

## SOCIAL IMPACT OF THE TAX SYSTEM

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**Abstract:** Taxation is a very important part of the financial system. It affects all aspects of our lives, including social and economic. The tax system and the social sphere are interconnected. Taxation influences social processes through taxation of income and real estate, as well as pricing. And the social sphere has an impact on the tax system in two directions: through the need to introduce tax benefits for certain social groups of citizens and through the fiscal orientation of the tax system. In developed countries, the tax system is quite organically connected with the ideas of social justice. But adherence to the principle of social justice through the provision of tax benefits conflicts with fiscal and incentive objectives. Tax benefits of a social nature reduce tax revenues to the budget, which ultimately leads to a general increase in the tax burden for other taxpayers. Thus, analyzing the effectiveness of the interaction between taxation and the social sphere is important both for improving the tax system and for leveling the negative impact of taxes on some social phenomena.

**Key words:** taxation, income level, social justice, income differentiation, tax benefits

**JEL Classification:** H24

### Introduction

One of the main functions of the state is social. At the same time, one of the main meanings of this function, in our opinion, should be the leveling of existing social tensions in society, the equalization of the social status of the population, the development of the healthcare system, education and culture. Today, the successful fulfillment by our state of its social function is associated, first of all, with solving the most pressing social problems - the maximum possible elimination of sharp differentiation of incomes of different segments of the population, solving pension problems, supporting the most socially vulnerable segments of the population.

To solve these problems, the state uses various tools. To implement the principle of fairness in the distribution of income, weaken the existing severity of social stratification of the population and reduce the level of poverty in the country, it is necessary to change the entire system of income redistribution. In this regard, an important tool is the tax mechanism, primarily taxation of personal income. The influence of taxes on the income of the population occurs both directly and indirectly, is carried out in the course of tax regulation and represents a system of special measures in the field of taxation aimed at state intervention in the market economy in accordance with the concept of social development adopted by the government. At the same time, through taxation it is possible to smooth out some negative aspects of the distribution of income of the population.

## Headings

An important aspect of the social crisis in the Republic of Moldova is the uneven distribution of income among the population. The continuing decline in the standard of living of the majority of the population is accompanied by the concentration of enormous wealth in the hands of a very narrow group of citizens.

Increasing inequality in income distribution, its low level among the majority of the population, and the concentration of funds by a relatively small group of people reduce aggregate consumer demand, making it one-sided, which does not contribute to the development of production and the real sector of the economy. And growing socio-economic stratification is becoming one of the most pressing problems of our time. Through tax regulation, the problem of income redistribution can be partially solved in order to reduce their differentiation among different segments of the population. Various coefficients are used around the world to determine the degree of inequality.

1) Quintile coefficient: the ratio of the average income of the richest 20% of the population to the average income of the poorest 20% of the population.

2) Palma Index: the share of the richest 10% of the population in gross national income (GNI) divided by the share of the poorest 40%. Based on the work of José Gabriel Palma (2011), who found that middle-class incomes almost always account for about half of GNI, with the other half split between the richest 10% and the poorest 40%, but the shares of these two groups vary widely across countries.

3) Gini coefficient: an indicator characterizing the deviation of the actual distribution of income of individuals or households in a particular country from absolute equality. An index value of 0 corresponds to absolute equality, 100 to absolute inequality.

**Table 1. Income quintile ratio, Palma index, Gini index in selected countries**

<b>Selected countries</b>	<b>Income quintile ratio 2010–2015</b>	<b>Palma index 2010–2015</b>	<b>Gini index 2010–2015</b>	<b>Gini index (year)</b>
Israel	10,3	2,2	42,8	39, 0 (2016)
Russia	8,2	2,0	41,6	37,5 (2018)
USA	9,1	2,0	41,1	41,1 (2016)
Türkiye	8,0	1,9	40,2	41,9 (2018)
Georgia	8,2	1,9	40,1	36,4 (2018)
Bulgaria	6,9	1,5	36,0	40,4 (2017)
Latvia	6,7	1,4	35,5	35,6 (2017)
Germany	4,6	1,1	30,1	31,9 (2016)
Romania	4,1	1,0	27,5	36,0 (2017)
Moldova	<b>3,8</b>	<b>0,9</b>	<b>26,8</b>	25,7 (2018)
Czech Republic	3,8	0,9	26,1	24,9 (2017)
Norway	3,8	0,9	25,9	27,0 (2017)

Source: Human Development Report 2016. Gini coefficient by country. List of countries by income inequality indicators.

