

Fiscal reforms that fall flat?

THE SOCIAL AND ECONOMIC
IMPACTS OF FLAT TAX AND
SOCIAL SECURITY REFORMS
IN EASTERN EUROPE.



CLIMATE-FRIENDLY JOBS
WAGES
RIGHTS
SOCIAL PROTECTION
EQUALITY
INCLUSION

A New Social Contract



ITUC CSI IGB

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1 Introduction

Over the last decade, several countries in Central Asia and Eastern Europe introduced reforms to their tax and social security systems, with the aim of improving economic efficiency and reducing informality, and improving employment and investments. Yet, many of these reforms reduced the progressivity of these systems and have likely hampered broader social and economic outcomes, while not necessarily delivering on their stated objectives. The study will undertake research and analysis to investigate the broader social and economic impacts of tax and social security reforms in Eastern European and Central Asian countries in recent years, focusing on four case study countries of Moldova, Ukraine, Romania and Georgia.

Moldova and Ukraine both introduced flat personal income tax rates of 12 per cent and 18 per cent, respectively.¹ Romania and Georgia, on the other hand, have reformed their contributory social security systems, shifting away from employer-based social contributions towards financing via what is effectively a personal income tax of 35 per cent in Romania (in addition to a 10 per cent official personal income tax) and 20 per cent in Georgia.

These reforms reflect a general trend in Eastern Europe and Central Asia towards increasingly regressive tax systems, as countries have transitioned from the centrally planned and state-led economies of the Soviet era to a market-led model. Over the last three decades, other countries in the region have introduced similar reforms to their taxation and social security systems. Since

Estonia introduced flat-rate tax in 1994, countries such as Latvia (1995), Russia (2001), Serbia (2003), Slovakia (2004), Macedonia (2007), Albania (2007) and Bulgaria (2008) followed suit.²

The general rationale behind introducing flat income tax rates is that, by simplifying tax rules and making the single rate sufficiently low, governments can boost compliance rates by reducing the incentive for tax evasion and stimulate economic growth through fostering a better business environment that attracts foreign investment, encourages risk-taking and broadens the tax base through increased labour market participation.³ The rationale for privatising pensions and shifting contributions from the state or the employer to the employee is similarly focused on promoting macro-economic outcomes, but with the added argument that this would also ensure the sustainability of pension financing and enhance the adequacy of benefits.

However, this rationale is not robust. There is little evidence that flat-rate taxes, and the tax cuts for the wealthy that they imply, does in fact stimulate the kind of economic growth that is used to justify them. Similarly, global studies that have looked at the impacts of pension privatisation have found these reforms are likely to lead to the deterioration of pension benefits and coverage, have a limited effect on capital markets, entail high administrative costs and benefit the financial sector (including international financial institutions), not the state budget or the citizens it is supposed to serve, as the net winner (Ortiz et al, 2018).

¹ While Moldova implemented a minimum tax-exempt income threshold, whereby those earning an income below subsistence level were exempt from paying tax, Ukraine's income tax is applied universally to all taxpayers.

² For more information see ECB (2007). Some countries have since taken steps towards reversing this trend, with Russia, for example, introducing a slightly more progressive taxation structure as of January 2021 (PwC, 2021a).

³ Wilson (2020).

Further, beyond a seeming failure to stimulate economies in the way advocates hoped, the reforms are also likely to have generated net social harms. In a reality of uneven disposable incomes, ‘levelling out’ the proportion of tax paid by all income-earners in a society implies in tax cuts for the wealthy and a higher proportion of income taxes paid by lower income earners. As such, in practice, the tax burden effectively shifts from the wealthy and onto those on low or middle incomes.

Further, if pension systems deteriorate and workers are expected to shoulder the majority-share of contributions directly from their own salaries, those with lower savings, who rely on the basic income that should be guaranteed by a pension floor, are harmed disproportionately.

Because decisions to introduce flat-rate taxes, reform social contributions and/or privatise pensions are not backed by strong evidence of a positive impact on economic growth, and given that these policies disproportionately favour the

wealthy within a society, this paper argues that they are largely political and ideological decisions. The paper investigates the impacts of these types of reforms to taxation and social contributions in the four case study countries, using a desk-based review of literature and some supplementary secondary data analysis. An initial section will describe the tax and social security contribution reforms that have taken place in the region, situating the trend in broader historical context and identifying the apparent objectives of the reforms. Then, for each country, the analysis will examine whether the reforms have achieved their apparent objectives and consider the broader impacts of the reforms on the welfare and living standards of the population. After initial analysis of the case study countries is presented, a final section will briefly discuss the impact of the reforms on trust in governments and national social contracts.

2 Tax and social security contribution reforms in the region since 2009

This section provides some background on tax and social security reforms in the region since 2009, first situating the reforms in their wider historical context, looking at the rise in the neoliberal model and the role that influential international financial institutions (IFIs) have played in the promotion of market-led structural reforms in post-Soviet economies and elsewhere in the world. The section then details the specific reforms in question, before examining the apparent objectives and rationale for their introduction.

