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Article

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IMPLICATIONS OF THE ASSOCIATION AGREEMENT WITH THE EUROPEAN UNION ON THE FINANCIAL PUBLIC MANAGEMENT IN THE REPUBLIC OF MOLDOVA

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Abstract. *European integration is not just a goal of the foreign policy of the Republic of Moldova, but also a natural aspiration of an European nation to join the European family and the signing of the Association Agreement between Moldova and the European Union is an important step in achieving this goal. The Republic of Moldova has developed and continues to promote rigorous reforms in the area of public finance management. In this article we have analyzed the main reforms and achievements in the field of public finance management in the Republic of Moldova, their importance by reference to good European practices, but also the need to continue them in the context of signing the Association Agreement. The authors argue that until now, the public finance management reform had been focused mainly on the planning and execution phases of National Public Budget, nonetheless the main problems lay in poor budgetary reporting and control. Corruption and fraud are the main risk areas for all the promoted reforms. The conclusion of this paper is that the most urgent actions that should be undertaken consist in improving public procurement procedures, enhancing the internal control, financial inspection and external audit. Only in such a way trustful relation with EU could be created and this is particularly important as it could permit to absorb more European funds to invest in the economic and social development in our country.*

Keywords: European integration; Association Agreement; public finance management reform

JEL Classification: F36; H61; H83

Introduction

The relations between the Republic of Moldova and the European Union (EU) were formally launched on the 28th of November, 1994, by signing the Partnership and Cooperation Agreement (PCA), which entered into force on the 1st of July, 1998. This agreement created the basis for cooperative relations with the EU. The cooperation in the area of public finance was manifesting at that time as a financial support for other reforms. Thereafter, relations between the EU and the Republic of Moldova have evolved by signing the EU - Moldova Action Plan, within the European Neighbourhood Policy, on the 22nd of February, 2005, which has complemented the PCA. The Republic of Moldova has taken initial commitments to reform public finances by signing the Action Plan with the EU. Generally these commitments consisted in the consolidation of public finances,

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tackling debt and reforming the fiscal system. At that time the EU support for public finance management reforms evolved from budget financial support to twinning initiatives in the field of public internal financial control and public procurement system. At present the legal framework of the relations between Moldova and the EU is defined by the Association Agreement, which replaced the CPA. The signing of the Association Agreement between the EU and the Republic of Moldova is an important step to European integration, a new stage of the relations between both sides, which brings Republic of Moldova closer to the European values. The agreement, signed on the 27th of June, 2014 recognizes Moldova's European aspirations and represents not only a base for a cooperation in about 25 sectors, including public finance, but and a connection of the Republic of Moldova's political and economic systems to European values and EU regulations. The Republic of Moldova has developed and continues to promote rigorous reforms in the sphere of public finance management since obtaining its independence. The paragraphs below provide the overview of reforms which are currently in progress in the Moldovan public finance system and budget management, including the assessment of their importance by reference to good European and international practices, but also their perspective in connection to the commitments that result from the Association Agreement.

1. Literature review and theoretical background

European Integration requires changes in the management of public finance. There are two main motivations for the changes in the public finance management in this context. First, as it is argued by Hallerberg and Yläoutinen (2008), is the need for the country to comply with the Maastricht criteria, which includes direct restrictions on fiscal policy (deficits and debts) and this requires more advance techniques of public finance management. The second motivation is the need to create trustful relations with European authorities by demonstrating good abilities to manage public funds. As it is argued by Vasicek and Maletic (2010, p.26), „by introduction of pre-accession assistance programmes the European rules for managing public finance were also partially introduced”.

