all jurisdictions.
Step 3.	**Compute Fiscal Capacity** Fiscal capacity for jurisdiction *i* equals: $\boxed{\text{Fiscal capacity}_i = \text{AETR} * \text{Tax Base}_i}$ This amount reflects the amount of collections that each jurisdiction would have if it would exert an average level of fiscal effort in collecting own source revenues.

The measurement of the fiscal limbalance. Having defined expenditure needs and fiscal capacity for each jurisdiction, now the fiscal imbalance for each jurisdiction can be computed. The methodology can be summarized in three simple steps. First, define the *fiscal imbalance as the difference between expenditure needs and the potentially available resources.* These latter include own fiscal capacity, shared revenues, and other transfers. Jurisdictions that do not have a positive fiscal imbalance—i.e., those where potential available resources exceed expenditure needs—are dropped from the process entirely, since they do not qualify for an equalization grant.

The second step is to define the *"relative fiscal imbalance"* for each jurisdiction that has pre-qualified for an equalization grant. *The relative fiscal imbalance is simply the relative size of each jurisdiction's fiscal imbalance as a share of the aggregate fiscal imbalance* (summed over all jurisdictions with a positive fiscal imbalance). The third step is the assignment of equalization transfers in proportion to each jurisdiction's relative fiscal imbalance (i.e., assign equalization transfers directly to each jurisdiction's "relative fiscal imbalance" (Table 4.14).

TABLE 4.14 **Assigning equalization transfers: compensating for the fiscal imbalance**		
Step 1.	**Define Fiscal Imbalance**	
	Fiscal Imbalance[91]	*= Expenditure Needs – Potential Available Resources* *= Expenditure Needs – Own Fiscal Capacity* *– Shared Revenues – Other Transfers*
	For every region that does not have a positive fiscal gap, set : *Fiscal Imbalance = 0*	
Step 2.	**Define Relative Fiscal Imbalance** $\boxed{\text{Relative Fiscal Imbalance}_i = \text{Fiscal Imbalance}_i \ / \ \sum_i \text{Fiscal Imbalance}_i}$ The relative fiscal imbalance is the relative size of each region's fiscal imbalance as a share of the aggregate fiscal imbalances of all jurisdictions.	
Step 3.	**Assign Equalization Transfer** Define the equalization transfer to local government *i* as: $\boxed{\text{Transfer to Jurisdiction}_i = \text{Relative Fiscal Imbalance}_i * \text{Equalization Account}}$ Where: $\boxed{\text{Equalization Account} = \text{Regional Transfer Fund} - \sum_i \text{Conditional Transfers}_i}$	

The simulation results

The empirical results from the simulations are presented in two sets of tables. The simulation results for Scenario 1 are presented in Tables 4.15 to 4.17 and the simulation results for Scenario 2 are presented in Tables 4.18 to 4.20. The results for the intermediate steps of the computation of conditional and equalization transfers in Scenario 1 are shown in Table 4.15. The first four columns show the estimation of expenditure needs for each jurisdiction on the bases of

[91] This work measures fiscal imbalance from an additive perspective, by subtracting the potential fiscal capacity from the expenditure needs. An alternative approach could be to measure the fiscal imbalance from a multiplicative perspective, where the transfers would be affected by the inverse of the fiscal capacity index. In both cases fiscal capacity is "discounted" from the expenditure needs. Depending on design of the measurement model, both methods can lead to similar results, the former being in general less sensitive to changing assumptions on parameters and easier to understand the results.

the factors and weights discussed above. Table 4.15 also shows the estimates for fiscal capacity and conditional grants, and the absolute and relative fiscal imbalances for each jurisdiction. The overall simulation results for Scenario 1 are shown in Table 4.16 in total amounts and in Table 4.17 in per capita terms. These two tables show the simulated assignment of budget revenues by source, conditional transfers and equalization transfers for each of the jurisdictions, and provide descriptive statistics.

Table 4.15
Scenario 1: Simulated allocation of resources for 2002
Determining the allocation of equalization transfers
(in millions of Lei)

	Factor 1: Population	Factor 2: School-aged pop	Factor 3: Pension-age pop	Expenditure Need	Own Fiscal Capacity	Shared Revenue	Conditional grants	Fiscal Imbalance(FI>0)	Relative Fiscal Imbalance (coefficient)
weight	0.24	0.53	0.23						
Judets/municip.									
Balti	57 588	111 735	62 961	232 284	90820	0	88 361	53 103	0.11
Cahul	21 916	47 027	18 278	87 222	22436	0	32961	31 825	0.06
Chisinau	43 814	106 569	35 926	186 310	39105	0	71867	75 338	0.15
Edinet	32 365	76 405	45 365	154 135	32711	0	61611	59 813	0.12
Lapusna	32 321	62 953	30 353	125 627	30847	0	47150	47 630	0.09
Orhei	34 683	85 735	34 759	155 177	30801	0	60829	63 547	0.13
Soroca	31 952	74 502	36 725	143 179	35865	0	56213	51 101	0.10
Taraclia	5 330	11 346	4 856	21 531	9609	0	8182	3 740	0.01
Tighina	19 437	44 104	17 164	80 705	17454	0	30922	32 329	0.06
Ungheni	29 505	75 728	30 604	135 836	22328	0	53678	59 830	0.12
Gagauzia UTA	18 735	51 088	17 857	87 680	26843	0	34778	26 059	0.05
Mun.Chisinau	88 177	171 086	63 651	322 914	315637	0	118447	0	0.00
Total	415 824	918 278	398 498	**1 732 600**	**674 456**	**0**	**664 999**	**504 315**	**1.00**

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.

Table 4.16
Scenario 1: Simulated allocation of resources for 2002
(in millions of Lei)

Judets or municipalities	Own Revenues	Shared Revenues	Local Taxes and Fees	Total Revenues (excl. transfers)	Transfers from: Education Acc.	Health Acc.	Equaliz. Acc.	Total Intergov. Transfers	Simulated Revenues (incl. transfers)	Total Projected Expend.	Projected Budget Balance
Balti	77 202	0	18 799	96 001	55 972	32 389	41 066	129 427	225 428	206 849	18 579
Cahul	24 145	0	9 448	33593	23 558	9 403	24 611	57 572	91165	84 556	6 609
Chisinau	31 816	0	7 483	39299	53 385	18 482	58 261	130 128	169427	165 438	3 989
Edinet	38 030	0	5 865	43895	38 274	23 337	46 255	107 866	151761	112 726	39 035
Lapusna	32 404	0	10 798	43202	31 535	15 615	36 834	83 984	127186	127 252	-66
Orhei	33 108	0	7 470	40578	42 948	17 881	49 143	109 972	150550	127 677	22 873
Soroca	37 037	0	8 770	45807	37 321	18 892	39 518	95 731	141538	115 226	26 312
Taraclia	7 356	0	1 786	9142	5 684	2 498	2 892	11 074	20216	20 736	-520
Tighina	22 057	0	4 866	26923	22 093	8 829	25 001	55 923	82846	77 106	5 740
Ungheni	22 548	0	6 239	28787	37 935	15 743	46 268	99 946	128733	117 730	11 003
Gagauzia UTA	22 635	0	4 865	27500	25 592	9 186	20 152	54 930	82430	78 186	4 244
Mun. Chisinau	326 118	0	90 927	417045	85 703	32 744	0	118 447	535492	499 118	36 374
Total	674 456	0	177 316	851 772	460 000	205 000	390 000	1 055 000	1 906 772	1 732 600	174 172
Per Capita (L '000)	**185.08**	**0.00**	**48.66**	**233.74**	**126.23**	**56.26**	**107.02**	**289.51**	**523.25**	**475.46**	**47.80**

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.
Note: See text for a description of the assumptions underlying the simulation.

Table 4.17
Scenario 1: Simulated allocation of resources for 2002
(In Per Capita Terms, Thousands Lei)

Judets or municipalities	Own Revenues	Shared Revenues	Local Taxes and Fees	Total Revenues (excl. transf.)	Education Fund	Health Fund	Equalization Fund	Intergov. Transfers	Simulated Revenues (incl transf.)	Total Projected Expenditures	Projected Budget Balance
Balti	152.97	0.00	37.25	190.22	110.91	64.18	81.37	256.46	446.68	409.87	36.81
Cahul	125.71	0.00	49.19	174.90	122.66	48.96	128.14	299.75	474.66	440.25	34.41
Chisinau	82.86	0.00	19.49	102.35	139.04	48.13	151.73	338.90	441.25	430.86	10.39
Edinet	134.08	0.00	20.68	154.76	134.94	82.28	163.08	380.30	535.06	397.44	137.62
Lapusna	114.40	0.00	38.12	152.52	111.33	55.13	130.04	296.50	449.03	449.26	-0.23
Orhei	108.93	0.00	24.58	133.50	141.30	58.83	161.68	361.82	495.32	420.06	75.26
Soroca	132.27	0.00	31.32	163.59	133.28	67.47	141.13	341.88	505.47	411.50	93.97
Taraclia	157.50	0.00	38.24	195.74	121.70	53.48	61.92	237.10	432.84	443.98	-11.14
Tighina	129.49	0.00	28.57	158.06	129.70	51.83	146.78	328.31	486.37	452.67	33.70
Ungheni	87.20	0.00	24.13	111.33	146.71	60.89	178.94	386.54	497.87	455.32	42.55
Gagauzia UTA	137.87	0.00	29.63	167.50	155.88	55.95	122.74	334.57	502.06	476.22	25.85
Mun. Chisinau	422.03	0.00	117.67	539.70	110.91	42.37	0.00	153.28	692.98	645.91	47.07
Average	**148.78**	**0.00**	**38.24**	**187.01**	**129.86**	**57.46**	**122.30**	**309.62**	**496.63**	**452.78**	**43.85**
CoV	**0.60**	**-**	**0.69**	**0.61**	**0.11**	**0.18**	**0.42**	**0.22**	**0.14**	**0.14**	**0.95**
Minimum	**82.86**	**0.00**	**19.49**	**102.35**	**110.91**	**42.37**	**0.00**	**153.28**	**432.84**	**397.44**	**-11.14**
Maximum	**422.03**	**0.00**	**117.67**	**539.70**	**155.88**	**82.28**	**178.94**	**386.54**	**692.98**	**645.91**	**137.62**

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.