2.1 The trend towards flat taxes and pension privatisation in historical international perspective

The reforms in the case study countries reflect a trend in Eastern Europe and Central Asia towards increasingly regressive tax systems, as countries have transitioned from the centrally planned and state-led economies of the Soviet era to a market-led model. Over the last three decades, other countries in the region have introduced similar reforms to their taxation and social security systems. Since Estonia introduced flat-rate tax in 1994, countries such as Latvia (1995), Russia (2001), Serbia (2003), Slovakia (2004), Macedonia (2007), Albania (2007) and Bulgaria (2008) followed suit.⁴

Yet, these reforms follow a legacy of a much larger global trend towards neoliberal policies and economic restructuring. The rise in a fundamentalist approach to economic liberalism and the narrow pursuit of a market-led model, which includes a commitment to regressive taxation regimes and a shift towards pension privatisation, arguably began in Chile under Pinochet's radical neoliberal experiment in the 1980s. With the support of IFIs such as the World Bank and the International Monetary Fund (IMF), the Chilean experience worked as "a paradigmatic case study for the future propagation of global neoliberalism" (Alemparte, 2021: 86). This economic model, characterised by the retreat of state intervention and governance, instead, by market principles, became an enduring blueprint for what was seen as 'good economics'. Social spending was cut in the name of fiscal austerity; tax systems were reformed to favour market interests, with low tariffs on imports; social security, state industries and banks were privatised; and markets were de-regulated.

Historically, international actors have played a significant role in the convergence in the policy agenda towards this blueprint, with the emergence of the Washington Consensus among the IFIs leading to the wholesale export of the market-led model to low- and middle-income countries globally.⁵ IFIs promoted regressive income tax reforms and the privatisation of pension funds as part of the structural adjustment packages they offered in exchange for loans. In addition to influencing the policy space using their financial weight, IFIs were also able to proliferate these ideas through asserting their technical expertise and "self-repositioning as a Knowledge Bank" on what Mkandawire (2014: 182) calls "the marketplace of ideas". As Ortiz et al (2018: 9) point out, with significant resources and direct access to Ministries of Finance, the World Bank, the IMF, the OECD, USAID, the Inter-American Development Bank and the Asian Development Bank, "managed to promote the pension privatization agenda through policy advice, setting up regulators or supervisory bodies, creating modelling software, training, publications and by providing multi-million-dollar loans". Orenstein (2008) estimates that, despite being a highly contentious and challenging issue in most countries, the success rate of the World Bank projects promoting reform consistent with pension privatisation was high – nearly 76 per cent. Indeed, the privatisation of pensions were contested by many, particularly the ILO who warned that relying on privately managed individual accounts would unavoidably transfer the risk of market fluctuation from states and onto the individual and would likely undermine what should be the primary objective of pension systems: providing income security for

⁴ For more information see ECB (2007). Some countries have since taken steps towards reversing this trend, with Russia, for example, introducing a slightly more progressive taxation structure as of January 2021 (PwC, 2021a).

⁵ For example, the World Bank's 1996 World Development Report identified 'good' and 'bad' policies and argued that these were associated with differences in economic performance: "consistent policies, combining liberalisation of markets, trade, and new business entry with reasonable price stability, can achieve a great deal even in countries lacking clear property rights and strong market institutions".

all in old age. Notably, no advanced industrialized democratic country has ever replaced its public pension system with a private individual account system or introduced a radical flat rate income tax. Yet, in developing countries, privatisation and a strict adherence to pro-market reforms was offered as the magic bullet (Ortiz et al 2018).

This was the case in Eastern Europe and Central Asia, where economic restructuring was modelled as the solution for transitional post-Soviet countries in the 1990s. Following the fall of the Soviet Union and the collapse of state and non-state institutions, Eastern European and Central Asian countries began to suffer economic crises. During this period, countries transitioned away from the Soviet-era planned economy to a free-market economy and began to quickly implement economic liberalisation reforms *en masse*. This became known as ‘shock therapy’ and was promoted by IFIs, namely the IMF. Price controls were lifted, state enterprises were privatised and public spending was cut.⁶ The privatisation of social security and the introduction of flat taxes (an idea sparked, in part, by an influential book by Hall and Rabushka (1995) on the subject), were part of this package of market-oriented policies which spread in the region. What followed was a period of economic collapse and social crisis.⁷ Post-Soviet countries experienced hyper-inflation and shortages. This transitional period also had significant impacts on living standards and social wellbeing. For example, in post-Soviet Moldova, in just five years (between 1990 to 1995), life expectancy at birth fell by almost three years, to below 66.⁸ The scale of collapses in output and life expectancy during the 1990s during peacetime was globally unprecedented.⁹

While less explicit than during the shock therapy of the 1990s, economic liberalism and the privatisation agenda remains a *de facto* policy position that is

recommended in the technical advice of IFIs to many low- and middle-income countries. Eastern European and Central Asian countries have continued to implement reforms consistent with the market-led model, with a new wave of reforms sweeping the region over roughly the past decade. Beyond the obvious role that IFIs have played in the convergence of the global policy agenda around market ideals, there is a reason why these ideas have ostensibly ‘stuck’ and been propagated by national actors in the region too. There are strong incentives to de-regulate markets and privatise public assets in political systems whereby economic and political power are intricately connected. When state assets were sold off during the transition to capitalist systems in the 1990s, a small group of elites benefitted from this wave of privatisation and became very wealthy, emerging as influential political and economic actors.¹⁰ This period had an enduring legacy on wealth inequality in the region. It also meant that there was a strong basis for resistance to policies which might entail greater redistribution of wealth and assets across societies (such as more progressive taxation systems and stronger public pensions), backed by elites who ultimately exerted the most influence on policy direction within political economic systems with oligarchic and kleptocratic characteristics. As a consequence, the legacy of these reforms can be seen today in the kinds of fiscal reforms which are unerringly prescribed to promote macro-economic stability and balance the books as making ‘good economic sense’. Yet, as this paper will discuss, this was not necessarily the case. The high expectations of the reforms have not been realised. In addition, there have been negative social impacts, as risks have been shifted onto individuals and the region continues to experience high levels of income inequality, which risks triggering social and political instability.

