

# FISCAL INSTRUMENTS THROUGH THE IMPACT OF MACROECONOMIC AND STRUCTURAL FACTORS AND PARAMETERS OF THE MARKET ECONOMY

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## Abstract

The existence of a functioning market economy is a prerequisite for the Republic of Moldova to successfully develop its capacity to cope with competitive pressure and market forces within the EU. Therefore, at the beginning of the transition period, when the creation and reformation of the public expenditure, taxes, and tax systems was sought in order to ensure their compatibility with the market economy mechanisms along with the changes in the structures of the financial institutions and the national public budget, the functions of the fiscal policy were reasonably focused on the priority role of ensuring the main governmental functions. Over the next few years, after the overall restructuring of the fiscal system, its mechanisms had different effects from what it was expected, in the conditions of a management that proved not to be performing well. This article, in fact, involves dealing with a very complex issue and with numerous and varied interdependencies on the fiscal instruments and the functionality of the national economy.

**Key words:** taxes, tax instruments, tax policies

Economic growth is one of the main objectives of the state's economic policy. The experience of many countries demonstrates that most economic recovery policies use taxation policy instruments that have a positive impact on the real economy of the state. Taxes refer to the fundamental categories of the market economy, with a historical character and with many implications on the socio-economic sphere. It is difficult to understand the nature of the tax because it can be viewed as a multidimensional phenomenon, because it is not approached only from a certain point of view, but it involves a multitude of approaches: economic, financial and social, etc. So, we can speak of the tax as an indispensable part of human civilization.

## MATERIAL AND METHOD

This research paper was based on a vast documentary material that comprises legislative developments at national level, as well as regulations, recommendations and other reference papers. The research has also been based on the results of studies and assessments made on the basis of European information provided by specific databases.

## RESULTS AND DISCUSSIONS

The design and application of fiscal instruments must be preceded by the activity of identifying and assessing the influence factors on them. According to the authors the factors impacting on fiscal instruments and, finally, on the functionality of the national economy can be divided into the following two categories: a) the initial conditions, which represent objective characteristics and variables for the Republic of Moldova; and b) macroeconomic and structural factors, which are essentially dependent on the quality of the promoted public policies.

In the category of **initial conditions** with a direct impact both on the functionality of a national economy and on fiscal instruments, we can include (see Figure 1):

- geographical location: proximity to Western Europe and access to the sea;
- resource endowment;
- the existence of institutional traditions;
- exposure to armed conflicts;
- progress in the transition to the market economy and political system;
- classification according to income grouping and level of human development;

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Table 1

- the direction of development (the potential influence of relations with the EU).

**Geographic position.** Some authors consider proximity to "prosperous market economies" as a development-friendly condition, with a direct impact on the country's fiscal potential. This approach has been coupled with an incentive to join the EU and hence with the "import" of market institutions and better access to the EU markets.

After the EU enlargement to the East, this criterion can be reinterpreted in terms of neighborhood with the EU. In this context, although there is no border with Western European countries, the Republic of Moldova is neighboring the EU.

*The impact of this factor on fiscal instruments is the following:* Prerequisites are created for the tax system to become sustainable, stable and predictable - qualities characteristic of tax systems in developed countries.

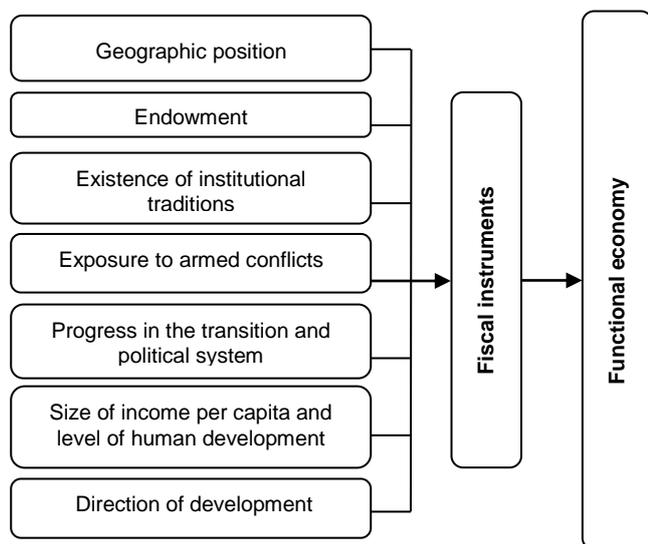


Figure 1 Factors of influence on the fiscal instruments and on the functionality of the the Republic of Moldova's economy

**Resource endowment.** Resource endowment is another important attribute that determines the development, the larger volume and the more diversified structure of public revenues. According to this criterion, three groups of countries are distinguished: rich (countries with a large amount of natural gas and oil), moderate (countries endowed with other natural resources, such as metal ores), and poor countries.

