**July 25, 2018**

Public Policy Observer

Preliminary Note

**Responsible Sustainable Development Policy**

*The Public Policy Observer includes the analysis of draft legislation and regulations that are on the agenda of Government and Parliament, which are generally perceived as sensitive, as well as of certain publicly available information, with a view to identify potential risk to the public interest.*

*The Note is published under the project 'Holding Governors Accountable: Civil Society Conducting Economic Expertise of Risky Legal Initiatives', which is financed by the National Endowment for Democracy. The opinions expressed here are the authors' and do not necessarily reflect the viewpoint or the donors.*

# The New Tax Policy Announced by Authorities: Challenges and Risks

On July 23, 2018 several statements were made at the headquarters of the current ruling party. A 'tax revolution' was announced, and three key directions were traced:

* 'capital amnesty', i.e. legalization of assets and capital,
* decriminalization of economic offenses, and
* tax cuts for individuals and legal entities.

This *Note* is meant to review **announced changes in the taxation of individuals**, particularly the authorities' statements (as no officials acts/drafts are available to the public at the moment):

* Personal income tax rate cut from 18 percent to 12 percent. *'It will be possible because we will cut the rate of personal income tax from 18 percent to 12 percent by introducing a flat tax rate'*;
* two-fold increase in the yearly PIT exemption - from MDL 11,280 to MDL 24,000, and *'Those whose monthly wage is below MDL 3,500 will pay not taxes'. 'Those whose wage is below the subsistence level will no longer be taxed. The measures we are talking about will result in higher income for employees (by 6 percent) and employees (by 5 percent). people will end up with more money in their pockets and we count on more revenue to the national budget';*
* *'We are discussing the new measures with the International Monetary Fund'. 'All reforms, including these, have been agreed upon with external partners, with the IMF and the World Bank'*;
* *'The reform will be approved until the end of the current Parliament session, i.e. by end of this week. We are talking here about the reform that has been long awaited by the business community. Its impact on the budget would amount to about* ***MDL 2 billion****. The state budget can* ***accommodate******the*** *first-stage* ***expenditure'****;*
* *'Tax measures to be implemented in fall will allow for collecting* ***revenue of MDL 2 billion****.'*

# Identified Challenges and Risks

* The statements seem to give the signal that the authors of the initiative see differently the immediate short-term impact of this act. The Prime Minister believes that the budget will get immediate additional revenue of MDL 2 billion, while the Chairman of the Standing Parliamentary Committee expects a budget gap in the same amount due to lower revenue. In this context, it should be noted that such comprehensive legislative initiatives need to include clear impact assessments that can be discussed with the public.
* The flat personal income tax (12 percent) will be applied by **cutting the maximal PIT rate** from 18 percent to 12 percent and **increasing the minimal PIT rate** from 7 percent to 12 percent. The first group of taxpayers are high-wealth individuals. The second group includes individuals will low and medium income levels: the tax rate for this group will go up from 7 percent to 12 percent.
* A compensatory measure for low-income individuals might be the announced two-fold increase of the amount of personal exemption (non-taxable minimum), from MDL 11,280 to MDL 24,000. However, given that in 2018 taxable income up to MDL 30,000 is taxed at the PIT rate of 7 percent, while in future the 12-percent PIT rate will apply to income above MDL 24,000, the impact of the measure is not unequivocal. Individuals with low and medium income would feel an insignificant impact of the increase in personal exemption, while high-wealth individuals will have substantial gains.
* The analysis of the data in the table (see annex: 'Disposable income of individuals: current tax policy vs. the proposed 'new tax policy'') shows that for different groups of employees (in agriculture and forestry, education, health care, the financial sector and one example of a high-wealth individual) the use of the new flat PIT rate of 12 percent would look as follows:
* tax exemption and lower tax burden mostly for high-wealth individuals, significant increase in their disposable income (from several hundreds to several thousands of MDL);
* the 'savings' of individuals with low and medium income would be insignificant and their disposable income would increase only slightly (from several MDL to several tens of MDL);
* the gap between the disposable income of the low and medium income group and of high-wealth individuals would widen and tax unfairness would increase. It would be a consequence of the change in the rate of (after-tax) disposable income against (pretax) gross earnings. Thus, the disposable income of individuals with low and medium income would basically remain the same (83-85 percent of gross earnings). High-wealth individuals, however, will gain 3-4 percentage points of disposable income in gross income if compared to the current taxation formula. Hence, the announced increase in income by 6 percent would mostly end up in the pockets of those who have higher income rather than of those with low or medium income;
* higher disposable income of high-wealth individuals might lead to higher domestic consumption and inflationary expectations (higher prices), which would affect those who have low income.
* For countries with strong income gaps and obvious poverty, progressive taxation of income of individual is recommended, i.e. different tax rates for different taxpayer groups, as it is now. Flat tax rates are used in large advanced economies that have a significant middle class.
* PIT revenue is split between the central and local budgets. Hence, lower budget revenue would first of all affect local budgets, at least at the first stage. The authors of the reform initiative did not mention any clear compensatory measures or funds to be provided to local budgets. One might assume that inter-budgetary relations between some local public authorities and the state budget would be channel used to 'ensure loyalty' in regions, as already concluded by a number of recent studies.[[1]](#footnote-1)
* Restricting the funding of local authorities, particularly during election periods, is a sensitive matter and would generally ensure 'greater' loyalty' towards central authorities. The local budgets might get about MDL 800 million a year less funding.
* Thus, the immediate burden of the reform would be borne by the state budget. On one hand, local budgets should get compensation equivalent to the amounts lost due to the implementation of the new taxation system. On the other hand, additional funds need to be identified to increase transfers to the social fund, to compensate lower contributions by employers (down from 23 percent to 18 percent) if other measures fail to yield expected outcomes in due time.
* As it was announced that the new provisions would apply since October 2018, the state budget needs to be revised no later than September. Otherwise, the public sector might face financial blockage.
* The state budget would not get in 2018, as planned initially, certain funding from external partners, particularly the EU. The wipe-off of MDL 2 billion more at the initial stage of the reform implies urgent measures to cut budget expenditure or borrow more by end of 2018, which would affect the budget in the years to come.
* The authorities count on inflows from quasi-financial projects, which is not sustainable in the long term. Moreover, some of these projects involve greater state debt and state guarantees rather than greater investment in the real sector that would generate new tax capacity.
* The IMF-supported program, as well as the authorities' dialog with the IMF might be affected by policies that might undermine the budget setup and the stability of public finance in the long term.