⁶ (Bligh and Ware, 2020).

⁷ Popov and Sundaram (2017).

⁸ Weeks (2014).

⁹ Popov and Sundaram (2017); Weeks (2014).

¹⁰ Marandici (2014).

2.2 The specific reforms in question

This sub-section will briefly outline the specific reforms that the paper will analyse in the case study countries of Moldova, Ukraine, Romania and Georgia. A summary of the reforms is provided in Table 2-1.

Table 2-1:
Summary of reforms

Country	Year reform was introduced	Type of reform	Small blurb
Moldova	2018	Flat rate personal income tax	Flat rate PIT of 12 per cent was introduced, with a minimum tax-exempt income threshold set at the official minimum subsistence level
Ukraine	2015/16	Flat rate personal income tax	Flat rate PIT of 18 per cent was introduced, without any minimum tax-exempt income
Romania	2018	Social security contributions shifted to employees	Employees to pay 94 per cent of social contributions, as opposed to 42 per cent before the reforms. Overall contribution rate reduced by 2 percentage points. Employee contributions largely eliminated. Income tax rate reduced from 16 to 10 per cent to 'offset' this
Georgia	2009	Social insurance system dissolved, and flat rate personal income tax introduced	All employees pay a 20 per cent "income tax" that is deducted at source from their salaries

2.2.1 Moldova

Moldova's transition from planned to market economy involved a total reconstruction of the tax system structure, particularly: taxes, tax administration and legislation of tax matters. Namely, personal income tax rates were made less progressive.

In October 2018, as part of a broader fiscal reforms package, a flat income tax rate of 12 per cent was introduced.¹¹ The Moldovan tax system had been gradually becoming less progressive, until reaching this flat tax rate, indicating a general trend towards regression. Before 2018, the personal income tax

¹¹ Cojocaru et al (2019).

was a progressive two-tier system with 7 per cent for the portion of annual income up to MDL 33,000 (US\$1,941)¹² and 18 per cent for incomes above that threshold, while the corporate income tax was set at 15 per cent. Before this, personal income tax rates varied across seven taxation brackets, from 7 per cent to 50 per cent.¹³ As a result of the

advocacy of the National Confederation of Trade Unions of Moldova (CNSM), a minimum tax-exempt income was established. The amount of income exempt from personal income tax was approved at the level of the official minimum subsistence level (MDL 24,000 or US\$1,411 per year).¹⁴ Income obtained from farming is taxed at 7 per cent.¹⁵

2.2.2 Ukraine

Over the last decade, Ukraine has shifted from a system of progressive personal income taxation to a flat-rate personal income tax rate of 18 per cent. It is generally acknowledged that the main way tax policy can reduce income inequality is through progressive income taxation. This regressive tax reform implies that lower earners are contributing a higher share of their disposable income for the same benefits.

On 24 December 2015, Parliament passed a *Law on Amendments of the Tax Code of Ukraine and Some Other Legal Acts to Balance Budget Revenues*, which introduced the following reforms to the tax system, among others:

- Personal income tax. The Tax Code stipulates an 18 per cent flat tax rate instead of the previous 15/20 per cent tax. Previously, the 15 per cent rate was applicable to that part of income not exceeding ten minimal statutory wages and the 20 per cent rate was applicable to the part of income exceeding ten minimal statutory wages. This general 18 per cent rate applies to the most types of individuals' income (salary, investment income, etc.). There is no tax-exempt income threshold in place. Dividends received from Ukrainian companies are still subject to 5 per cent tax.
- Social tax/ social security contributions. Social tax payable by the employer was reduced to the flat 22 per cent rate (instead of previous rates ranging from 36.8 per cent to 49.7 per cent). The social tax payable by the employee from the salary has been cancelled.¹⁶ This was previously social security contributions set at 3.6 per cent and 2.6 per cent withheld from salaries and from payments under civil law agreements.¹⁷

In addition, a temporary 1.5 per cent military tax on personal income was introduced in August 2014. This is effective until the reformation of the Ukrainian Military Forces is completed. In effect, this means that individuals are taxed a flat-rate 19.5 per cent of their personal income. They are then required to contribute a flat 22 per cent social tax to fund their social security benefits, with no contribution from their employer.

¹² Using exchange rate for June 2018.

¹³ Criclivaia (2016).

¹⁴ Using exchange rate for June 2018.

¹⁵ Cojocarui et al (2019).

¹⁶ Solyar and Khomyakov (2016).

¹⁷ Demchenko (2015).

2.2.3 Romania

Since 2018, Romania adopted a fiscal legislation package that shifted nearly all employer social security contributions to employees. The reform included the following changes:¹⁸

- The total employer/employee social security contribution rate declined by two percentage points (from 39.25 per cent to 37.25 per cent).
- The new employee social security contribution rate is 35 per cent, comprised of a general 25 per cent rate and a 10 per cent health insurance contribution.
- Employer social security contributions have largely been eliminated and the responsibility for social contributions shifts almost entirely to employees (employees pay 35 per cent out of 37.25 per cent, i.e.: 94 per cent of the total social contributions, as compared to 16.5 per cent out of 39.25 per cent of the gross wage payable before the reforms, i.e. 42 per cent).
- The personal income tax rate decreased from 16 per cent to 10 per cent to offset the increase in contributions, but the overall result will be a reduction in net pay for employees at current rates of gross pay. (The flat rate tax of 16 per cent has been in place in Romania since its introduction in 2005).¹⁹
- The Government promised to increase public sector gross wages accordingly to maintain the same level of net incomes.²⁰ Law No. 153/2017 was implemented in July 2017 stipulating an increase in public wages of 25 per cent from January 2018. The pay rises are scheduled to increase gradually, until they increase by 56 per cent on average in 2022, whereby they reach the maximum level provided by the law.²¹