Vasicek and Maletic (2010, p.25) also note that the preparatory activities for the accession into the European Union is associated with important changes in the management of public finance through the introduction of the following elements: strategic planning, multi-annual budget framework, fiscal discipline, internal audit as well as financial management and control system based on clearly set work processes and procedures. Basing on previous studies on this subject Wescott (2008, p. 2) complements this key elements of the public finance management reform in developed

countries with greater flexibility to managers and organizations in reallocating funds within budget, the emphasize on targets and the use of performance information and computerized information systems providing timely financial and related information. We consider that these reform actions represent an adaptation of the public finance management practices as to correspond to a far more wide reform of the public sector administration, known as the „New Public Management”. This reform of the public management represents a shift from the governance of „rules” to the governance of „scopes”. Translated into budgetary practices this means a shift from the incremental line-item budget to medium term program based budget. According to the World Bank (1998, p.17) and Allen and Tommasi (2001, p.19-20) the main three goals that should be pursued by the public finance management reform are the aggregate fiscal discipline, resource allocation based on strategic priorities and efficiency and effectiveness of programs and service delivery. These goals are very hard to be achieved as this represents a complex change of the public finance management practices, starting with the national public budget preparation, its execution and finishing with public financial control.

2. Data and methodology

The study of the ongoing public finance reforms in the Republic of Moldova performed in this paper is based on the synthesis of the information from several reports on the activity of the Ministry of Finance, the World Bank reports on the technical assistance project in Republic of Moldova, the Strategy on the Development of Public Finance Management 2013-2020 and the Public Financial Management Performance Report prepared in 2011, that has been commissioned by the European Commission.

Regarding the conclusions on the impact of the Association Agreement provisions on the management of public finance reforms, the conclusions were deducted from the analyses of the Association Agreement, EU-Moldova Association Agenda and the Financing Agreement between the Government of the Republic of Moldova and the European Union.

3. Achievements and problems in the area of public finance management in the Republic of Moldova

The analysis of the experience of the countries that are already EU Members shows that European integration has coincided with the application of best practices in public financial management to ensure sustainability, performance, transparency and accountability of public finance.

The main directions of the reforms for strengthening public financial management in the Republic of Moldova coincide with those goals. As it follows we will shortly describe the main reform actions that are being performed in our country.

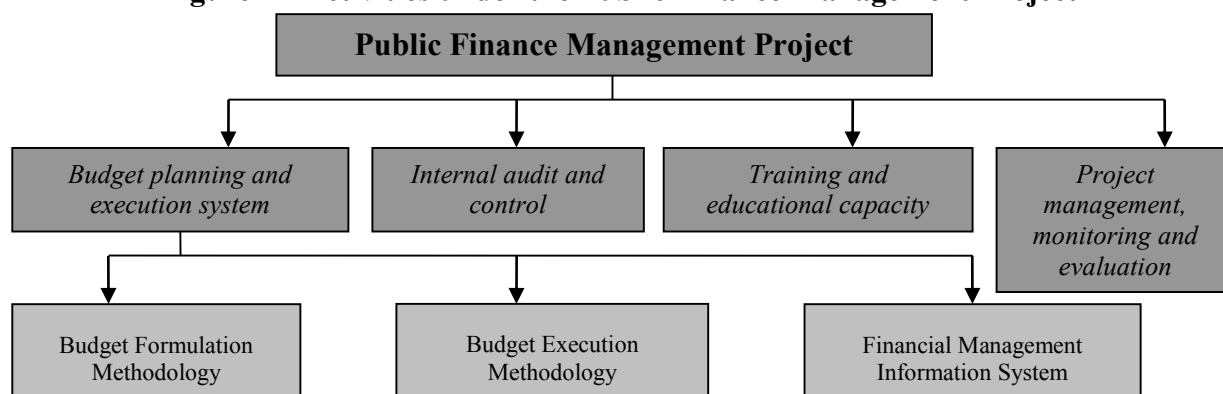
The public finance management reform actions were started in the Republic of Moldova mainly after 2000 and resulted from the commitments that our country has taken to achieve the Millennium Development Goals at the New York Millennium Summit in September, 2000. That is why the period after 2003 was marked by the strategic planning actions at the country level through the development of national strategies in the Republic of Moldova, the first such strategy being the Strategy for Growth and Poverty Reduction. In order to support the practical application of the strategy's provisions it was necessary to review the myopic budget planning process by increasing the time horizon for planning, shifting the emphasis from resources to results, but also linking policies and budget planning. This was performed by introducing a new tool in planning the National Public Budget (NPB) in 2002, namely the Medium Term Expenditure Framework (MTEF) (since 2011 – the Medium Term Budgetary Framework (MTBF)). So we can say that Moldovan authorities have a rich experience with MTF application as so far 11 such documents have been already developed. This area however should be considered as work in progress because MTBF practice has some limitations related to the credibility of the forecasts. More than that, there is still much room to improve detailed processes as well as organisational capacities and skills in the central and local government institutions. There is also a need to advance to a Medium Term Performance Framework that would include sector budgets based on performance indicators.