In Table 1 we present the position of the Republic of Moldova evaluated in terms of this criterion in comparison with other Central and Eastern European countries and the CIS.

Natural resource endowment

Poor countries	Moderate countries	Rich countries
Albania	Georgia	Azerbaijan
Armenia	Ukraine	Kazakhstan
Belarus	Uzbekistan	Russia
Bosnia și Herțegovina		Turkmenistan
Croatia		
Macedonia		
Kirgizstan		
Republica Moldova		
Munteenegro		
Serbia		
Tadjikistan		

Source:elaborated by the authors

The impact of this factor on fiscal instruments is the following: poor countries, in terms of resource endowment, have a strong emphasis on the efficient administration of tax instruments.

**Institutional tradition.** Institutional tradition (institutional legacy) is characterized by "market memory" (number of years under centralized planning) and the experience of being an independent state. From this point of view, the Republic of Moldova for over 51 years have existed under the conditions of a centralized economic system, lacking, among other things, its own capacity to form, develop and manage its own fiscal potential.

The impact of this factor on fiscal instruments is the following: for countries with restricted institutional traditions, as the Republic of Moldova, the quality of the institutions involved in the design and management of fiscal instruments that are in the training and development phase, is very important (the Ministry of Finance and the structures involved in public finance management, etc.). In addition, at the initial stage of development of institutions managing public finances, fiscal instruments typically fulfill the function of financing public budgetary needs without being used as incentives to increase the functionality of the national economy. Corruption is another threat to the efficient management of fiscal instruments that may be characteristic of countries with insufficient traditions in the field of public finance management.

**Armed conflicts and internal disturbances** are frequent in the Central and Eastern European countries and in the CIS countries, the Republic of Moldova suffering from the Transnistrian conflict that also affects its macroeconomic and financial life.

The impact of this factor on fiscal instruments: fiscal policy instability and tax

evasion often accompany the existence of various armed conflicts and internal disturbances.

**Progress in the transition process and political system.** In the author's opinion, measuring progress in the transition process implies two dimensions:

- (i) the economic transition from the planned economy to the market economy (applying the transition indicators developed by the EBRD);
- (ii) political transition from authoritarian to democratic (using the Freedom House index).

Table 2  
**The evolution of the transition indicators EBRD, 2016**

	Enterprises			Markets and trade		
	Privatization of large enterprises	Privatization of small enterprises	Corporate governance and enterprise restructuring	Price liberalization	Trading and currency system	Anti monopoly policy
<i>Republic of Moldova</i>	3	4	2	4	4+	2+
Albania	4-	4	2+	4+	4+	2+
Armenia	4-	4	2+	4	4+	2+
Estonia	4	4+	4-	4+	4+	4-
Georgia	4	4	2+	4+	4+	2
Hungary	4	4+	4-	4↓	4↓	3+↓
Latvia	4-	4+	3+	4+	4+	4-
Lithuania	4	4+	3	4+	4+	4-
Polonia	4-	4+	4-	4+	4+	4-
Roland	4-	4-	3-	4+	4+	3+
Russia	3	4	2+	4	4	3-
Slovakia	4	4+	4-	4+	4↓	3+↓
Slovenia	3	4+	3	4	4+	3-
Ukraine	3	4	2+	4	4	2+

**Note:** Transition indicators range from 1 to 4 +, 1 representing a minor change or a lack of change from the centrally planned rigid economy, 4+ signifying compliance with the standards of an industrialized market economy. The arrows indicate progress or regression compared to the previous year.

As follows from Table 2, the Republic of Moldova records a general transition indicator similar to that obtained by Ukraine, being at the same time outstripped by the other countries included in the analysis. Estonia and Poland record the best performance in promoting market reforms.

Concerning democratization, the countries included in the analysis summarized in Table 2.2. represent different types of political regimes, suggesting the conclusion that the closer a country is to a market economy, the lower the *Freedom House* democratization index is. The promotion of market reforms is in close correlation and dependence with the level of democratization and the political regime, Table 3. indicating that the Republic of Moldova is behind the former

socialist countries included in the analysis, with the exception of Ukraine, Armenia and Russia.