2.2.4 Georgia

Georgia's social security system has oscillated between different financing modalities in recent decades, shifting away from social contributions towards financing via personal income tax. The evolution of these financing modalities is depicted in Figure 5 1. In the mid-1990s, employers were obliged to pay 37 per cent of payroll, while employees only paid 1 per cent of earnings, with the Government covering deficits. The employer

contribution was subsequently reduced to 27 per cent by the turn of the decade and then to 20 per cent. Then in the mid-2000s, employer contributions dropped to zero, shifting the burden to employees, who were required to pay 25 per cent. And finally, contributions dropped to zero with the complete elimination of social insurance in 2006 (ISSA/SSA, multiple years).

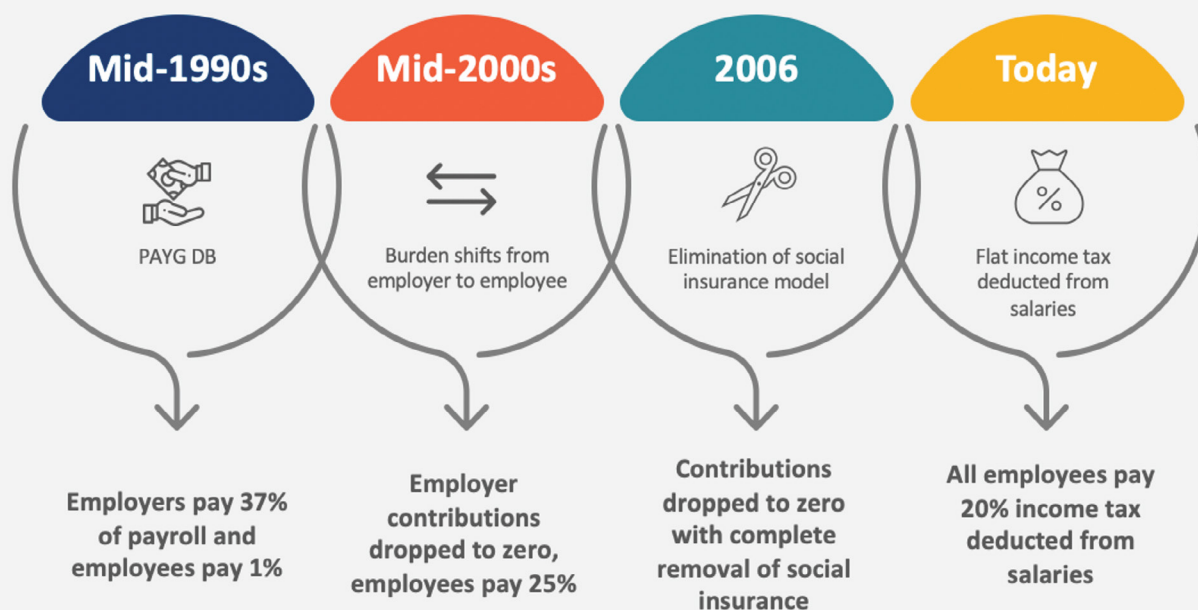
¹⁸ Pop and Urse (2018).

¹⁹ Packard et al (2012).

²⁰ Pop and Urse (2018).

²¹ Eurofound (2017).

Figure 2-1:
Evolution of financing modalities of social security in Georgia



Source: Development Pathways based on McClanahan et al (2021)

Today, since 2009, all employees pay a 20 per cent “income tax” that is deducted at source from their salaries.²² While the income tax is not directly related to the financing of the social security system in law, it is one of the main sources of revenue for the Government’s general revenues. Employers deduct the 20 per cent tax directly from the salaries of employees, and this indirectly comes back to them in the form of tax-financed benefits they may be eligible for, including the universal social pension. Effectively, this is a tax on formal labour. Workers outside of the formal economy are not paying this contribution through the 20 per cent tax, but are deriving benefits from the tax-financed universal old age and disability benefits system.

There are some exemptions to the 20 per cent flat-rate income tax for business-owners. Individuals with an annual turnover of less than GEL 30,000 (USD 9,615)²³, with no employees, and who register as a micro business will be exempt from tax on their business income. In addition, individual entrepreneurs with annual turnover of less than GEL 500,000 (US\$ 160,256)²⁴ may register as a small business and pay 1 per cent tax on their turnover. The rate increases to 3 per cent if annual turnover will exceed GEL 500,000.²⁵

²² Ministry of Finance of Georgia (2011).

²³ Using exchange rate from 1 January 2022.

²⁴ Ibid.

²⁵ PwC (2022).

2.3 Apparent objectives and rationale behind the introduction of the reforms

Before assessing the success of these reforms in achieving their intended objectives and examining any other unintended impacts, it is crucial to first consider what these objectives were and develop a clear understanding of the rationale behind their implementation. Most broadly, the reforms to tax systems and towards privatising pension systems reflected a general shift in most post-Soviet economies from centrally planned to market-led models, underpinned by a neoliberal commitment to a small-state ideology of de-regulation, privatisation and pro-market policies.