The same order of presentation is followed for the results for Scenario 2. The results from the intermediate computations are presented in Table 4.18. In this scenario some of the revenue sharing is retained but the assumption is that there are no conditional transfers. The overall results for Scenario 2 are presented in Table 4.19 in total amounts and Table 4.20 in per capita terms; showing the simulated assignment of budget revenues by source, conditional transfers and equalization transfers for each of the regions, and provide descriptive statistics.

Table 4.18
Scenario 2: Simulated allocation of resources for 2002
Determining the allocation of equalization transfers
(in millions of Lei)

	Factor 1: Population	Factor 2: School-aged pop.	Factor 3: Pension-age pop.	Expenditure Need	Own Fiscal Capacity	Shared Revenue	Conditional transfers	Fiscal Imbalance (FI>0)	Relative Fiscal Gap
Weight	0.24	0.53	0.23						
Judets/Municip.									
Balti	57 588	111 735	62 961	232 284	90820	27 025	0	114 439	0.121
Cahul	21 916	47 027	18 278	87221.97	22436	6950	0	57 836	0.061
Chisinau	43 814	106 569	35 926	186310.2	39105	13900	0	133 305	0.141
Edinet	32 365	76 405	45 365	154134.6	32711	8750	0	112 674	0.119
Lapusna	32 321	62 953	30 353	125627.2	30847	7693	0	87 087	0.092
Orhei	34 683	85 735	34 759	155177	30801	8750	0	115 626	0.122
Soroca	31 952	74 502	36 725	143179.1	35865	9600	0	97 714	0.103
Taraclia	5 330	11 346	4 856	21531.25	9609	2580	0	9 342	0.010
Tighina	19 437	44 104	17 164	80704.52	17454	4625	0	58 626	0.062
Ungheni	29 505	75 728	30 604	135836.2	22328	8050	0	105 458	0.111
Gagauzia UTA	18 735	51 088	17 857	87679.7	26843	6650	0	54 187	0.057
Mun. Chisinau	88 177	171 086	63 651	322914	315637	236000	0	0	0.000
TOTAL	415 824	918 278	398 498	1 732 600	674 456	340 573	0	946 294	1.000

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.

Table 4.19
Scenario 2: Simulated allocation of resources for 2002
(in millions of Lei)

Judets or municipalities	Own Revenues	Shared Revenues	Local Taxes and Fees	Total Revenues (excl. transf.)	Education Fund	Health Fund	Equalization Fund	Intergov. Transfers	Simulated Revenues (incl transf.)	Total Projected Expenditures	Projected Budget Balance
Balti	77 202	27 025	18 799	123 026	0	0	87 072	87 072	210 098	206 849	3 249
Cahul	24 145	6950	9 448	40543	0	0	44 005	44 005	84548	84 556	-8
Chisinau	31 816	13900	7 483	53199	0	0	101 427	101 427	154626	165 438	-10 812
Edinet	38 030	8750	5 865	52645	0	0	85 729	85 729	138374	112 726	25 648
Lapusna	32 404	7693	10 798	50895	0	0	66 261	66 261	117156	127 252	-10 096
Orhei	33 108	8750	7 470	49328	0	0	87 976	87 976	137304	127 677	9 627
Soroca	37 037	9600	8 770	55407	0	0	74 347	74 347	129754	115 226	14 528
Taraclia	7 356	2580	1 786	11722	0	0	7 108	7 108	18830	20 736	-1 906
Tighina	22 057	4625	4 866	31548	0	0	44 606	44 606	76154	77 106	-952
Ungheni	22 548	8050	6 239	36837	0	0	80 239	80 239	117076	117 730	-654
Gagauzia UTA	22 635	6650	4 865	34150	0	0	41 229	41 229	75379	78 186	-2 807
Mun.Chisinau	326 118	236000	90 927	653045	0	0	0	0	653045	499 118	153 927
Total	674 456	340 573	177 316	1 192 345	0	0	720 000	719 999	1 912 344	1 732 600	179 744
Per Capita (L '000)	**185.08**	**93.46**	**48.66**	**327.20**	**0.00**	**0.00**	**197.58**	**197.58**	**524.78**	**475.46**	**49.33**

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.

Table 4.20
Scenario 2: Simulated allocation of resources for 2002
(In Per Capita Terms, Thousands Lei)

Judets or municipalities	Own Revenues	Shared Revenues	Local Taxes and Fees	Total Revenues (excl. transf.)	Transfers from: Education Acc.	Health Acc.	Equaliz. Acc.	Total Intergov. Transfers	Simulated Revenues (incl transf.)	Total Projected Expenditures	Projected Budget Balance
Balti	152.97	53.55	37.25	243.77	0.00	0.00	172.53	172.53	416.31	409.87	6.44
Cahul	125.71	36.19	49.19	211.09	0.00	0.00	229.12	229.12	440.21	440.25	-0.04
Chisinau	82.86	36.20	19.49	138.55	0.00	0.00	264.15	264.15	402.71	430.86	-28.16
Edinet	134.08	30.85	20.68	185.61	0.00	0.00	302.26	302.26	487.87	397.44	90.43
Lapusna	114.40	27.16	38.12	179.68	0.00	0.00	233.93	233.93	413.62	449.26	-35.64
Orhei	108.93	28.79	24.58	162.29	0.00	0.00	289.45	289.45	451.74	420.06	31.67
Soroca	132.27	34.28	31.32	197.87	0.00	0.00	265.51	265.51	463.38	411.50	51.88
Taraclia	157.50	55.24	38.24	250.97	0.00	0.00	152.19	152.19	403.16	443.98	-40.82
Tighina	129.49	27.15	28.57	185.21	0.00	0.00	261.87	261.87	447.08	452.67	-5.59
Ungheni	87.20	31.13	24.13	142.47	0.00	0.00	310.32	310.32	452.79	455.32	-2.53
Gagauzia UTA	137.87	40.50	29.63	208.00	0.00	0.00	251.12	251.12	459.12	476.22	-17.10
Mun. Chisinau	422.03	305.41	117.67	845.11	0.00	0.00	0.00	0.00	845.11	645.91	199.20
Average	**148.78**	**58.87**	**38.24**	**245.89**	**0.00**	**0.00**	**227.70**	**227.70**	**473.59**	**452.78**	**20.81**
CoV	**0.60**	**1.33**	**0.69**	**0.78**			**0.38**	**0.38**	**0.25**	**0.14**	**3.25**
Minimum	**82.86**	**27.15**	**19.49**	**138.55**	**0.00**	**0.00**	**0.00**	**0.00**	**402.71**	**397.44**	**-40.82**
Maximum	**422.03**	**305.41**	**117.67**	**845.11**	**0.00**	**0.00**	**310.32**	**310.32**	**845.11**	**645.91**	**199.20**

Source: World Bank Staff estimates based on budget data (Ministry of Finance) and Department Statistical and Social Analysis.

The best way to make sense out of these simulated reforms is to compare the aggregate results from each simulation to the counterfactual (i.e., the current situation without reform, or the status quo).[92] Each of the two reform scenarios can and should be assessed in terms of the logic of the reforms and how they address important issues, such as providing no negative incentives for revenue mobilization, equalizing the right concept, or finding a balance between the objectives of equalization and enhancing central government objectives on health and education. It is also important that the proposed systems get tested and the simulation results compared to those in the status quo (or counterfactual). These latter comparisons are presented in Table 4.21 in nominal totals and Table 4.22 in per capita terms. Both tables compare the total revenues and the budget balance that result for each of the jurisdictions under each of the three scenarios (the status quo, Scenario 1, and Scenario 2). In any change in the distribution regime it is inevitable to have winners and losers. Tables 4.21 and 4.22 also indicate who are the winners and losers in Scenarios 1 and 2 versus thestatus quo.