The main project supporting the Moldova's public finance management developments during 2006-2013 have been the World Bank - funded Public Finance Management Technical Assistance Project, which was completed in December 2013. The Public Finance Management Project (PFMP) represents the most complex program of reforms in this field and includes several activities (Figure 1). According to the World Bank reports the project has accomplished many of its intended results.

First of all the project was concentrated on continuing the previous MTEF reform and enhancing its results. Subsequently, new methodological guidelines for budget preparation have been developed as to integrate medium-term budget planning into the overall budget cycle and enable stronger links between budget allocations and government policy priorities. Besides that, in order to ensure the economic, efficient and effective management of public expenditure, the program-based budget methodology has been applied into practice. As a start it is implemented at the central level. At present the State Social Insurance Fund (SSIF) and the Compulsory Insurance Funds for Medical Assistance (CIFMA) are already being planned and executed basing on expenditure programs. The

share of the State Budget's expenditures that are included in expenditure programs is also growing. Subsequently, a new budget classification was developed and implemented in accordance with the requirements of the IMF GFS standards 2001. The new budget classification, which includes and program classification was adopted by the Ministry of Finance's Order No.190 of 31 December 2014 and entered into force from the 1st of January 2015, for the 2016 draft budget. Alignment of the newly developed budget classification and chart of accounts with international standards has laid a solid foundation for improved transparency of budget and financial reporting.

Figure 1 - Activities under the Public Finance Management Project



Source: Prepared by the authors based on data from the Ministry of Finance of the Republic of Moldova

Concerning the budget execution, the development of the Single Treasury Account (TSA) system was finalised in March 2007 when all budgets, including the whole local level as well as SSIF and CIFMA, were executed via the TSA, which is held in the National Bank of Moldova. All revenue is thus collected on the TSA and all payments are executed from there. Expenditure control is concentrated in the State Treasury within the Ministry of Finance and in the Territorial Treasuries. This contributed to increased transparency and efficiency of budget management through consolidation of all national public budget balances.

Another important action of this project, that represents the largest project activity, is the replacement of the current incomplete and non-integrated information system used by the Ministry of Finance for budget planning and execution with the Financial Management Information System (FMIS). This measure is not simply a technical task, but aims primarily to become a real support for the practical implementation of the new methodology of budget preparation and its execution. The automation of budget operations and financial controls will reduce the time to perform transactions and processing errors, will provide timely and reliable information for effective public expenditure management and enable reliable audit. The Treasury system, implemented through the FMIS is the

main factor in providing proper authorization processes and controlling expenditure, ensuring that budget institutions do not exceed the available appropriation and the monthly allocation. So FMIS will ensure the Government with necessary tools for an effective planning and management of local and central government budgets. Unfortunately this reform measure is still underway.

The application into practice of an internal control and audit system in central government bodies in accordance with best practices and international standards is also one of the latest reform actions within PFMP. According to Moldova - EU Action Plan, Moldova has committed to implement the system of public internal financial control (PIFC) at national level in accordance with internationally recognized methodologies and standards and best EU practices. Subsequently this assumed a comprehensive reform of the internal control and audit in the public sector. Hence, the strengthen of the public financial control was achieved by developing and updating the legal framework for public internal financial control, the establishment of the Central Harmonization Unit (Directorate for the harmonization of public internal financial control within the Ministry of Finance) and internal audit units within central public institutions (77 units at the end of 2013), as well as staff training. According to the consolidated annual Report on public internal financial control prepared by the Ministry of Finance of the Republic of Moldova for the 2013 financial period (Ministry of Finance of the Republic of Moldova, 2014), the development of public internal financial control has registered important improvements, surpassing the implementation phase, during which the institutional foundation were laid, and moved to the consolidation phase, which supposes that the internal audit function should become fully functional and should make an important contribution to the sound management of funds public. We believe that strengthening the external public financial control performed by the Court of Accounts, the Financial Inspection and the National Anti-Corruption Centre is a natural step that should follow after that.