Table 3  
**Political systems and level of democratization, 2015**

	Indicator of democratization	Political regime
<i>Republic of Moldova</i>	4,82	Transitional Governance or Hybrid Regime
Albania	4,25	Transitional Governance or Hybrid Regime
Armenia	5,36	Semi-consolidated authoritarian regime
Estonia	1,96	Enhanced democracy
Georgia	4,75	Transitional Governance or Hybrid Regime
Hungary	2,89	Enhanced democracy
Latvia	2,07	Enhanced democracy
Lithuania	2,32	Enhanced democracy
Poland	2,18	Enhanced democracy
Romania	3,50	Semi-consolidated democracy
Russia	6,21	Enhanced Authorized Regime
Slovakia	2,57	Enhanced democracy
Slovenia	1,89	Enhanced democracy
Ukraine	4,86	Transitional Governance or Hybrid Regime

**Source:** elaborated by the authors

**Note:** The indicator of the democratization level ranges from 1 to 7, 1 representing the highest level of democratic progress, 7 - the lowest level.

The impact of this factor on fiscal instruments: the higher is the democratization indicator, the more stable and predictable is the country's tax system. In addition, the phenomenon of tax evasion is decreasing.

**Per capita income and level of human development.** Compared with the countries considered in the analysis, the Republic of Moldova has the lowest GDP per capita and the human development index (Table 4).

The impact of this factor on fiscal instruments: the small size of the per capita income determines the limited size of the national public budget, the priority character of the social financing needs, the priority character of the public finance financing function at the disadvantage of the function of stimulating the functional character of the national economy.

Table 4  
**Development level, 2015**

	Per capita income level	GDP per capita, USD	IDU
<i>Republic of Moldova</i>	2	5 026	0.699
Albania	2	10 252	0.764
Armenia	2	8 189	0.743
Estonia	4	26 362	0.865
Georgia	2	8 856	0.769
Hungary	3	23 394	0.836
Latvia	4	22 589	0.830

Lithuania	4	26 006	0.848
Poland	4	24 117	0.855
Romania	3	19 428	0.802
Russia	4	23 286	0.804
Slovakia	4	26 764	0.845
Slovenia	4	28 664	0.890
Ukraine	2	7 361	0.743

Source: elaborated by the authors

**The potential influence of relations with the EU.** The former USSR countries in Eastern Europe and in the Caucasus region can benefit from different instruments of cooperation with the EU. The EU accession negotiations stimulate political and economic reforms that stimulate the development of the countries applying for the membership. The Republic of Moldova initialed the Association Agreement with the European Union in November 2013.

Table 5  
The country's relationship with the EU

	The status of the country in relation with the EU
Republic of Moldova	Partner country of European Neighborhood Policy and Eastern Partnership. <i>Association Agreement, initialed 2013</i>
Albania	Potential candidate
Armenia	EU-Armenia Partnership and Cooperation Agreement (1999), a participant in the European Neighborhood Policy and the Eastern Partnership(2004).
Estonia	Member State (2004)
Georgia	<i>Association Agreement, initialed 2013</i>
Hungary	Member State (2004)
Latvia	Member State (2004)
Lithuania	Member State (2004)
Poland	Member State (2004)
Romania	Member State (2007)
Russia	Partnership and Cooperation Agreement, 1994
Slovakia	Member State (2004)
Slovenia	Member State (2004)
Ukraine	Priority Partner Country of the European Neighborhood Policy and Oriental Partnership. <i>Association Agreement, initialed 2012</i>

Source: elaborated by the authors

*The impact of this factor on fiscal instruments:* Prerequisites are created for the fiscal instruments system to become sustainable, stable and predictable that are the qualities characteristic of tax systems in developed countries.

We will further identify and evaluate **the macroeconomic and structural factors** that determine the performance of the fiscal instruments in the Republic of Moldova.

**Recent performance and growth prospects.** As shown in Table 6, the Republic of

Moldova has registered high growth rates over the years, with the exception of 2009, 2012 and 2015.