Scenario 1 has a few big winners, and fewer big losers. Big winners are relatively poorer judets, such as Edinet, Soroca, and Orhei. Big losers are Chisinau municipality and Lapusca Judet. The results for Scenario 1 are seemingly quite acceptable: *the inequality in total revenues per capita, as measured by the coefficient of variation is lower than in the counterfactual. Scenario 1 also yields a higher average budget balance than the counterfactual.*

The results for Scenario 2 are quite distinct. In this case, Chisinau municipality is the big winner and almost every other jurisdiction loses. The main reason is that in the pursuit of non-discrimination in the derivation-based revenue sharing, Chisinau municipality is allowed to keep the 100 percent of CIT revenues, which more than offsets the centralization of all VAT revenues. Nevertheless, it would always be possible to adjust the simulation for Scenario 2 and, instead, decentralize only a percentage of CIT revenues (thereby adjusting column "Simulation 2" in Table 4.7, accordingly). At the limit, if no decentralization of the CIT is made (with these additional moneys added to Equalization Account of the Regional Transfer Fund), the situation would reverse again with Chisinau municipality being the big loser and all other judets becoming winners. The value of Simulating Scenario 2 is to highlight the interdependence of the transfer system with other elements of the fiscal decentralization policy, in this case revenue assignments. For example, any other intermediary assumption (between the two extremes just shown in this paragraph) is also possible to simulate, including one initial position, which could render a neutral result for Chisinau Municipality as compared to the status quo. In the particular case at hand, all depends on how the percentage of the derivation-based shared taxes (i.e., the CIT in the example) is calibrated to generate the desirable result.

[92] It is also possible to use regression analysis to examine the main features of each alternative system, for example how strong the level of equalization is. However, there are too few observations to make that analysis reliable in the case of Moldova.

Table 4.21
Comparative analysis of the different scenarios:
Total revenues and budgetary balance (in millions of Lei)

	Total Revenues (incl transf.)			Budget Balance			Difference Simulation i versus counterfactual	
	Counterfact.	Simulation 1	Simulation 2	Counterfact.	Simulation 1	Simulation 2	Simulation 1	Simulation 2
Balti	225 656	225 428	210 098	18 807	18 579	3 249	-228	-15 558
Cahul	94 003	91 165	84 548	9 447	6 609	-8	-2 838	-9 455
Chisinau	172 929	169 427	154 626	7 491	3 989	-10 812	-3 502	-18 303
Edinet	118 595	151 761	138 374	5 869	39 035	25 648	33 166	19 779
Lapusna	138 055	127 186	117 156	10 803	-66	-10 096	-10 869	-20 899
Orhei	135 148	150 550	137 304	7 471	22 873	9 627	15 402	2 156
Soroca	123 997	141 538	129 754	8 771	26 312	14 528	17 541	5 757
Taraclia	22 522	20 216	18 830	1 786	-520	-1 906	-2 306	-3 692
Tighina	81 978	82 846	76 154	4 872	5 740	-952	868	-5 824
Ungheni	123 967	128 733	117 076	6 237	11 003	-654	4 766	-6 891
Gagauzia UTA	83 050	82 430	75 379	4 864	4 244	-2 807	-620	-7 671
Mun. Chisinau	590 045	535 492	653 045	90 927	36 374	153 927	-54 553	63 000
Total	1 909 945	1 906 772	1 912 344	177 345	174 172	179 744	-3 173	2 399

Sources: :This table summarizes information contained in previous tables, as: Table 4-9 (counterfactual), columns 9 and 13; Table 4.16 (Simulation 1), columns 9 and 11; and Table 4.19(Simulation 2), columns 9 and 11. The last two columns in this table are derived from its column 5 minus column 4, and column 6 minus column 4, respectively.

Table 4.22
Comparing the different scenarios: total revenues and budgetary balance (in per capita terms; in thousands of Lei)

	Total Revenues (incl transf.)			Budget Balance			Difference simulation versus counterfactual	
	Counterfactual	Simulation 1	Simulation 2	Counterfactual	Simulation 1	Simulation 2	Simulation 1	Simulation 2
Balti	447.13	446.68	416.31	37.27	36.81	6.44	-0.45	-30.83
Cahul	489.43	474.66	440.21	49.19	34.41	-0.04	-14.78	-49.23
Chisinau	450.37	441.25	402.71	19.51	10.39	-28.16	-9.12	-47.67
Edinet	418.13	535.06	487.87	20.69	137.62	90.43	116.93	69.73
Lapusna	487.40	449.03	413.62	38.14	-0.23	-35.64	-38.37	-73.78
Orhei	444.65	495.32	451.74	24.58	75.26	31.67	50.67	7.09
Soroca	442.82	505.47	463.38	31.32	93.97	51.88	62.64	20.56
Taraclia	482.21	432.84	403.16	38.23	-11.14	-40.82	-49.37	-79.05
Tighina	481.28	486.37	447.08	28.60	33.70	-5.59	5.10	-34.19
Ungheni	479.44	497.87	452.79	24.12	42.55	-2.53	18.43	-26.65
Gagauzia UTA	505.84	502.06	459.12	29.62	25.85	-17.10	-3.78	-46.72
Mun. Chisinau	763.58	692.98	845.11	117.67	47.07	199.20	-70.60	81.53
Average	**491.02**	**496.63**	**473.59**	**38.25**	**43.85**	**20.81**	**5.61**	**-17.43**
CoV	**0.18**	**0.14**	**0.25**	**0.69**	**0.95**	**3.25**	**9.21**	**-2.98**
Minimum	**418.13**	**432.84**	**402.71**	**19.51**	**-11.14**	**-40.82**	**-70.60**	**-79.05**
Maximum	**763.58**	**692.98**	**845.11**	**117.67**	**137.62**	**199.20**	**116.93**	**81.53**

Sources: previous Tables

Phasing in a new system of transfers

An important step in the reform of the system of transfers is whether to introduce reforms "cold turkey" or whether to phase-in the reforms over a period of years to smooth out the transition to the new regime. The Government of Moldova will have to weigh these considerations if it decides to go forward with the reforms. A more gradual approach would typically make the changes in regional funding more politically acceptable, since it would give time for the territorial units' administrative structures to adjust. The changes in transfers—and the losers that reform will generate—are often an impediment for the serious implementation of a new system that imply significant departures from the *status quo*. Drastic changes in the system of transfers and the overall level of funding can hurt local governments' ability to carry through longer term plans, may create uncertainty, and may increase political friction, destabilizing the reforms.

Basically there are two approaches to phase in a new transfer system. One approach is to introduce the new mechanism gradually, while maintaining part of the status quo for a period of time. In this case, for a number of years the transfers would be the result of a combination of the original allocation mechanism (i.e., the status quo) and the new allocation system (i.e., the approved alternative scenario).

The other approach is to hold jurisdictions partially harmless, by partially compensating the losers for their loss in revenues due to the regime shift. Often these approaches fix the base transfer or entitlement for the local governments in nominal terms. The transition to the new system is achieved through real growth and inflation, both of which kept to the shrinkage of the historical transfer. This is typically harder to implement at the beginning, because additional funds for the purpose of holding harmless are often not available. Unless there is significant growth in revenues or additional resources could be identified, a holding harmless provision would significantly reduce the available pool of funds for equalization (i.e., the reform implementation may take longer than initially desirable). However, a phased-in program or the use of a hold-harmless scheme may be a preferable alternative to having no reform whatsoever.

In this regard, a viable alternative is to design from the outset a phased-in program of reforms for the system of transfers, aiming at converging to the new system (say, scenario 1) in an explicitly agreed period of time. For instance, in the previously discussed scenarios the program of reform could start with an intermediary position between the two scenarios—as discussed in the previous section—which could generate a financially-neutral result for Chisinau municipality in the first year. From the second year onwards both the uniform CIT sharing rate and the conditional transfer expenditure uniform shares (for education and health) would gradually adjust year after year, so that, say, at the end of the fourth or fifth year the implementation of the program of reforms would be fully accomplished, with the system entirely converged to the Scenario 1.

Managing the new system of transfers

A final consideration is the need to formalize the management and upkeep of the new system of transfers. There will be from the start a need to collect better statistics and improve the existing ones. There will also be a need to update, from time to time, the equalization formula, introducing changes in the mechanism to keep it within its objectives, and to maintain a dialogue with the subnational governments and other stakeholders in order to guarantee the required political support for the sustainability of the system. Administering and improving a system of equalization transfers and conditional grants is a time and qualified human resource consuming activity that will require exclusive attention and dedication within the Ministry of Finance.[93] In this regard, it is crucial to put in place the essential institutions and capacity building programs (see options in Chapters 1 and 5).

[93] Some countries, such as Australia, India, and Nigeria, have also used, in some cases very successfully, the institution of a "Grants Commission." The Commission is a semi-autonomous institution at the central government level, which is exclusively charged with the administration and upkeep of the transfer system. The "Grants Commission" has to be impartial and object in administering the equalization grant system.

APPENDIX

Table A.4.1: Socio-Economic Characteristics of the Judets

	Average monthly nominal salary by judets in 2000, Lei	Percent of population that is elderly (60 and over y. o.)	Share of Pupils in Population (%)	Infantile Mortality (Rate to 1000 New Born in 2000)
1. Chisinau municip.	614.7	10.3	14.1	16.8
2. Balti	358.9	15.6	15.6	18.1
3. Cahul	307.0	11.9	17.7	24.1
4. Chisinau	315.3	11.7	17.2	21.8
5. Edinet	281.0	20.0	14.2	14.9
6. Lapusna	275.7	13.4	18.0	20.9
7. Orhei	317.9	14.3	17.0	18.2
8. Soroca	305.6	16.4	15.5	18.1
9. Taraclia	274.6	13.0	16.5	12.5
10. Tighina	251.1	12.6	18.7	21.4
11. Ungheni	293.1	14.8	18.1	15.5
12. Gagauzia TAU	299.1	12.8	19.9	11.8
Average Republic	**407.0**	**13.6**	**16.3**	**18.3**
Coefficient of Variation	**0.29**	**0.18**	**0.10**	**0.21**

Source: World Bank Staff estimates based on information from Ministry of Finance and Department Statistical and Social Analysis.