An analysis of the data presented in the table shows that the situation with coefficients characterizing the level of income inequality in Moldova is not bad. On all three indicators we are in a fairly good position, characterizing the level of inequality as low and in a better situation than many more highly

developed countries. According to official data, the income ratio of households included in the extreme quintile groups is 3.8:1. In reality, this gap is much higher, since real incomes are often underestimated by respondents.

Let us note that this problem is typical not only for our country, but also for developed countries, where the incomes of the wealthiest citizens are 5-10 or more times higher than the incomes of the poorest segments of the population, as can be clearly seen from the data in the table.

However, for Moldova the consequences of social differentiation are much more serious. The main danger is that property polarization counteracts the formation of the middle class, which in developed countries makes up the bulk of the population (usually 50-70%). And the size and social position of the middle class, as world experience shows, to a large extent determines the depth and dynamics of socio-economic transformations. It is this part of the population that is interested in political stability, the formation of social institutions of modern civil society, and the creation of conditions for the development of entrepreneurial activity.

The large middle class is also a critical source of tax revenue. In addition, the imbalance in income distribution is a factor in the investment decline for the reason that the incomes of the bulk of consumers are too low to produce sufficient consumer demand, and the incomes of rich people are too high and cannot be used within the country, and therefore are exported abroad.

Polarization of the population by income gives rise to fragmentation of the unified social structure of society into many increasingly autonomous and isolated layers and groups, and also helps to undermine social solidarity and push certain categories of citizens out of the economic and social spheres. Therefore, the problem of property polarization requires, in our opinion, a more active position of the state in pursuing income policy. The experience of developed countries shows that economic efficiency is closely related to the level of government investment in the human factor, including leading to a reduction in inequality in income distribution and the achievement of greater social harmony in society.

At the same time, the state must balance between economic efficiency and social justice. Too large social payments increase the burden on the budget, lead to the development of a dependent lifestyle among low-income segments of the population, and reduce incentives for effective work. If an increase in the amount of budget funds allocated for social purposes occurs due to increased taxes, then the level of savings, investments, business activity and the level of labor productivity may fall. One of the most effective levers of state regulation of income differentiation in society is the personal income tax. There are two main methods of income taxation: proportional and progressive. The use of progressive taxation helps to reduce the differentiation in income of different segments of the population, which is why in most developed countries of the world this method of taxing citizens is used. However, the Republic of Moldova has taken the path of introducing a flat income tax rate of 12%. The adoption of such a decision was justified by the need to legalize shadow income of citizens and simplify the administration of income tax.

Today, personal income tax in Moldova is extremely ineffective both from a fiscal point of view and as an instrument of income redistribution. Thus, in 2023, this tax amounted to only 2.4% of GDP or 7.1% of the revenues of the national public budget of the Republic of Moldova [author's calculations based on: 4.5]. One of the reasons is that, despite the formal unitarity of the income tax (it is levied on a single scale on all types of income), in practice it turns out that the tax base is mainly wages.

That is, income tax is paid mainly by hired workers, and income from property does not actually fall into the tax base due to tax evasion.

Direct taxes are the most progressive and socially fair form of taxation, as they take into account the income of the payer and his marital status. This is especially true for personal income tax, which is traditionally calculated on a progressive scale and has a number of social benefits.

In developed countries, the tax system is quite organically connected with the ideas of social justice. For example, with regard to indirect taxes, there is an idea about their social injustice, since they are less related to the amount of income of various social groups than direct taxes. Also, indirect taxes, by raising prices, can stimulate inflation and reduce household incomes.

But adherence to the principle of social justice through the provision of tax benefits conflicts with fiscal and incentive objectives. Tax benefits of a social nature reduce tax revenues to the budget. Contradictions with the tasks of economic stimulation are manifested in the struggle over the degree of progressiveness of taxation of the population.