Table 6  
GDP at constant prices, annual changes in%

2004	7.4
2005	7.5
2006	4.8
2007	3.0
2008	7.8
2009	-6.0
2010	7.1
2011	6.8
2012	-0.7
2013	9.4
2014	4.9
2015	-0,4
2016	4,2

It should be noted that almost all emerging market economies benefited from the global boom at that time. The boom was the result of a market-oriented transition and reform policies in many major developing countries and regions (China, India, South-East Asia, Latin America, part of Africa), of trade liberalization at the world level as well as of the expansionary monetary policies of the US and other major central banks. The latter has led to large global imbalances and to the creation of numerous asset bubbles, which have caused a huge financial crisis not seen in the last 60 years. When the global boom ended in 2007 and the asset bubbles broke, almost everyone went into a recessionary phase, with post-communist economies being among the most affected, though not immediately (with time lag from six months to one year after the US and Western Europe).

The positive annual GDP dynamics over the period 2010-2011 was interrupted by the economic decline in 2012 largely determined by the severe unfavorable development of the agricultural sector caused by drought, by temperate domestic demand but also by a less favorable external environment, especially by the recession of the European economy, which conditioned a moderate increase in exports. In 2015, the negative evolution of economic activity was largely determined by the domestic economic and political uncertainty and the deterioration of the regional economic climate that generated the decline in domestic demand from the population and the contracting of investments.

*The impact of this parameter on fiscal instruments:* the instability and the volatility of economic growth determine similar developments in the fiscal system of the Republic of Moldova.

**Poverty and income inequality.** The high level of poverty, measured by its depth and severity, means that more resources are needed to

normalize the situation and fund social measures to reduce poverty.

The persistence of poverty is strongly interdependent on the existence of inequalities in the distribution of income / consumption, demonstrated by three indicators: the income quintile ratio, the Palma ratio and the Gini coefficient. Figure 2. suggests that the Republic of Moldova exceeded Armenia, Belarus, Hungary, Kazakhstan, Romania, Slovakia, Slovenia, Ukraine, Tajikistan at the level of inequality in the distribution of consumer spending.

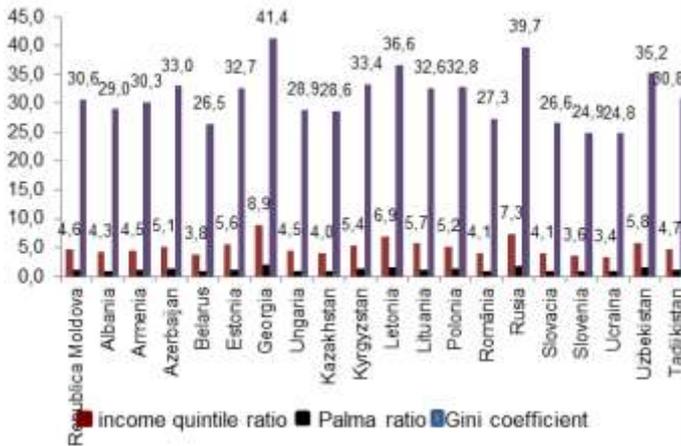


Figure 2 **Measuring the average level of inequalities over the period 2000-2014**

Source: elaborated by the authors

In countries where income inequality is high, it will be difficult, if not impossible, to rapidly increase the income of poor families without a certain reduction in income gaps. In addition, producing a macroeconomic decline could increase inequalities, dramatizing even more strongly the economic situation of the poor. But even if inequalities do not grow, social policy will face the challenge of helping an ever-increasing number of poor with limited resources, critically limiting the government's ability to raise taxes on low-income people.

*The impact of this macroeconomic parameter on fiscal instruments:* on the one hand, the country's fiscal potential is affected, on the other hand, the prospect of increasing the tax burden on low-income social layer is limited. In addition, the social character of public spending predominates.

**Fiscal deficit and its financing.** The size of the fiscal balance of the national public budget is determined by several factors, including:

- rapid GDP growth: Gray and others have found that an improvement in the fiscal balance of 1 percentage point of GDP is associated, on average, with an increase of 0.4-0.5 percentage points in the GDP growth rate or an

aggregate earnings of about 4.6 percentage points of GDP over a period of more than 10 years;

- high oil and gas prices for large exporters;

- the size of official external assistance to poorer countries and debt service.

The tax position in many of the former USSR countries was better than the average figures for the EU and the new EU Member States. This performance could be attributed to their rapid economic growth in the years 2000. However, the global financial crisis has dramatically reversed this favorable cyclical trend, reducing public revenues and forcing governments to increase public spending.