The general rationale presented by proponents of flat income tax rates is that, by simplifying tax rules and making the single rate sufficiently low, governments can boost compliance rates by reducing the incentive for tax evasion and stimulate economic growth through fostering a better business environment that attracts foreign investment and encourages risk-taking.²⁶ Another key argument by flat tax advocates is that, when well-designed, flat taxes can also encourage incentives for the formalisation of the labour force, by making labour cheaper.²⁷ As such, the policy option of a flat tax reflects the 'small state' ideology of neoliberal thinking. Advocates of flat taxes argue that, by stimulating entrepreneurial activity, flat taxes can be self-financing. If reducing the tax burden can reinforce incentives to work, innovate and invest, this could lead to higher employment and economic growth, which would broaden the tax base and boost tax revenues despite a lower tax rate.²⁸

Indeed, in the case study countries, one of the most prominent stated objectives for introducing flat taxes was to improve the efficiency of fiscal systems by making taxation clearer and reducing

the possibilities for tax evasion and corruption.²⁹ In Moldova, this was particularly pertinent as a political objective following a bank fraud scandal in 2014, whereby over a billion dollars was stolen from Moldova's public finances, eroding public confidence in the country's fiscal management. Similarly, in Ukraine, Ivan Miklos, advisor to Kiev's government, explained that the flat-rate tax reform was introduced in part "to reduce the extent of corruption".³⁰ The rationale for privatising pensions and shifting contributions from the state or the employer to the employee is similarly focused on promoting macro-economic outcomes and deepening capital markets, but with the added argument that this would also ensure the sustainability of pension financing and enhance the adequacy of benefits (Ortiz et al, 2018). In Romania, reforms to the pension system were ostensibly introduced to address concerns that "the sustainability of the pension system is... endangered", owing to significant deficit within the public system.³¹

However, the rationale for introducing these specific tax and social contribution reforms is not robust. Ultimately, there is little evidence that flat-rate taxes, and the tax cuts for the wealthy that they imply, can stimulate the kind of economic growth that is used to justify them. A study by Piketty et al (2011) found no observable correlation between reductions in top tax rates and economic growth in its analysis of tax systems across 18 high-income countries. Other studies by Gale et al (2016) and Gale (2017) from the Brookings Institution and Horton (2017) report that there is no evidence that increased economic growth resulted from major tax cuts implemented in the United States under President Reagan in 1981 or President George W. Bush in 2001 and 2003. Equally, the study

²⁶ Wilson (2020); Murphy (2006); US Department of State (2020).

²⁷ Packard et al (2012).

²⁸ Peichl (2014).

²⁹ IPM (2007); Fan (2015).

³⁰ Virostkova (2015).

³¹ Nuță et al (2016).

also found no evidence that tax increases under President Bill Clinton in 1993 had any effect on reducing economic growth. In a separate study, Feldstein and former Congressional Budget Office Director Doug Elmendorf (1989) found no evidence that the tax cuts under Reagan in 1981 got people to work more. Instead, a substantial literature argues that flat taxes can have negative distributional effects at the expense of those on low- or middle-incomes, which may call into question the sustainability of flat rate tax systems depending on the political system.³² As Hettich and Winer (1999: 92) argue, “it is possible to have a flat tax, or to have democracy, but not both”.

Similarly, global studies that have looked at the impacts of pension privatisation have found that these reforms were far from successful on their own indicators, and in some cases even had the opposite effect from what was intended. They are more likely to lead to the deterioration of pension benefits and coverage, have a limited effect on capital markets, entail high administrative costs and benefit the financial sector (including international financial institutions), not the state budget or the citizens it is supposed to serve, as the net winner (Ortiz et al, 2018). Instead, the ILO has recommended that countries pursue parametric rather than radical structural reforms to their contributory systems, where even small changes to eligibility criteria or pension formulas can dramatically improve the financial health of public pensions for many years to come.³³ The reversal of pension privatisation reforms globally is testament to the failure of the privatisation agenda.³⁴

In the absence of strong, evidence-based rationale for introducing regressive reforms to taxation and contributory social security systems, the

waves of market-led reforms that have swept the region since the fall of the Soviet Union can, at least in part, be seen as a political project.³⁵ Indeed, countries have continued to introduce such reforms in the last decade, despite their questionable record of success in raising tax revenues. For example, it has been argued that the “Moldovan tax law is influenced more by political reasons, rather than a well-thought approach of imposing economic aspects” (Criclivaia, 2016 172). The reforms have arguably reflected a broader ideological signalling towards a neoliberal market-led model for countries’ political economy. Keen et al (2006) support this explanation, arguing that a core rationale for the flat tax is that it is a way of outwardly ‘marketing’ a fundamental regime change to the rest of the world, as has been the case as countries have transitioned from planned to market-led economies, and sought to integrate into the global free market.

³² Efremidze and Salayeva (2021); Paulus and Peichl (2007); Peichl (2014); Cohen (1999); Carrol et al (2019); Alt et al (2010).

³³ Cichon et al. (2006); Diop, (2008); ILO (2014); ILO (2017).

³⁴ Ortiz et al (2018).

³⁵ Murphy (2006).

3 Have the reforms achieved their apparent objectives?

Despite high expectations, the reforms appear to have largely failed to achieve the grand objectives and aspirations that justified their rapid implementation. The promised positive impacts on the formalisation of the labour market, the expansion of the tax base and economic growth have seemingly not been delivered. Indeed, there have been very few notable changes in economic indicators across the countries, and those changes that have occurred are very difficult to attribute to the reforms, explained largely by other factors. Additionally, reforms to contributory systems in Romania and Georgia have seemingly not achieved the improvements to pension adequacy and sustainability that they set out to achieve. Instead, the risk of financial market fluctuations was merely shifted onto individuals.³⁶ This section seeks to evaluate the extent to which the reforms have achieved their stated objectives, looking first at the impacts of the reforms on broad macro-economic indicators in the case study countries before then turning to assess the impacts on pension adequacy and sustainability.