CHAPTER 5: TRANSPARENCY AND ACCOUNTABILITY

A. LOCAL FISCAL MANAGEMENT

The budget process at the local government level in Moldova is regulated by two basic pieces of legislation: The *Law on the Budgetary Process and System* and the *Law on Local Public Finance*.[94] Although the original legal framework in the Budget Process Law has become obsolete, the government has kept updating this law, which has undergone several important reforms. These include, for example, the adoption of a modern budget classification system, pilot programs on program-based budgeting and the development of performance measurement techniques, the beginnings of a medium term fiscal framework, and the adoption of a treasury function at all levels of government.

Although important reforms are in progress, the budget process at the local level in Moldova still presents important problems. The modern budget classification is still not fully used in budget execution and budget reporting is late and incomplete. The approval of budgets is not always timely. Despite the recent reform introducing a modern treasury function, the preparation for this reform was inadequate and an effective treasury function will require more human and physical resources. Controls over budget execution remain weak. Ex-post external audit is also weak and budget evaluation is non-existent. The current reforms of the budget process at the subnational level lack an adequate scope because they leave out important problems with the local budget process. The reform effort could benefit from being more comprehensive by capturing some of the interrelationships that exist among the different stages of the budget process. Moldova could also learn from the more comprehensive approaches to the budget process reform recently adopted by Russia and Ukraine.

Increased expenditure efficiency in Moldova requires an adequate degree of budget autonomy to pursue policy priorities that fit the needs and preferences of local residents. Increased expenditure efficiency also requires budget institutions that are effective in implementing those policy priorities by providing clear positive incentives as well as penalties to spending agencies that do not adhere to the stated priorities during budget execution. Expenditure efficiency also requires a high degree of accountability enhanced by external ex-post audit and by evaluating the performance of programs and feeding back that information in the next cycle of budget formulation.

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[94] The initial intention within the Ministry of Finance had been to have the contents of Law on Local Public Finance as part of an amended Law on the Budgetary Process and System. However, parliament opted for two separate laws. In the long term the Ministry of Finance plans to integrate these laws and several other pieces of legislation into a budget code. The Law on Local Public Finance has been fully implemented during 2001 for the first time and it regulates the relations between the state budget and local budgets. The main objective of the Law on Local Public Finance is to structure the transfer of funds from the state to local budgets.

B. BUDGETARY AUTONOMY

All local budget authority in Moldova is delegated by the central government. However, if the public sector in Moldova is to realize the benefits of decentralization, as many other unitary countries have been able to do, there is a minimum degree of budgetary autonomy local governments will require. The principle of autonomy is stated in the Law on Local Public Administration (articles 3 and 4). Financial autonomy implies that local councils can establish tariffs for services provided, establish tariffs to cover expenses for the creation and maintenance of public services, and determine prices to be paid by service users. In addition, article 13 of the Law on Local Public Administration states that local authorities are competent to approve the local budget, manage its execution, borrow, and establish in accordance with the laws, local taxes and fees, as well as mechanisms for their collection.

However, local budgetary autonomy is a complex concept, including multiple dimensions and implications over degree:

Functionality versus hierarchy. Local governments must be able to plan and approve their own budgets separately from the budget of the central government and any other upper-level government. This means that local governments must be able to approve their own budgets even if the upper-level government fails to approve its budget in a timely fashion. For this to happen, local government revenue sources must be certain and stable. For funds that come from upper-level governments, such as tax sharing and transfers, the funds must be determined by fixed and stable rules in the case of revenue sharing, and by formula in the case of transfers. The instability of tax assignments at the sub national level is one of the main culprits. Another possibility for maintaining the autonomy of local governments in this regard is to introduce different and lagged budget process schedules for lower-level governments so that when it comes time to make their own decisions, the upper-level governments already have made theirs.

Sub national budgetary practices in Moldova have not complied with this dimension of local budgetary autonomy. The budget processes at the three levels of government continue to be hierarchically interlinked. Judet budgets cannot be formulated until the central government budget is formulated, and similarly between judets and primarias. This hierarchical dependence takes a special twist in Moldova.

Given the dependence of local governments on central government transfers, the budget process at the local level is, to a large extent, driven by and mirrors the budget process at the central level. The local budget process starts in April when the Ministry of Finance issues the budget circular (the "Methodological Instructions") to the judet councils. The circular contains, besides the fiscal objectives of the central government, the planned tax sharing arrangement and transfers from the central government. Not long after and following the hierarchical tradition of the previous regime, the judet councils issue their own budget instructions to their primarias or local governments. As it was in Soviet times, the next step in the budget process is a bottom-up flow of information, together with dialog and negotiations between each pair of levels of government. First, the primarias forward the judets their budget projections. After discussions with each local government, the judets get together a consolidated budget of their own budget and the aggregate of the primarias' budgets with the judet. These consolidated proposals are forwarded to the Ministry of Finance, where again there are discussions and negotiations with each judet. Once agreement is reached, each local government proceeds to submit their budget to the respective local councils for approval. The Budget Process Law requires local executives to submit their budget to the local councils not later than November 1st. In the case of the judets, this deadline is November 15th. Local councils are supposed to approve their budgets not later than December 10th and judet councils, not later December 20th (Box 5.2).

It is evident how hierarchy wins over function in the scheduling of deadlines. Since the lowest level of government, the primarias, depend on the budgetary decisions on revenue sharing, transfers and also expenditure assignments, made by the judet councils, it would seem more reasonable that he judet budgets get approved before those of the primarias. By the same token, that the central government budget would get finalized and approved before those of the judets. After all, the judets depend on the revenue sharing and transfer decisions of the central government and not the reverse.

Autonomy versus self-supporting. Local budget autonomy implies the ability of local governments to increase and decrease the size of their budgets through the exercise of an adequate degree of tax autonomy. At present, judet councils and local governments (primarias) lack revenue autonomy (Chapter 3).[95] Practically, all revenues for the judets come from tax sharing and other transfers. Local government have their own revenues and some discretion to set rates. But this does not lead to revenue autonomy, mainly because their budgets are determined at the discretion of the judet councils. In theory, local governments are supposed to keep revenues from fees and other local revenues, but in reality they are not free to do so because judets can adjust revenue sharing and transfers in a way that can effectively confiscate (or claw back) local revenues. Thus, basic legislated principles and actual practice are congruent. While the Law on Local Public Finance and the Law on Local Public Administration proclaim that local governments are autonomous, the Budget Law and actual budgetary practice give judet governments practically full discretion to set the budget of local governments. Thus, in practice, the principle of fiscal autonomy of local governments is not obeyed.

There is an important misconception about the nature of local autonomy in Moldova. It is often argued that true autonomy at the primaria level can never exist because most of them are not self-supporting from the revenue side. Autonomy, no doubt, can be deeper and wider if local governments can be self-supporting without any need for transfers from upper level governments. But equating self-support with autonomy is a misconception. Any system of intergovernmental finance has both net donor and net deficit units. The fact that some jurisdictions have to be assisted with transfers does not

[95] Several circumstances have contributed to squeezing the little level of fiscal autonomy that exists at the local level. One such circumstance has been the drastic shrinking of budgetary resources experienced at all levels of government over the entire transition period in Moldova. The lack of skilled and trained local budget officials (on autonomous decision making) made things worse.

detract from genuine autonomy at both the local and regional levels.[96] This autonomy exists not only among net donor but also among net deficit jurisdictions. Autonomy requires stable and certain revenue sources, including those from transfers and shared revenues, the ability to meaningfully raise own revenues at the margin, and discretion in making budgetary choices involving priorities and method of delivery.

Predictability versus uncertainty. To enjoy budget autonomy local governments need a sufficient degree of stability and predictability of revenues and expenditures. Moldova has no formal revenue assignment at the sub-national level, since sharing rates for the major taxes are decided every year in the annual budget law. The current system of transfers is still changed every year by upper-level governments. The entire budget system is informed by a principle of negotiation and uncertainty, not very different from what was practiced in Soviet times. The introduction of a medium-term budget framework and the use of stable rules and formulas, with explicit and stable revenue assignments at the sub-national level, are critical to increase budget predictability and certainty.

Discretion versus rigidity. Local budget autonomy requires that local governments have discretion to use their resources, or most of them, according to their own priorities and that they have freedom to deliver public services using the production techniques and combinations of inputs they consider to be most cost efficient. Although on paper judets and primarias do enjoy certain autonomy in expenditure decisions, in practice this autonomy is reduced in two significant ways.[97] First, staffing decisions are often constrained by central government norms such as teacher-pupil ratios. A different interpretation of current central rules on staffing is that the central governments only recommends staffing levels to local governments which are not compulsory, although central government regulations establish the maximum staffing levels based on several factors including size of the population and financial status. Therefore local governments approve their own staffing levels subject to the ceilings imposed by the central government in statutes of 15 June 1999 and 22 July 1999 and decision No. 139 of February 9, 1998. Second, local government wages are practically set by the central authorities. See Box 5-1. This lack of flexibility detracts from the ability of local governments to keep more able employees or to take advantage of local labor market conditions.