*In one of the following issues of the Public Policy Observer we will have a look at two other aspects of the tax reform package, namely the capital amnesty and the decriminalization of economic offenses, in a more complex context.*

***Annex***

|  |
| --- |
| **Disposable income of individuals: current tax policy vs. the proposed 'new tax policy'**  |
|  |  | Agriculture and Forestry | Education | Health | Financial Activities and Insurance | Case Study: high-wealth\*\* |
| Average monthly wage, Q1 2018\* | MDL | 3,713 | 4,680 | 5,477 | 11,263 | 41,667 |
| Yearly Income | MDL | 44,556 | 56,160 | 65,724 | 135,156 | 500,000 |
| **current tax policy** |
| individual social contributions | 6% | 2,673 | 3,370 | 3,943 | 8,109 | 30,000 |
| Health insurance | 4.5% | 2,005 | 2,527 | 2,958 | 6,082 | 22,500 |
| Personal exemptions | MDL | 11,280 | 11,280 | 11,280 | 11,280 | 11,280 |
| **Taxable income** | MDL | 28,598 | 38,983 | 47,543 | 109,685 | 436,220 |
| Yearly income tax, 7% | MDL | 2,002 | 2,310 | 2,310 | 2,310 | 2,310 |
| Yearly income tax, 18% | MDL | 0 | 1,077 | 2,618 | 13,803 | 72,580 |
| **Total yearly income tax** | **MDL** | **2,002** | **3,387** | **4,928** | **16,113** | **74,890** |
| Monthly income tax | MDL | 167 | 282 | 411 | 1,343 | 6,241 |
| **Available monthly income (post-tax)** | MDL | 3,156 | 3,906 | 4,491 | 8,738 | 31,051 |
| **Available monthly income (post-tax)** | **% of gross income** | **85%** | **83%** | **82%** | **78%** | **75%** |
| **New tax policy** |
| individual social contributions | 6% | 2,673 | 3,370 | 3,943 | 8,109 | 30,000 |
| Health insurance | 4.5% | 2,005 | 2,527 | 2,958 | 6,082 | 22,500 |
| Personal exemptions | MDL | 24,000 | 24,000 | 24,000 | 24,000 | 24,000 |
| **Taxable income** | MDL | 15,878 | 26,263 | 34,823 | 96,965 | 423,500 |
| **Yearly income tax, 12%** | **MDL** | **1,905** | **3,152** | **4,179** | **11,636** | **50,820** |
| Monthly income tax | MDL | 159  | 263 | 348 | 970 | 4,235 |
| **Available monthly income (post-tax)** | MDL | 3,164 | 3,926 | 4,554 | 9,111 | 33,057 |
| **Available monthly income (post-tax)** | **% of gross income** | **85%** | **84%** | **83%** | **81%** | **79%** |
| \* - <http://www.statistica.md/category.php?l=ro&idc=452&>  |
| \*\* - income of heads of agencies, state owned companies etc. |
| **Clear loss:** local budgets |
| **Clear gain:** high-wealth individuals |
| **In future,** the 'new tax policy' will result in: |
| - greater gap between the rich and the poor, |
| - greater dependence of local budgets on the "Central power' |

1. <http://www.transparency.md/2018/07/18/studiu-monitorizarea-implementarii-reformei-administratiei-publice-si-a-distributiei-resurselor/> [↑](#footnote-ref-1)