3.1 Impacts of the reforms on economic indicators

Across all four case study countries, there is little evidence that the introduction of flat-rate income taxes and the shifting of contributions onto employees has achieved their apparent fiscal and labour market objectives. While it is difficult to identify and attribute changes during such a recent period and disaggregate the impacts of the reforms from other interacting variables, analysis of macro-economic indicators during the reform period and an assessment of the literature suggests that the reforms have, ultimately, not had their intended economic effects. Even in countries that introduced these reforms much earlier, there is little evidence that they have delivered the expected economic impacts that were promised. Indeed, this is consistent with Greenberg's (2009) study of similar flat tax reforms in other Baltic countries in the 1990s, which concludes that "looking at both the theory and data, there is no clear evidence that the flat tax improves revenues, labor output, growth, or equity". For Slovakia –the first Central European country to introduce a flat personal income tax in

2004 – Peichl (2013) argues that "while the flat tax reform was expected to boost the economy, no causal empirical evidence apart from revenue-neutrality has been reported". Assessing reforms in the region, ECB (2007) find that "there is no clear evidence that the introduction of flat taxes has been self-financing, although reports do not point to dramatic deteriorations in tax revenues either".

Advocates of flat rate taxes argue that their introduction will boost tax revenues by disincentivising tax evasion and broadening the tax base. Yet, in all case study countries, there has been little to no indication that tax revenues have increased since the respective reforms were introduced (see Figure A 1 to Figure A 4 in Annex 1). In Ukraine, for example, the large-scale tax evasion that continues today shows clearly that the introduction of the flat-rate income tax of 18 per cent has failed to encourage higher income earners to pay their taxes through an improved simplicity of the system, as was hoped.³⁷

³⁶ Ortiz et al (2018).

³⁷ Barannyk et al (2021).

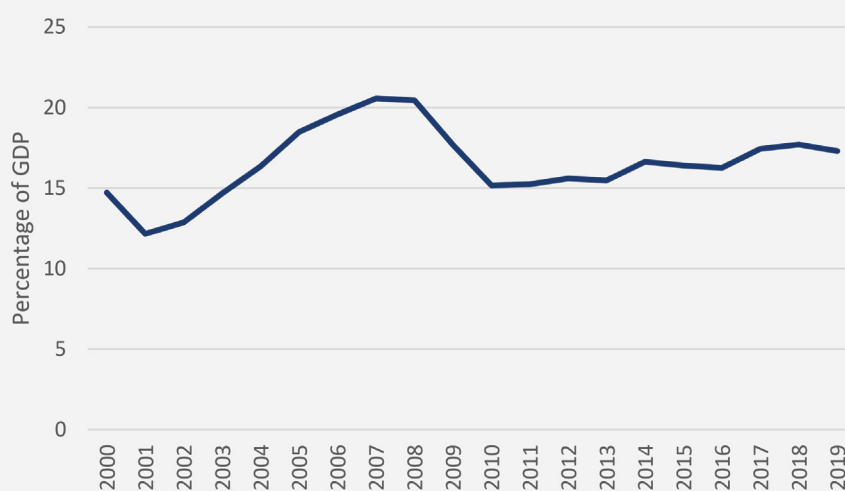
Box 1: Moldova's '2% law' allows taxpayers to fund CSOs through their income tax

Interestingly, in Moldova, in September 2016, the government adopted a new regulation which gave individual taxpayers the right to designate 2 per cent of their income tax to a non-commercial organisation, as an indirect way of providing financial state support to the nongovernmental sector. The law provides that individuals can re-direct their 2 per cent away from the state budget and towards “nongovernmental organizations or to religious entities that act in the public interest”. In 2017, 11 per cent of all taxpayers chose to designate their 2 per cent to around 300 different non-governmental organisations (NGOs). This re-direction of tax revenues away from the state budget is likely to further undermine the capacity of the state to make productive investments and deliver on social spending, signalling that CSOs might take on the role of provider of social goods. It is also consistent with the political decision to shift towards individualising responsibility for the financing of key domains.

In fact, it is likely that cuts to income tax have actually undermined governments' ability to mobilise revenues, which will have had a negative impact on the provision of public goods and social services, as well as the capacity of governments to stimulate further economic growth. In Moldova, the European Commission (2019: 11) explain that “the fiscal situation has deteriorated significantly in 2019 following cuts to personal income tax rates and the increase in public sector wages and social packages”, referring specifically to the fiscal package of 2018 that introduced the single flat-

rate income tax of 12 per cent, the doubling of the threshold for the deduction of personal income tax to MDL 24,000 (roughly US\$1,411) and a reduction of social contribution from 23 per cent to 18 per cent of wages. Other critics of Moldova's overall tax systems claim that “it hampers economic growth, applying half measures, and does not ensure state programmes and services are efficient”.³⁸ As Figure 3-1 indicates, while data are limited due to this being a recent reform, between 2018 and 2019, overall tax revenues have actually declined between 2018 and 2019.

Figure 3-1:
Annual tax revenue in Moldova since 2000 (as a percentage of GDP)



Source: World Bank Development Indicators Database (2021)

³⁸ Criclivaia (2016).