Allegiance versus dual-subordination. Local budget or finance officials need to respond exclusively to local authorities. Unlike other transitional countries, Moldova has kept the old system of dual subordination of local finance officials to the local government and to

[96] It must be noted that most judets in Moldova are not self-supporting either, but autonomy at this level is seldom questioned.

[97] As is the case in other countries in transition, the law in Moldova proclaims the fiscal autonomy of local governments, such is the case in article 9 of the Law on Local Public Administration, but little is said to further guarantee or develop this proclaimed local fiscal autonomy. See Munteanu and Popa (1999). The lack of effective fiscal autonomy is decried in a 2001 declaration of the national league of mayors in Moldova.

the Ministry of Finance.[98] A truly decentralized system cannot have budgetary autonomy and at the same time its key finance officials subordinated to the central government authorities. If there is to be budgetary autonomy, and decentralization is to make progress, finance officials at the local level need to be exclusively subordinated to the local government for which they work.[99] But, this would mean also that the salaries and any fringe benefits for local finance officials would have to be paid exclusively by the local governments. This approach would require that the interest of the central government at the subnational level would have to be carried out by central government de-concentrated offices. One such arrangement is the current system of territorial treasury offices (Trezoreria).

All the way versus halfway. International experience shows that maximum efficiency gains from decentralization are obtained when autonomy and accountability reach all levels of government, and not only, for example, the second tier. Therefore, autonomy and accountability need to be provided at the primaria level rather than stopping just at the intermediate level. In fact, the evidence from other countries shows that the most important gains in efficiency are attained when decentralization reaches further down to the implementation units, such as schools and hospitals. The ongoing sectoral reviews, including the health and education sectors, need to search for ways to increase the autonomy and accountability of officials in charge of the day-to-day operations of hospitals and schools as well.

Free versus induced choices. The pursuit of central government objectives needs to respect subnational budgetary autonomy. The decentralization of public services with national significance provides the advantage of increasing the efficiency of expenditures, but also poses the risks of under-spending by local governments and of significant spending disparities across local governments. Possibly the best way to address this type of concern is to use conditional matching grants, whereby the central government "bribes" (or induces) subnational governments to spend more on particular items of national importance. The central government may also choose to impose minimum expenditure requirements on local governments in areas such as basic education and primary health services. The use of these requirements is clearly detrimental to local governments' discretion and autonomy to make their own expenditure decisions. Therefore, their use should be minimized in a system of decentralized government.

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[98] Law # 496 of June 2001 strengthened the attachment of local finance officials to the central government, but even after this amendment law local finance officials remained under the dual subordination of Local Councils and the Ministry of Finance.

[99] By doing this, Moldova would be joining the ranks of other transitional countries, which have abandoned the dual subordination arrangements of the Soviet Union.

C. BUDGET STRUCTURE AND FORMULATION

Despite recent important innovations in Moldova's budget process, local budgets still fall short of the required standards of providing a clear list of expenditure priorities and complete information for policy-makers to make the right choices.

Negotiation pervades the budget process. The Budget Process Law and the Law on Local Government Finance regulate budget preparation at the subnational level. The budget calendar for local governments must be in line with the state budget calendar. Every year, the Ministry of Finance issues a calendar and a Methodology Note with instructions to the intermediate level of governments on how to prepare their budgets (see Box 5.2 for the 2002 calendar). Each intermediate government does the same for their local governments (primarias, including communes and villages). The Ministry of Finance does not deal directly with the local government.

The budgets of subnational governments need to be balanced. That is, deficits cannot be planned, nor can borrowing from the central government or from commercial banks be counted on to fund recurrent budget expenditures. On paper at least there is a modern budget classification system (article 7 of the Law on the Budgetary System and the Budget Process). The provision is for functional, economic and organizational classification of budget expenditures. There has been much more of a problem with keeping budget execution accounts with this modern classification system.

Box 5.2 Budget Calendar for Local Governments for 2002

April 20	MOF issues Methodology Note for local governments.
June 10	Judets, ATU Gagauzia, and Chisinau municipality submit budget requests to MOF.
August 1st	Discussions of the budget between MOF and judets, ATU Gagauzia and Chisinau municipality will take place.

Local budgets:

Nov. 1st	Mayor of the village, commune, city and municipality review the developed draft budget and based on a decision, shall submit it to the local council for approval.
Dec. 10	Council members approve local budgets.

Judets, the ATU Gagauzia and Chisinau municipality by:

Nov. 15	Submit draft budgets to corresponding councils for approval.
Dec. 20	Approval of the draft budgets by the councils.
Jan. 15	Prepare financial plan submitted to MOF.

Extra-budgetary funds are allowed in Moldova's budget system, although more recently local governments in Moldova do not appear to have used extra-budgetary funds as widely as governments in other countries in transition. The recent requirement that both revenues and expenditures from the extra-budgetary funds at all levels of government be realized through the Treasury Offices has contributed to keeping these extra-budgetary accounts under control.

The methodological guidelines for budget formulation do not vary much from year to year. The first stage in budget formulation is the projection of total revenues from all sources. For tax revenues, the judet's department of finance makes its forecasts on the bases of last year revenues, new data from the tax inspectorates about major trends and taxpayers[100], and the macroeconomic indicators for economic activity from the Ministry of Economy. These forecasts for each tax and in the aggregate are discussed with the Ministry of Finance, and they finally get "approved" by it. Although some disagreement between judets and the Ministry of Finance has occurred, there is much more conflict and need for coordination on the expenditure side of the budget.

On the expenditure side, the methodological guidelines from the Ministry of Finance include a set of norms on the basis of which the judets' finance departments can formulate their expenditure forecasts. These norms are for the entire country and tend to cover the very minimum expenditures (Chapter 2).

The judet finance departments in essence replicate with the primarias the same steps they have followed with the Ministry of Finance, including projections for their revenues and expenditures. At this stage again, the most complex issue in settling local government budgets is the use of expenditure norms. Judets appear to use for the most part the same norms they get from the Ministry of Finance for most primarias, but they also appear to reduce these norms when negotiating the budgets for the smaller villages, on the basis, for example, that there is no "need" for central heating in small villages. In substance, the norms finally applied are negotiated between the primarias and the judet councils, and the primarias are free to submit their own requests and to produce beforehand their own forecast of expenditure needs. The final outcome of this complicated process of negotiation is a set of differentiated budgets for each primaria. All primarias have the same expenditure norms although divided in two groups (municipalities and villages) and each primaria has a different package of shared tax ratio and transfers.

It is unclear who sets expenditure priorities. In theory, subnational governments have freedom to set their own expenditure priorities without minimum expenditure requirements or other a priori restrictions. In practice, allocative efficiency at the subnational level is restricted by implicit expectations by the central government on the

[100] The information provided by the territorial tax inspectorates includes tax return information for the major taxes and a forecast for each large taxpayer. Traditionally there has been some coordination between the state tax inspectorates and the local finance offices in the projection of budget revenues. There appears to be a clear need to update the methodology used for revenue projections, in particular to let different assumptions on macroeconomic performance play a more important role in the forecasts.

use of general transfer funds and also by local expenditure priorities listed in the laws. For example, the Law on Local Public Finance (article 4) declares as priority expenditures the payment of salaries to public employees, allocations to the state social insurance budget, the payment of communal services, the payment of food and medicines in public institutions, and other expenses stipulated by the local council when approving the annual budget. Probably, the proper interpretation of this article is the setting of priorities for payment under budget sequestering for the lack of sufficient revenue inflows to fund the entire budget. The intent would seem to avoid budget arrears in politically sensitive areas, such as wage arrears, even at the expense of other urgent needs on education and health care. On the other hand, article 9 of the same Law on Local Public Finance seems to contradict this interpretation for setting budget priorities by stating that in the case of a shortfall in forecast revenues then "all expenses shall be reduced with the corresponding amounts." The latter would seem to call for equal proportional cuts across the board. To add to the confusion, the Budget Process Law states different priorities for the budget. According to this law, debt services must be first priority for payment.

Decentralization will require that local governments are set free to establish their own priorities for their budgets, both at the time of budget preparation and in the contingency of a budget amendment or sequestering. Mandated priorities make it difficult to increase the allocative efficiency of budgets.

Budget formulation is still incremental and input-oriented. Budget formulation in Moldova has continued for the most part the practices of the old Soviet model, being input-oriented and building incrementally on the resource allocations of past years, without the due concern on goals, outcomes or performance. The result has been little prioritization of public expenditures and whatever prioritization has taken place has been on the input side of the budget.

However, recently important changes have been initiated. Starting with the 2002 budget, the Ministry of Finance commenced the adoption of a "program and performance budgeting" approach on a limited basis at the central government level. This new approach is being used in 2002 in parallel with the traditional methodology for the budgets of the Ministry of Finance, the Statistical and Sociological Analysis Department, in the area of higher education of the Ministry of Education, and in the area of hospitals of the Ministry of Health.[101] Although an unrealistic target, the current plans are to expand the performance budgeting approach to the rest of the budget in 2003. While it will take longer to implement the shift in budgeting approach at the local level, it is clear that this is the right direction to go, and the Government should invest in capacity building and training to this end.

[101] The performance budget pilot project is supported by a USAID project.

Medium-term expenditure framework is still incipient. The lack of predictability and stability in budget flows has been a significant negative feature of the subnational budget process in Moldova. One way to increase the predictability of budget funds is to adopt at least at the central level a Medium-Term Expenditure Framework-MTEF (See Box 5.3).