The social sphere of influence of income tax in developed countries is constantly expanding. Over the past decades, it has consistently included tax benefits for providing assistance to the poor, solving housing problems, compensating for financial expenses for providing medical care, obtaining education, improving qualifications, and financial support for the elderly and young family members. As an example of a tax incentive system, let's take Latvia, a small Baltic republic. The tax-free minimum in 2024 applies to income up to 1,800 euros per month. In order to reduce population inequality, from January 1, 2016, a differentiated non-taxable minimum was introduced in Latvia, which provides that a higher non-taxable minimum is applied to lower incomes, and a lower non-taxable minimum is applied to higher incomes.

In 2024, the following amounts are determined for calculating the differentiated non-taxable minimum:

- 1) the maximum tax-free minimum is 6,000 euros per year or 500 euros per month;
- 2) the amount of taxable income to which the maximum non-taxable minimum applies is 6,000 euros;
- 3) the amount of taxable income above which the differentiated tax-free minimum does not apply is 21,600 euros per year or 1,800 euros per month;

In addition to the non-taxable minimum, an individual is also entitled to the following tax benefits:

- tax benefits for dependents (for each dependent 3,000 euros per year or 250 euros per month);
- additional tax benefits for persons with disabilities (1848 euros per year or 154 euros per month for persons with a certain disability group I or II and 1440 euros per year or 120 euros per month for persons with a certain disability group III), politically repressed persons and members of national resistance movements (1848 euros per year or 154 euros per month) [6].

As a comparison, in Moldova the non-taxable minimum applies to an income of up to 360,000 lei (approximately 18,500 euros per year) and amounts to 27,000 (approximately 1,385 euros per year or 115 euros per month) [1]. The dependent exemption in Moldova is approximately €460 per year and the disabled exemption is €1,615 per year. As for other types of income tax benefits (deduction of various types of expenses), they are completely absent in Moldova.

Another problem, common to the Republic of Moldova and other countries, is the erosion of income of a significant part of the population (primarily the middle strata) due to inflationary growth in tax payments. The erosion of nominal amounts due to inflation, unless steps are taken to compensate for it, results in the effective tax rate rising with inflation and more individuals paying higher tax rates.

Many countries have managed to avoid this by indexing these amounts. But adjustments for inflation based on an assessment of inflation processes that occurred in previous years may harm budget revenues in the next year, in which the inflation rate may be lower. Governments benefit from erosion because inflationary processes lead to increased taxes without making unpopular decisions. In the Republic of Moldova, partial indexation of the income tax scale and exemption amounts has been used for many years (see Table 2).

**Table 2. Evolution of the personal income tax scale in the Republic of Moldova and the amounts of personal and dependent exemptions**

Year	Income tax scale	Personal exemption (lei per year)	Exemption for dependents (lei per year)
2016	– 7% of annual taxable income not exceeding 29,640 lei; – 18% of annual taxable income exceeding 29,640 lei	10128	2256
2017	– 7% of annual taxable income not exceeding 31,140 lei; – 18% of annual taxable income exceeding 31,140 lei	10620	2340
2018	12% annual taxable income	24000	3000
2019	12% annual taxable income	24000	3000
2020	12% annual taxable income	24000	3000
2021	12% annual taxable income	25200	4500
2022	12% annual taxable income	27000	9000
2023	12% annual taxable income	27000	9000
2024	12% annual taxable income	27000	9000

Source: adaptation by the author based on: Tax Code for 2016-2024.

But although there is an increase in personal exemption by 2.7 times and exemption for dependents by almost 4 times, a comparison of these amounts with the minimum consumer basket (2877.1 lei in 2023 [7]) allows us to conclude that the impact of direct taxes is low to improve the social sphere in the Republic of Moldova.

The progressive scale of income tax affects the mechanism of redistribution of income of individuals and helps to weaken the social stratification of society. The spread of personal income tax rates across developed countries is very significant. The minimum rate ranges from 0% in Switzerland to 38% in Denmark, and the maximum ranges up to 56.4% in Sweden [8]. At the same time, even at the legislative level, the authorities of developed countries recognize income tax as an instrument of social policy.