## CONCLUSIONS

Adaptation of the contemporary tax structure to the new requirements of the functional economy could be a prerequisite for countries to attract and grow successful economic players for a sustainable, functioning society.

- Financial instruments are: economic indirect methods of state intervention in the economy; they have stimulating virtues and coercive forces; they are characterized by stability, elasticity and flexibility with convergent action, aimed at achieving the same goals.

- In the field of fiscal policy, we distinguish three major areas: the budgetary revenue policy, the budgetary spending policy and the budgetary balance policy. Correspondingly, taxes and duties are the main fiscal instrument in the area of budget revenues. Two fiscal instruments appear in the area of budgetary spending: the allocation for public sector resources and the private sector grants. In the area of budgetary balance there are instruments related to the solutions to achieve the budgetary balance: counter-cyclical policies, compensatory policies or systematic deficit policy.

- Fiscal instruments are subject to modeling in fiscal policy. The role of fiscal instruments can be understood through the objectives of fiscal policy. Fiscal policy objectives are varied across countries, depending on economic conditions and needs. The role of fiscal policy in less developed countries differs from that of the developed countries.

**In order to ensure fiscal sustainability, it is necessary:**

- to introduce the following principles in the *Public Finance Act and Budgetary Fiscal Responsibility*: (a) Maintaining public debt at a prudent level so as to provide sufficient reserve against the factors that may have a negative impact on public debt in the future by ensuring that, until the prudent levels of public debt are attained, the total operating

expenditure in each financial year is lower than the total operating income; (b) the prudent management of fiscal risks faced by the government; (c) promoting public policies so as to maintain a reasonable degree of predictability regarding the level and stability of future tax rates. According to the author, the prudent level of public debt for the Republic of Moldova is the maximum of 30% of public debt in GDP;

-to promote structural reforms, in particular the reform of social protection and fiscal decentralization, in order to strengthen tax institutions and to protect fiscal sustainability;

-to develop the methodological and analytical framework for the design, implementation and evaluation of sustainable fiscal instruments by taking over and adjusting the concepts of fiscal position and fiscal incentive from the international fiscal theory and practice;

- to apply tax uniformization in the Republic of Moldova;

**In order to design an efficient tax incentives system** that will contribute to the increase of the innovation activism in the Republic of Moldova we recommend implementing the following proposals:

- based on a cost-benefit analysis, to design a consistent system of financial incentives designed to support and revitalize the processes and results of innovation activities at the level of economic units that rationally combine direct incentives and fiscal incentives so that the economic, social and financial benefits that will be obtained to considerably exceed the costs (those related to BPN);

- to design the research and development regime in the Republic of Moldova that should be firmly placed on Manual Frascati (OECD, 2002). In order for research and development to benefit from tax incentives, the economic unit must carry out a project aimed at progressing in science or technology;

-to examine the possibility of applying the fiscal credit as an incentive for the innovation activity at the level of economic unit;

- to implement tax incentive system in order to support R & D activities at the level of the economic unit, this implementation must be accompanied by the obligatory periodical fiscal audit.

**In order to increase the efficiency of fiscal administration**, we propose:

-a gradual increase in budgetary fiscal revenues, in particular by streamlining fiscal administration so that their share in GDP reaches the EU average, i.e. 38-40%;

- design and implementation of the audit strategy focused on taxpayers' non-compliance risks. This strategy is the preferred choice of the audit strategy in the fiscal administrations of many developed countries; it is supported by international organizations in emerging and developing countries;

- we recommend the following Basic Risk Assessment Framework: as a general rule, the dependent variable that measures nonconformity should be modeled; several exogenous variables that are likely to affect the dependent variable must be identified. There must be chosen the best method to find statistical ratio between the dependent variable and a set of explanatory variables (between parametric and nonparametric methods). In this context, we can mention parametric methods (regression analysis and discriminant analysis), and nonparametric techniques that include data mining;

- decisions on possible tax changes or increases in expenditure based on potential tax-efficiency gains should be made only ex-post, after tax administration efficiency, including through effective tax audit implementation, will become irreversible;

-the effect of relatively high marginal tax rates, discouraging economic behavior, makes the author formulate a proposal to identify solutions to minimize irrecoverable losses by implementing a large tax system based on low rates;

- reforming the legislative, organizational and institutional framework related to fiscal administration;

- upgrading the way to address taxpayers' compliance;

- making the use of information technologies more efficient in fiscal administration;

-streamlining resource management in fiscal administration institutions.

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