Box 5.3 A Medium Term Expenditure Framework

An MTEF requires an explicit statement of specific medium-term fiscal objectives and the development of, say, three-year projections for the budget, including expected revenues and transfers, aggregate expenditures by function, the projected budget deficit and its financing. This budget tool allows establishment of a stronger link between budget priorities and budget formulation. The MTEF offers several other advantages. It reveals more clearly the recurrent expenditure implications (in terms of operation and maintenance costs) of capital investment projects. It enhances efficiency by allowing expenditure programs to follow more stable and predictable paths. It encourages government officials to look ahead and establish expenditure priorities over time. It provides governments with an early signal to anticipate budgetary imbalances due to spending commitments in future years. On the other hand, the MTEF should be seen only as a planning tool and not as a budget that commits funds in future time periods. This is important because the macroeconomic conditions of future years may or may not allow for the conversion of planned spending into actual expenditures in the annual budget. The development of the MTEF is a complex task which should be undertaken in stages.

Fortunately, Moldova's government has already started to introduce a medium term perspective on budgeting at the central government level. Even though the Budget Process Law only requires budget projections for two years, the Ministry of Finance has been requiring three-year projections from all spending units, including subnational governments (consolidated at the judet level). The three-year projections are broken down by functional expenditure program and by economic items. In 2001, the Ministry of Finance required revenue projections for 2002 and also 2003 and 2004. These projections are developed on the basis of revenue collections over the past several years taking into account any changes in policy up to 2002 and potential improvements in tax administration. The Ministry of Finance also collected expenditure projections for 2003 and 2004 with the 2002 budget. The expenditure projections were based on the expenditure norms and staff positions that had been introduced by June 1, 2001 and using specific inflation rate forecasts provided by the Ministry of Economy.[102] Although this innovation still falls short of a full MTEF, it has been credited with helping to contain overall growth in public expenditures and the budget deficit, mostly due to the conservative assumptions the Ministry of Finance has been requiring to be used in the projections. The immediate agenda is to start using multiyear projections to set expenditure priorities.

Yet the agenda for reform has been set right, the central government should establish its own MTEF and over time the fundamentals of this practice may be expanded

[102] For 2002 the forecast was 12 percent and for 2003 and 2004, 8 percent and 7 percent respectively.

to sub national budgets. However, no benefit will be derived from this and other budget process innovations unless they are used to solve current bottlenecks and eliminate negative practices. For example, Moldova's budget process still continues the old practice of not setting concrete expenditure ceilings prior to the detailed preparation of budget proposals by the local governments and other spending units. In particular, the methodological instructions for the preparation of the 2002 budget still sets rates of growth for the consolidated budget, without specific budget ceilings. This perpetuates the existing budgetary inertia, where the emphasis is on expanding existing budgets and programs rather than making hard choices on how best to use the resource envelop that each sub national government/ agency has available.

The expenditure projections within the new MTEF should be used as the total expenditure ceilings for each agency for forthcoming years. Although it is not clear at this point that the Ministry of Finance intends to roll over the MTEF projections as expenditure ceiling for budget preparation, this would be a good way to increase budgetary discipline and increase efficiency in the use of budgetary resources both at the central and local levels.

Capital expenditures are poorly budgeted. There has been very little capital spending in Moldova during the transition years. This has been particularly true at the subnational level. Most of the capital projects that have taken place have been the result of direct negotiations between the upper and lower level government. This practice extends the negotiation system to the capital budget arena.

There will be a need to improve the current system of capital grants within the overall reform of the transfer system (Chapter 4). But there is also a need to review the budget formulation process in the capital arena. The Budget Process Law requires that capital spending must be a separate component in the annual budgets. Even though there is some risk that this practice may lead to putting too much emphasis on capital spending as opposed to recurrent expenditures, this risk at the moment does not appear to be a serious one. The questions are whether governments should have their separate public investment programs (PIP) and whether and how to integrate these programs into a medium term expenditure framework (MTEF). A PIP is typically a three-year rolling cycle of planned public investments, which states goals and objectives for capital expenditure programs, lists their potential financing sources, and allows capital spending coordination with the regular annual budgets. The PIP process offers many advantages. It typically includes: the determination of the size and sources of funds for public investment, the selection of projects to be included in the PIP using cost-benefit analyses or other suitable techniques; the development and updating of the PIP document every fiscal year; the monitoring of its execution; and the reporting on and review of its implementation.

One problem with the PIP approach is that the decision-making process is typically housed outside the finance bureaus or the ministry of finance, for example with the planning agency or a ministry of economy. This can lead to disjointed policy decisions and biased budget choices, for example, putting too much emphasis on capital expenditures and too little on the required operation and maintenance (recurrent) expenditures. If the PIP can be housed with finance bureaus and the PIP fully integrated within a MTEF, then the advantages of using separate budgeting for capital purposes can overcome the risks of biased decision making. Given the serious needs for capital infrastructure in Moldova it is important to improve capital budgeting, for example adopting a PIP framework, at the same time the government avoids the bias of considering any type of capital expenditures more productive than any kind of recurrent expenditures.

The costs of tax expenditures and contingent liabilities are not transparent in the budget. There are several other areas of the budget preparation process that can be improved over time. The granting of tax incentives and other favorable tax treatment to particular activities or enterprises (i.e., the cost of "tax expenditures") still goes unreported and not subject to regular budget scrutiny at the present time. Asking all levels of government to report on their destination and amounts should increase the transparency of budgets, reveal their budgetary costs, and is more likely to make them the subject of public scrutiny. It would be a good practice to require in the future a budget annex listing the beneficiaries and, if possible, estimates of the revenues foregone. The transparency of budget reporting would also be increased if all levels of government are required to provide full information on loans and loan guarantees provided by the budgets. This is justified because loans and guarantees represent potential future liabilities (i.e., contingent liabilities) and, therefore, an unplanned use of budget resources. Requiring the explicit reporting of these liabilities will make it more likely that the opportunity cost of these uses of funds would be taken into account at budget time and therefore lead to greater fiscal responsibility. It should be recognized that consistent choices on expenditure prioritization can only be satisfactorily exercised if all concerned expenditure items (including "revenue expenditures" and "contingent liabilities") are simultaneously presented and analyzed in the same specific budgetary document

D. BUDGET EXECUTION

After budget approval by the local councils before the end of the previous year, the judets also need to submit their financial plans to the MOF for budget execution by January 15th. The submitted financial plan allocates monthly budgetary resources throughout the year. Some adjustments can be made to the financial plan, such as for purchased goods and services. However, budget resources for wages and salaries cannot be changed. Changes across budget line items within a group or chapter (from an article to another article) can be made by the local finance department. Transfers of funds across chapters in the budget are not allowed. However, the Law on Local Public Finance (article 24) introduces the possibility of a budget amendment procedure.[103] Any budget

[103] This legislation, however, falls short of establishing clear trigger points to initiate a formal budget amendment process. Article 24 states that "When necessary the executive authorities shall make a proposal to the respective councils on the amendment of the approved budgets and these decisions should maintain budget balance."

additions must be approved by the local councils and, to maintain budget balance, the additional revenues need to be identified or other expenditures reduced. The amended financial plan must be approved by the local council and submitted again to the Ministry of Finance.

Confusing local budget execution authority. Quite recently, Law # 496 (June, 2001) shifted responsibility to execute judet budgets from the judet council itself to the Prefect's Office. Budget formulation and approval still remained the functions of the judet council. The general justification provided for this shift in authority was that in many instances judets used funds for a purpose quite different from that intended (at the center), such as the money intended for paying teacher salaries was used for other purposes. These alleged infractions had been mentioned in several reports of the Chamber of Accounts. There has been considerable confusion regarding the obligation judet councils had to use the money in a prescribed way, because the moneys were not part of conditional grants with explicit restrictions regarding their use. Actually, it appears that in most cases judet councils were exercising their legal authority. It would seem that the conflict arose from a clash of expenditure priorities in judet budgets between the center and the judets themselves. In a decentralized system, local priorities would have been respected in the use of general funding (as opposed to conditional grants). Law # 496 may have marked the beginning of a re-centralization process in Moldova.

The shifting of power for the execution of local budgets to the Prefect's Office created a basic contradiction in the budgeting system.[104] On the one hand, the Judet council remained responsible for approving the budget while the prefect became responsible for executing it.[105] In this way, the incentives had been set for judet councils to behave irresponsibly and approve budgets that could not be executed by the prefects. Thus, the fear has been that, despite the introduction of the treasury function at the local level and the increased control by prefects, arrears and other budget problems would develop at the local level.

[104] Note that at the primaria level the mayor is still responsible for the execution of local budgets. Several reasons have been behind the stripping of budget execution powers from the judets. The general concern at the central level in recent times has been the perception of a lack of sufficient control of the legality of the actions taken by local governments. Or what is similar, the generalized impression at the central level is that local governments have been quite arbitrary in their public finance decisions, in particular those involving local governments.

[105] Officially the role of the prefect has been to act as "administrative trustees over local governments." This has meant that the office of the prefect exercises control over the legality of all decisions and acts of the local and regional governments. The law required subnational governments to report all these decisions to prefecture. The prefect was entitled to ask for changes in acts and regulations he considered against national laws and in the case that the local governments refused to make those changes the dispute supposedly was sent to court. It is not clear that the latter has ever happened. Although the idea has been to uphold national laws, the figure of the prefect has diminished in practice local autonomy and the extent of decentralization in Moldova. Heavier reliance on the courts and less on administrative supervision by central government representatives such as the prefect may be a better way to ensure local government compliance with the national laws. According to the Law on Local Public Adminstration, the ATUs have the status of legal persons and are granted financial autonomy in all matters that pertain to the management of local affairs.