Besides the activities within PFMP there were and other important reforms that have been promoted in our country as to bring the public finance management closer to sound international practices. Regarding the external audit, the new Law on the Court of Accounts, effective from the 1st of January 2009 provides the basis for further development of external audit in line with the INTOSAI standards. Key change introduced by the new law is the shift from external financial control to regularity audit, which the Court of Accounts has carried out for the first time in 2010 by certifying the 2009 Government financial statements. Due to the lack of staff, the Court of Accounts is not able cover the whole spectrum of activities and shares its tasks with the Financial Inspection who audits smaller budget institutions, focusing however mainly on ex-post control of budget execution and regulatory audit.

Basing on the international best practices, the transparency in public finance management has been increased. At present the data on national public budget execution and on the government debt is publicly available through publication on the Ministry of Finance's website. The information on the execution of the NPB is presented not only for the entire financial year but is reported and monthly. Moreover, public expenditure BOOST database allows the public to have access to detailing information on all NPB expenditures since 2005. Transparency is ensured and at the stage of state budget's preparation when the draft budget as well as the amendments to it are being placed on the official website of the Ministry of Finance for public consultation. The Ministry of Finance of the Republic of Moldova ensures transparency and direct participation of members of civil society in working groups responsible for developing the MTBF, which precedes the preparation of central governments budgets. However, amending and supplementing the law on state budget in Parliament remains less transparent.

There have been continuing efforts on the reform of fiscal decentralization lately. According to the National Decentralization Strategy, approved in April 2012, amendments to the Law No.397 on local public finance were adopted in December 2013. They mostly refer to the calculation mechanism of the transfers from the state budget and the local budgets, as well as shared taxes (breakdowns of general state taxes to finance local budgets). This actions come to ensure that in the future it will reduce the mixture of the political factor from the central level in the decision making process at the local level, and therefore it will enhance the capacity of local governments.

The impact of the promoted reforms on performance public finance management can be analyzed from the latest report on Public Expenditure and Financial Accountability (PEFA) that was conducted in 2011. The 2011 PEFA assessment has examined the fiscal system and practices in 2008, 2009 and 2010 and was commissioned by the European Commission. The assessment performed in this report included the evaluation of 31 performance indicators and concluded that there is a general improvement in public finances management in the Republic of Moldova, despite the fact that the assessed periods refer to adverse circumstances due primarily to external shock caused by the global economic crisis as well as the internal disruptions related to the protracted electoral period in 2009 and 2010. However, there are several indicators that show deterioration in the management of public finance. For example, the situation regarding the credibility of the public budget has registered a slight slowdown because the indicator of the composition of expenditure out-turn compared to original approved budget has worsened lately. As experts say, that is due to the impact of the economic crisis. Another limit refers to the disruptions in the preparation process of the budgets because of the political instability, which has lead to a deterioration of the orderliness and participation in the annual budget

process. The most important issues regarding the performance of sound management of public finance refer to the predictability in the availability of funds for commitment of expenditures, effectiveness of internal audit, quality and timeliness of in-year budget reports and of annual financial statements, legislative scrutiny of external audit reports and what is more important there are weaknesses that refer to donor practices. However, since the performance of the PEFA report, the situation of public finance management has been slightly improved. We believe that the adoption and the implementation of the Law on public finance and fiscal responsibility on the 25th of July, 2014 as well as the development of the Strategy on the development of public finance management for 2013-2014 mark an important step in understanding the main weaknesses that remain to exist so far and the necessary actions that should be taken to strengthen previous efforts to enhance the public financial management.

3. The role of the Association Agreement on the management of public finance reforms

The provisions of the Association Agreement on the objectives to be followed in the field of public finance represent a natural continuation of the reforms that are underway in the Republic of Moldova. Issues relating to public finance management are set out in Chapter 7 of Title IV of the Association Agreement between Moldova and the EU and the Association Agenda of the EU and Moldova. Thus according to article 47 of the Association Agreement, cooperation in public finance management „will focus on the implementation of international standards as well as EU good practice in this field, which will contribute to the development of a modern public finance management system in the Republic of Moldova compatible with basic EU and international principles of transparency, accountability, economy, efficiency and effectiveness”.