Personal income tax in the Republic of Moldova is constantly being reformed in terms of changing and reducing the rates of this tax. To analyze the consequences of reforming the personal income tax in the Republic of Moldova in 2017-2024, the share of income saved for several income levels due to a decrease in the level of taxation was calculated (see table 3.).

**Table 3. Calculation of personal income tax in the Republic of Moldova in 2017 and 2024 (taking into account the availability of personal exemption), and savings from income tax reduction for 2017-2024**

Gross income	Income tax for 2017	Income tax for 2024	SI, %
2000	64,05	0	3,20
2500	95,55	3	3,70
3000	127,05	57,60	2,31
<b>5000</b>	<b>365,25</b>	<b>276,0</b>	<b>1,78</b>
7000	689,25	494,40	2,78
10000	1175,25	822,0	3,53
15000	1985,25	1368,0	4,11
20000	2795,25	1914,0	4,41
25000	3605,25	2460,0	4,58
30000	4415,25	3006,0	4,70
40000	6035,25	4368,0	4,17
50000	7655,25	5460,0	4,39
80000	12515,25	8736,0	4,72
100 000	15755,25	10920,0	4,84
150 000	23855,25	16380,0	4,98

Source: author's calculations

The share of saved income (SI) for each income level was calculated using the following formula developed by the author:

$$SI = \frac{IT_{2017} - IT_{2024}}{GI} \times 100 \%, \text{ where}$$

**IT<sub>2017</sub>** is an income tax calculated at the rates for 2017, taking into account personal exemption, mandatory contributions to state social insurance and contributions to compulsory health insurance;  
**IT<sub>2024</sub>** is the income tax calculated at the rates for 2024, taking into account personal exemption and contributions to compulsory health insurance;

**GI** – gross income.

The data obtained indicate that the group of citizens with an income of 5,000 lei per month received the smallest savings from changes in income taxation - 1.78% of income, and groups of people receiving 15,000 lei and above received more than 4% of income savings. At the same time, there is a clear tendency for the share of saved income to increase, the higher the income. That is, the income tax acquires a sort of regressive scale, which confirms our judgment about the unfair distribution of the tax burden between different segments of the population of Moldova.

A significant shortcoming and source of additional inequality is the current system of income tax benefits in the form of personal exemption and dependent exemption. In 2023, personal exemption amounted to 2,250 lei per month, and for dependents - 750 lei per month, while the cost of living in 2023 per person averaged 2,877.1 lei, that is, personal exemption did not cover even 79% of the subsistence level minimum, and exemption for dependents – even 26%. If for citizens receiving fairly high incomes, the amount of income tax exemptions is not of fundamental importance, then for



low-income citizens, this benefit allows them to save part of their small income by reducing income tax. Consequently, such a small amount of personal and other types of income tax exemptions neutralizes the significance of this benefit, designed to some extent to help the lowest income segments of the population.

## Conclusions

Based on the above, we can conclude that there are certain problems in the system of using income tax as an instrument for redistributing income and regulating inequality in our country. Among the measures, the adoption of which, in our opinion, will help mitigate the differentiation of personal incomes of the population of the Republic of Moldova, we can propose:

- establish a tax-free minimum income exempt from income tax at the subsistence level, with indexation of this amount, which will avoid leveling the value of this benefit. In this case, the amount of exemption for dependents must coincide with the personal exemption, since, in our opinion, the use of a smaller amount as an exemption for dependents is discriminatory towards them;
- calculate the possible consequences of changes in income tax rates for population groups with different income levels and adhere to the unshakable rule that the poorest should benefit to a greater extent and the richest to a lesser extent.

The problem of fair redistribution of income and reducing differentiation in the incomes of different segments of the population is especially acute at present due to the economic crisis and rising unemployment. Therefore, it would be extremely short-sighted to ignore it.

But in conclusion, I would like to note that, while emphasizing the importance of reforming the taxation of personal income, it is necessary not to forget that it in itself is not able to solve the problem of excessive stratification of society by income, even over a long period. Reforming the personal income tax is only one of the important tools in the complex of socio-economic measures necessary for this.

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