Incipient implementation of the treasury function. Until recently, the lack of adequate accounting and cash management procedures meant that budget execution control was implemented by tracking transfers of funds through bank accounts. One consequence of this was the slow disbursement of appropriated funds to spending units after the budget had been approved. Another problem was that that budget execution system did not provide effective expenditure control and monitoring to prevent the buildup of budget arrears. The budget execution system also was inefficient because it allowed idle cash balances to exist in the accounts of some spending units, while other units were forced to operate under sequester, even though they had not gone over their budget appropriations. In summary, the budget execution process in Moldova lacked a proper treasury function.

In recognition of this problem, the central government in the recent past moved for the fast introduction of a modern treasury function throughout Moldova. Actually, the government accomplished its plans of introducing a treasury system, if not fully operational, at all levels of government by the fall of 2001. The new treasury system covers all local government revenues, including fees in 2000. Coverage of local government expenditures became effective for all local governments in August 2001, with the exception of Chisinau municipality, which became integrated into the new treasury system only in October 2001. This fulfills the mandate in the Law on Local Public Finance. The main function of the treasury system at the local level is to perform the cash execution of local government budgets through the territorial offices of the treasury and the banking system. The territorial offices of the treasury are dependencies of the Ministry of Finance. The Ministry of Finance pays the salary of all treasury employees. The city seats of the judets and the previous rayons all have a territorial treasury office. These offices service the budgets of the smaller primarias in the surrounding geographical area.

Currently all revenues, including those of local governments, are deposited in the single accounts of the treasury system before the funds are channeled to the different government accounts. The central government account of the Treasury is administered by the Central Bank. Similar services are rendered by commercial banks to the territorial offices of the Treasury. Commercial banks compete through public tenders to provide these services to the treasury office.[106]

Unfortunately, there is as yet no computerized network between the primaria offices and the territorial treasury offices. The subnational government budgets are executed according to the approved monthly financing plan that each primaria needs to have. These financing plans are recorded in the territorial treasury offices, which ensure the amounts being paid by the primarias do not exceed those allocated in the primaria's financing plan. Until June 2001, it was the Chairman of the judet council who authorized final payments. After June 2001, this authority has been shifted to the Prefect. At the

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[106] The role of the Central Bank does not extend beyond the transfers of central government resources. If financing comes from central government sources, the transfer of money takes place from the Central treasury account at the Central Bank and is registered in the accounts of the territorial treasuries, which operate through the commercial bank system in the territories.

primaria level, it has been the mayor who authorizes payment. After the introduction of the treasury function on the expenditure side of the budget, the process changed. When suppliers submit payment invoices to the local government, the local treasury office verifies that the invoices are part of the financial plan. After the approval by the treasury office, the documents are sent to the local councils or to the prefect's office for authorization of payment, and finally submitted to the commercial banks for actual payment.

The introduction of the treasury function should also contribute significantly to increase the technical efficiency of budgets. Until now, technical efficiency has been negatively affected by the lack of certainty or even predictability of the flow of funds over the course of budget execution. Lack of cash planning and poor management have aggravated the consequences of a turbulent economic environment giving rise to budget execution under sequestering and cash rationing. So far, this has left spending units unable to execute spending plans and make efficient use of the available resources. Even though the new treasury function will not eliminate the consequences of the unstable economy, it should help increase the predictability of the flow of funds considerably, thus contributing to increased technical efficiency in budget execution.

Moreover, the adoption of a full treasury function at all levels of government can be instrumental in addressing some long-standing weaknesses in budget execution, including the lack of an adequate accounting system based on double entry principles and the low use of information technology for record keeping and sharing information.

However, as it stands, there are still two potential problems with the introduction of the new treasury. First, it remains unclear that control of expenditures is being conducted at the commitment stage, as opposed to the payment stage, although the treasury offices seem to carry out pre-approval of any significant expenditure items.[107] Second, the fast pace of these reforms, completed in many judets over a period of two months, has led to a lack of adequate preparation and training among many local governments and territorial treasury offices. Outside the Central Bank, the treasury system is still not fully computerized, and investment on information technology is particularly deficient at the local level. The central government has to provide all local governments with the basic computer equipment.

There is a second set of problems in budget execution. These issues cover three areas: the buildup of budget arrears, the practice of budget sequestering, and a soft budget constraint mentality.

[107] At least on paper, there is control at the commitment stage. For transactions over Lei 10,000, there has to be a tender approved or otherwise the treasury will not authorize payment. All contracts are registered in the territorial treasury offices. If there is no valid contract signed, the treasury does not consider the transaction valid and therefore does not authorize payment. For transactions under Lei 10,000 there is no need for them to be entered in the contract registry and the treasury pays them as long as the payments are within the totals allowed in the financial plan.

Build up of budget arrears. There has been an increasing accumulation of budget arrears at the primaria and judet levels, in spite of the fact that both deficit financing in general and the accumulation of arrears in particular are prohibited. [108] There is some hope that the accumulation of arrears will decrease over time as the new treasury function shifts the control function from the payment stage to the commitment stage. But it is still uncertain whether arrears will be eliminated in the future. The treasury function is most effective to control excessive commitment for discretionary items, such as supplies by private businesses. But there has hardly been a major problem in this area, because most often businesses have demanded pre-payment for supply delivery. The problem of arrears has been more common among recurrent expenditure items such as salaries and utilities. Here the treasury function will be less able to control arrears. Controlling budget arrears and over-commitment will require political will, explicit enforceable policies, and penalties on budget managers who transgress budgetary rules.

Budget sequestering. The Law on the Budgetary System and Budget Process provides for a budget sequestration procedure for the cases in which actual revenue collections fall well below budgeted revenues. The Law on Local Public Finance does not incorporate a sequestration procedure, but this does not mean that budget sequestration is not implemented at the local level. At the central level, the Ministry of Finance may reduce expenditures proportionally across the board or may propose a different set of priorities, subject to approval by the cabinet and eventually by parliament.

Budget sequestering and cash rationing should be used as a last resort tool to maintain budget balance and fiscal discipline. The practice of sequestering not only can disrupt budget priorities, but it can also deprive spending units of certainty and disrupt planning and budget execution in general. Nevertheless, budget sequestering has been an important instrument to contain the budget deficit at all levels of government. The negative implications of budget sequestering on the redirection of budget priorities should be minimized in the future by making use of the normal, formal budget amendment procedures, which require a new vote from the local councils to approve the amended budget.

Soft budget constraint. One of the most weakening features of any system of decentralized finance is the existence of a soft budget constraint or the ability of local governments to rely on extraordinary central government transfers. This is most damaging to local fiscal discipline and to any incentives for local revenue mobilization. Recent actions by the central government have contributed to create an atmosphere of soft budget constraints in Moldova, such as the Lei 181 million debt forgiveness of local governments (about half on behalf of Chisinau) engineered by the central authorities in 2000 (see Table A.5.2).[109]

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[108] Information on very recent performance is not available but domestic arrears on salaries, pensions contributions, electricity and heating, among a few other items increased by 324 million lei in 1998 and by 159 million lei from January to June 1999. See Table A.5.1 in the Appendix for a profile a wage arrears by judet in 2001.

[109] Article III (and Annex 2) of amendment Law # 1410-XIV (Dec.8th, 2000).

E. BUDGET AUDIT AND OVERSIGHT

Like in many other transitional countries, the weakest link in Moldova's budget process is budget oversight (ex-post audit and budget evaluation). Budget oversight typically covers three different functions as follows.

Internal control. Internal control and audit functions are typically carried out by the spending agencies themselves and by the budget office. The internal audit function in Moldova has been executed traditionally by the Department for Financial Control and Revision of the Ministry of Finance and by the State Tax Inspectorate.[110] The recent creation of a treasury function at all levels of government also dependent on the Ministry of Finance should strengthen the internal audit and control function. Moldova complies with the key feature of an effective system of internal audit and control that officials in charge of this function in the executive branch cannot be involved in any way in expenditure decisions. The territorial treasury offices and the budget execution authorities, at the subnational level, are obliged to file monthly, quarterly and annual reports on the execution of approved budgets.[111] The quarterly and annual reports need to be approved by a joint meeting of the local councils and the local executive authorities. The annual report needs to be presented to the local council for approval not later than March 1 of the following year.

External audit. The charge of the function for external ex-post audit is to examine after the close of the fiscal year the correct use of funds by the executive branch and other organs of government. This function needs to be carried out externally or independently of the spending units in the executive branch. The external audit unit may respond to the legislative branch of government or be an independent institution. In Moldova, at the national level, article 13 of the Law on the Budgetary System and Process establishes that external audit of state budget revenues and expenditures is conducted by the Chamber of Accounts of the Parliament. The Chamber of Accounts reviews the previous fiscal year accounts for the central government and prepares an annual report for Parliament, which deals more deeply with several cases of fund mismanagement.[112]

The status of external audit at the subnational level is murky. The Chamber of Accounts has powers extended to monitor and review the use of earmarked central government revenues by subnational governments. Although pending on confirmation, judet governments claim being audited in recent years by the Chamber of Accounts. Judets and local Councils do not have their own external audit units in the analogous

[110] There have been discussions about introducing internal audit units in the main spending agencies, such as line ministries, but so far this has not materialized.