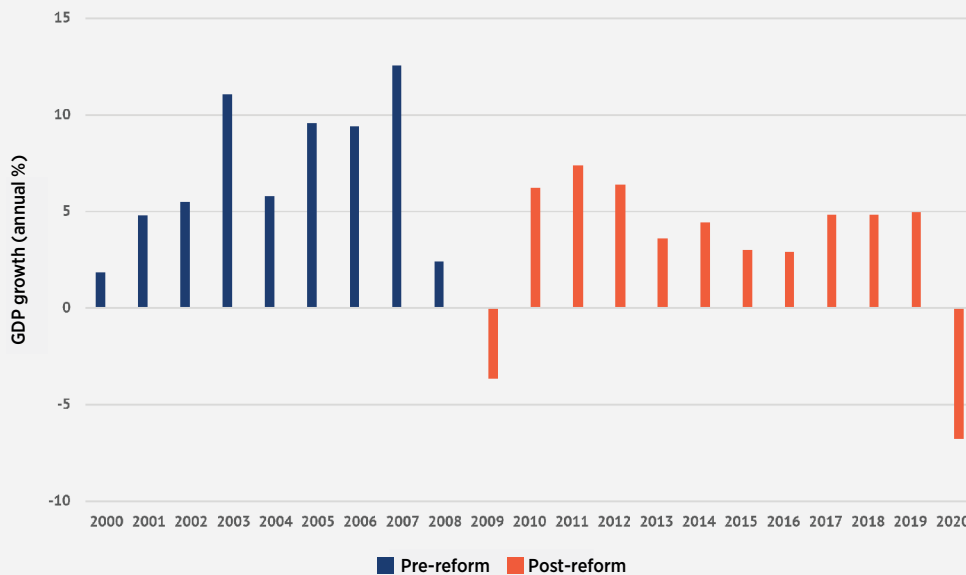
Instead of boosting economic growth, the growth rate of national GDP has declined in Moldova since the flat rate tax reform was introduced. It plummeted even more drastically in 2020 which can likely be attributed to the devastating economic impacts of the COVID-19 pandemic: a crisis which low government revenues precipitated by tax cuts may have left the country in an even weaker position to respond to.

In Ukraine, there has been no significant surge in GDP growth, except a gradual return to pre-2012 levels, with the economy recovering from an economic downturn, caused mainly by the loss of its largest trading partner, Russia, when hostilities broke out over the annexation of Crimea and the subsequent Separatist war in the East.³⁹ Predictably, government revenues in Ukraine have actually declined since the reform from 42 per cent of GDP in 2015 to 26 per cent of GDP. The flat-rate tax has thus not achieved its objectives of raising more revenues. In fact, it has achieved quite the

opposite and, while declining revenues are likely due to a number of interacting causal factors, ultimately the Government has been left with less to invest in other areas of the economy.

Similarly, in Georgia, the reforms to the contributory social security and tax systems (the dissolving of the social insurance system and the introduction of a flat 20 per cent income tax) were introduced with the apparent objectives of improving economic development and generating sustainable state revenues.⁴⁰ However, there is little evidence that the reforms have achieved these objectives. As Figure 3-2 shows, macro-economic indicators for Georgia during the reform period do not indicate there have been any consistent macro-economic benefits. GDP growth rates have been very uneven since the 2009 reform, dropping to a deficit in 2009 and oscillating between increasing and decreasing until 2020 when it returned to a deficit of 6.8 per cent, largely as a result of the COVID-19 economic crisis.

Figure 3-2:
GDP growth rate in Georgia since 2010



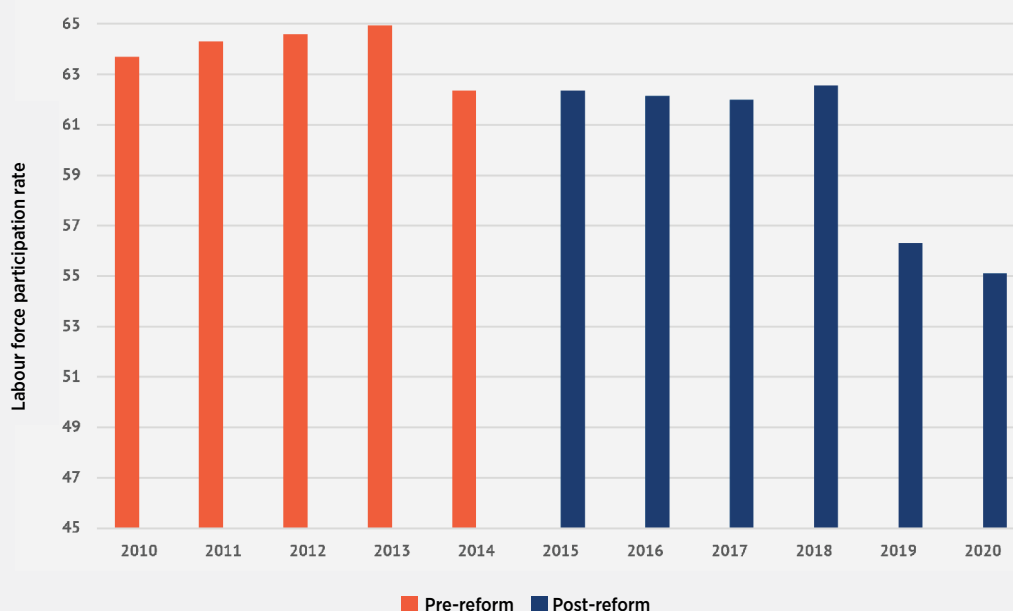
Source: World Bank Development Indicators Database (2021).
Note: * demarks projected estimates

³⁹ Valente and Bluszcz (2020).
⁴⁰ Jandieri (2019).