In the budgetary sphere this cooperation is aimed at removing the shortcomings identified from the assessment of the public finance management. Thus it will focus mainly on improvement and systematisation of regulatory documents on the budgetary, treasury, accounting and reporting systems and their harmonisation on the basis of international standards respecting also good practice in the EU public sector; continuous development of multi-annual budget planning and the alignment to good EU practices; studying the practices of the European countries in inter-budget relations, in order to improve this field in the Republic of Moldova etc. A special attention will be given to the fight with budget fraud and corruption by improving public procurement procedures, strengthening public financial control, including efficient cooperation with the relevant EU institutions. The Agreement does not indicate specific measures to be taken; however, it states that there will be a regular dialogue

on these issues. The dialogue between the two sides has already begun and it is accompanied by financial support for further reforms of public sector management, offered to the Republic of Moldova under the Financing Agreement between the Government of the Republic of Moldova and the European Commission on Support to Public Finance Policy Reforms in Moldova. It supports the efforts of the Government of the Republic of Moldova to progress in some of the crucial areas foreseen by the Association Agreement, including the improvement of public governance. The funding is included in the Single Support Framework for EU support to the Republic of Moldova (2014-2017), which was adopted on 11th of June, 2014 before signing the Association Agreement. Sound management and control of public finances, as well as improved public finance management and transparency, are key political dialogue and reform areas. The financial support is intended to enhance the capacities of the Ministry of Finance, Parliament and the Court of Accounts of Moldova in the management of public money.

The assessment of the objectives supported by the financial agreement shows that the purpose of the management of the public finance reforms in the Republic of Moldova, which are being funded by the EU, is the need to ensure effective use of public funds as to create trusting relationships with Member States, European institutions, and in particular the European Commission. The measures to be promoted include a much larger area of beneficiaries. Unlike previous reforms which were concentrated on the executive authorities, the new reform actions will also focus on legislative authority's capacity building, especially by strengthening the capacity of legislative control, increasing the transparency of the budget adoption procedure and enhancing the accountability of public finances by developing the institutional capacities of the Court of Accounts. As regards to the executive authorities, the reform will focus on improving tax administration and increasing independence of the State Tax Service and the Customs Service, strengthening medium-term planning, improving public access to budget information, improving debt management and strengthening expenditure control and public reporting. Unlike the previous reforms, the objectives of the present reforms envisaged in the Association Agreement, are defined more precisely. This allows us to assume that the EU puts much more hope in the management of public finance reforms, and thus the future European course of our country depends on achieving these objectives.

Until now, the public finance management reform had been focused mainly on the planning and execution phases of NPB. Nonetheless it is obvious that the main problems lay in poor budgetary reporting and control. More than that, we consider that corruption and fraud are the main risk areas for all the reform promoted in our country. Financial control fails to satisfy the needs of sound management of public finance. Although several actions regarding public financial control have been

undertaken until now, they were made separately, without coordination. This has led to the current situation when public financial control is regulated in a fragmented way through several legal acts and is exercised by several institutions with an overlapping and duplication of functions. The low effectiveness of financial control in recent years should prompt policy makers and specialists to concern about the reorganization of the existing public financial control system basing on internationally recognized principles and taking into account the realities of our country. Improving financial control should not be formal, but actual, realized through a productive cooperation with all the institutions involved that would contribute to the improvement of financial control in the Republic of Moldova.

Conclusions

Moldovan public authorities are involved in a complex process of public finance reforms and the agenda of these reforms is very ambitious and optimistic. The bases of the promoted reforms lays in strategic budget planning that was initiated back in 2002, by the introduction of the MTEF, that was continued afterwards with efforts made on enhancing sustainability, performance, transparency and accountability of public finance. Although a lot of work has been done already, many lacks remain to exist. The main problem with the financial public management is the weak public financial control. For this reason it is necessary to continue public finance management reforms that were initiated in the Republic of Moldova but with an emphasis on the fight with budget fraud and corruption. The most urgent actions that should be undertaken consist in improving public procurement procedures, enhancing the internal control, financial inspection and external audit. We believe that only in such a way trustful relation with EU could be created and this is particularly important as it could permit to absorb more European funds to invest in the economic and social development in our country.

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