[111] The Law on Local Public Finance makes local executive authorities responsible for the accurate execution of local budgets (Article 25 of the Law on Local Public Finance).

[112] As the Supreme Audit Institution in the country, the Chamber of Accounts is supposed to be above the daily political turmoil and use restraint and objectivity in its investigations. Unfortunately, there is some evidence that the Chamber has been used as a political tool, for example to complicate the processes for specific foreign investors.

form of regional chambers of accounts, although it has been said that their creation has been considered several times in the recent past. Nevertheless, the local and judet councils are supposed to implement the external audit of their respective executives. It has also been claimed that the finance departments of the judets have performed "external audits" of the primarias under their jurisdiction. There appears to be a wide variety of experiences across subnational governments, but in general, external audit appears to be extremely weak. In any case, the assumption that there is external audit on judets is more of a stretch, since representatives of the council also have direct executive powers. Since external audit requires an agency that is independent, or outside the executive (i.e., those in charge of implementing budgets), it is questionable that there is any external audit performed at the judet level. In summary, external audit is an extremely weak aspect of the budget process at the subnational level.

Performance evaluation. The function for budget oversight is the evaluation of budget performance. In addition to the ex-post audits, which focus on financial aspects and compliance with established budget rules, the government should promote the practice of budget evaluation, focusing on budget performance and outcomes. Unlike the ex-post audit, budget evaluation can be carried out not only by independent units but also by the executive branch of government itself. In Moldova, audit at the local level is mostly focused on the reconciliation of accounts for budget units with the financial statements coming from the banks.

Practically, performance measurement or ex-post evaluation of expenditures as compared with budget program targets and outcomes exist neither at the central nor at local levels. However, the government of Moldova has taken the first steps to put into place some form of budget evaluation by adopting a pilot approach to program and performance budgeting. Assessing the performance of budget programs and feeding those findings back into the budget preparation cycle will be key to improving public expenditure efficiency and also increasing accountability. The analysis of the performance of expenditure programs vis-a-vis the original objectives will help decision makers to redirect and better prioritize budget resources. The introduction of satisfactory budget evaluation practices throughout subnational governments may take time in Moldova, because of the inherent complexities involved in its implementation and the high level of technical skills required. However, these practices could well start at the central level and in the larger municipalities in areas of national significance, such as health and education.

F. RECCOMMENDATIONS

Many important reforms in the budget process at the central level have already been initiated. It will be important for the government of Moldova to stay the course with the current pilot projects supported by international technical assistance agencies. Significant progress has been made in some areas, such as the treasury function, and there is the promise that significant strides could be made in other areas such as program budgeting and external audit and evaluation. If these innovations are to reach fruition and be extended to the subnational level, it is important that the government keep the pace of the reforms.

Improving budgetary autonomy to increased fiscal policy efficiency. The gains in expenditure efficiency associated with fiscal decentralization can only be realized with an adequate degree of autonomy at the local level. In particular, local governments need:

- to have discretion on how to spend resources to minimize the costs of delivering public services,
- some degree of autonomy in raising their own resources at the margin
- to face fixed and stable rules for revenue sharing and explicit formulas for transfers,
- to have lagged budget calendars at different levels of government considered, and norms and legal requirements which impose upper level government expenditure priorities on lower level governments reduced or eliminated.

Eliminating ad hoc negotiations and establishing hard budget constraints. The reforms in expenditure and revenue assignments and the system of transfers proposed here will go a long way to eliminate case by case negotiation and bargaining, and introduce a hard budget constraint environment in the system of intergovernmental fiscal relations. Enabling a hard budget constraint environment requires central government restraints on extraordinary transfers, guarantees and bailing out subnational debt, as well as expanding the budget coverage to consider all implicit expenditures, including tax expenditures. Beyond the resources provided by rules and formulas for shared revenues and transfers, judets and primarias would have to rely more on their own revenues (local taxes and fees). Also, perhaps in the medium-term, they should be allowed to responsibly borrow for capital expenditures, if the government is prepared to put in place the adequate financial reforms based on market incentives and properly regulated municipal capital market. This would lead to more responsible and accountable government and greater efficiency and aggregate fiscal discipline.

Strengthening the incentives for local governments. Introduce the right incentives for reform of the budget process at the local level by allowing local governments to follow their own priorities, and keep any savings from more efficient spending or enhanced tax collection efforts. Top-down enforced reforms will not work without the introduction of vigorous economic incentives that can induce the local authorities to behave in the socially desirable direction.

Strengthening budget formulation to preserve spending priorities. The general budget formulation approach must evolve at all levels of government from an input-oriented exercise to one that focuses on outputs and performance. The government has made a good start with the pilot work on program-based budgeting for several central government agencies. It will be desirable to continue to use the traditional budget format for a while at least at the subnational government level, but practically all budgetary units could start specifying well-defined, feasible outcomes which could be expected from their main programs.

The budget formulation process can be simplified significantly if the budget authority at all levels of government provides a statement of budget priorities and specific expenditure caps for each spending unit. These expenditure ceilings should be linked to the expenditure projections from the rolling medium-term expenditure framework. Nevertheless, the introduction of a functional medium term expenditure framework at the subnational level may take more time and will require a centrally financed, substantial capacity building program. The Budget structure could be improved by requiring explicit accounting of contingent liabilities, cost of soft loans and foregone tax revenues from tax concessions. There will be no harm in keeping a separate capital expenditure budget, as long as the responsibility to commit resources to investment projects rests solely with the financial authorities and all the steps of the regular budget process are followed. If a public investment program (PIP) is used this should be an integral part of the medium-term expenditure framework. Moreover, the transparency and usefulness of subnational budgets could be much improved by declaring illegal the use of extra-budgetary funds at the subnational level.

Improving budget execution to expenditure efficiency and financial control. The government needs to reassess the investment needed for the full introduction of the treasury function at the local level. In particular, it would be desirable to have a computerized network between the primaria offices and the territorial treasury offices. A considerable amount of confusion, and political friction, between the central and intermediate level governments could be avoided in the future if the central authorities are entirely explicit about the unconditional or conditional nature of the funds being transferred to subnational governments. The new budget classification system must be used in both budget execution and reporting. This will require additional resources and training and preparatory work at the local levels. Controlling budget arrears and over-commitment will still require careful monitoring and the government should consider amending the budget process law to include explicit penalties for budget managers who accumulate arrears and transgress other budgetary rules. The budget process law should also be amended to include an automatic trigger for the budget amendment process, for example if there is a budget shortfall above, say, five or ten percent. This would help minimize the disruption of priorities that usually occurs during budget sequestration episodes. The central government needs in the future to dispel any perceptions of a soft budget constraint for local governments, by disengaging itself from any subnational debt forgiveness.

Strengthening external audit to increase transparency and accountability. External ex-post audit and general oversight over budget performance needs to be further developed in Moldova. External ex-post audit needs to be conducted by agencies that are independent from the executive branch of government. Apparently, this has been the case only at the judet level, where the Chamber of Accounts is supposed to conduct annual financial audits. In addition to the accounting audits which focus primarily on the financial performance and compliance with established budget rules, the government should promote the practice of budget evaluation, focusing on budget performance vis-a-vis programmed outcomes. Unlike the accounting audit, budget evaluation can be carried out not only by independent units but also by the executive branch of government itself, and its feedback into the budget formulation process is critical to increasing efficiency in the use of public resources.

Statistical Appendix to Chapter 5

Table A.5.1
Profile of wage arrears in 2001
(in thousands of Lei)

	01.01.2001	01.02.2001	01.03.2001	01.04.2001
Judet Balti	16 235,9	18 295,0	20 233,4	13 638,3
Judet Cahul	3 664,5	4 528,6	4 306,0	3 974,8
Judet Chisinau	7 515,5	6 788,0	5 798,2	5 684,5
Judet Edinet	12 820,7	15 064,0	15 914,5	16 170,6
Judet Lapusna	6 113,5	6 409,2	5 582,0	5 031,8
Judet Orhei	6 598,0	6 223,4	5 641,9	5 859,3
Judet Soroca	9 529,4	10 662,1	10 258,6	8 579,4
Judet Tighina	4 239,5	4 143,8	4 093,6	4 209,0
Judet Ungheni	7 261,4	7 135,1	6 976,9	6 133,9
Judetul Taraclia	1 610,9	1 905,3	1 922,3	1 923,5
UTA Gagauz-Yeri	4 556,3	5 078,6	4 236,6	3 993,2
Municipality Chisinau	13 738,7	10 571,8	12 379,8	12 230,4
Total	**93 884,3**	**96 804,9**	**97 343,8**	**87 428,7**

Table A.5.2
Local debt forgiveness in 2000 arising from Ministry of Finance loans during 1994-1998

Local Public Authorities	Amount of Debts (Thousand of Lei)
Judet Councils	
Balti	11,349.9
Cahul	9,725.4
Chisinau	8,325.2
Edinet	7,588.3
Lapusna	2,400.9
Orhei	4,471.5
Soroca	5,310.1
Taraclia	299.0
Tighina	1,438.8
Ungheni	14,904.5
UTA Gagauzia	19,613.5
Municipality of Chisinau	95,673.7
Total	181,100.8

Source: Ministry of Finance