There is also little evidence that the reforms have had any improvements on labour market outcomes in the case study countries, which constituted a core part of the rationale for introducing them. Since the flat personal income tax was introduced in Ukraine, for example, there has been little lasting impact on unemployment. While the unemployment rate declined in 2017, it has since climbed back up to 9.5 per cent in 2020. The labour force participation rate, however, has declined steadily and significantly since the reform was introduced,

dropping from 66 per cent in 2015 to 55 per cent in 2020 (see Figure 3-3). Similarly in Moldova, since the reform was introduced, there has been little consistent impact on unemployment. In fact, after the reform was enacted, unemployment increased by 1 percentage point before dropping back down to just below 4 per cent. There has been no notable impact on labour force participation, which initially dropped before plateauing to pre-reform levels.

Figure 3-3:
Labour force participation rate in Ukraine since 2010



Source: ILO-STATISTICS (2021).
Note: * sign demarks projected estimates

There has also been no consistent impact on unemployment in Romania (as shown by Figure 0 3). In fact, unemployment levels spiked in 2020 for the first time in the last decade, although this is likely to be largely attributed to the COVID-19 economic crisis. There has been no change in labour market participation since the reform. Further, in Romania, the ILO (2018) have challenged the impact that the reforms can have on reducing labour informality: since informality rates are only

high among own account workers and not salaried employees, “the idea of reducing employers’ contributions as a way to lower the informality of the Romanian economy is not substantiated by evidence. Rather the opposite actually – to reduce informality, social security schemes for the own account workers should be reviewed, avoiding penalization of own account workers through higher contribution rates”.

In Georgia, there has been no stable trend in labour force participation rates, with rates increasing following the introduction of the reform but then falling again after 2015. In fact, the replacement of the social insurance system with a flat rate income tax of 20 per cent disadvantages formally employed persons who are subject to the tax and is likely to actively disincentivise the formalisation of the labour force. As a consequence, this is likely to undermine the broadening of the tax base and the expansion of tax revenues over time. While the income tax is not directly related to the financing of the social security system in law, it is one of the main sources of revenues for the Government's

general revenues, from which all tax-financed social security benefits are funded – currently the backbone of Georgia's social security system. Employers deduct the 20 per cent tax directly from the salaries of employees, and this indirectly comes back to them in the form of tax-financed benefits they may be eligible for, including the universal social pension and universal disability benefits. Yet, workers outside of the formal economy are still eligible to receive the same tax-financed benefits but are not paying this contribution through the 20 per cent tax. As such, this is effectively a tax on labour, which, intuitively, is likely to actively undermine efforts to formalise the labour force.

3.2 Impacts of the contributory reforms on pension coverage and adequacy

It remains unclear if the pension reforms in Romania and Georgia have been able to deliver on their objectives to enhance the sustainability of the pension budget and the adequacy of benefits in the long run by increasing the efficiency of tax collection. Initial analysis suggests that the reforms have not had any positive macro-economic benefits and may have actually had negative impacts on the overall pension system.

The reforms seen in the case study countries over roughly the past decade are indicative of broader trends in reforming contributory social security systems in the region, which have shifted the burden from the employer to the employee. Historically, most countries had employer-financed post-Soviet systems with little, if any, contribution burden placed on workers. In Romania, for example, the principal pensions, those of former industrial workers, were financed by social security contributions that formally passed through a social insurance fund to the budget.⁴¹ However, this was seen broadly as unsustainable, in light of fiscal challenges during the post-Soviet transition, and most countries' contributory systems underwent a series of reforms. Yet, challenges persisted.

In 2010, the deficit accumulated by Romania's public system represented about 50 per cent of the collected contributions (Zaman, 2012). This was exacerbated by demographic challenges in Romania and Georgia. In both countries, significant out-migration of working age persons has led to population decline, yet, at the same time, an increase in life expectancy has caused a rapidly ageing population.⁴² Increased contribution and tax rates for workers likely provides a further incentive to emigrate. These demographic challenges have undoubtedly put an increasing strain on pension budgets. Under the wave of privatisation and market-led reforms that swept the region, pension privatisation and the shifting of contribution rates to employees, was – at least officially – expected to enhance the sustainability of pension budgets, boosting the coverage and adequacy of benefits.

Yet, evidence suggests that this has not necessarily been the case. In Romania, this reform appears to be undermining the financing base for the pension system by significantly reducing the overall contribution rate.⁴³ There is insufficient data to track the adequacy of benefit levels over time. However, in 2018, the minimum pension

⁴¹ De Menil and Sheshinski (2002).

⁴² Nuță et al (2016); Tembon et al (2018).

⁴³ In Georgia, there is no erosion of pension financing, since social insurance was eliminated altogether.

for Romania was around 24 per cent of the net average earnings, which is already low compared to the OECD average of nearly 60 per cent and the EU's average of nearly 63 per cent.⁴⁴ When the 2018 reform package was introduced, the total social contribution rate declined by two percentage points from 39.25 per cent to 37.25 per cent. Analysis by the European Commission (2021) suggests that the reforms are negatively impacting pension replacement rates and benefit levels. The aggregate replacement rate (ARR) is used to measure the pension income of people in early retirement years, as a ratio of work incomes in late working years.⁴⁵ It is the gross median individual pension income of the population aged 65-74, relative to gross median individual earnings from work of the population aged 50-59, excluding social benefits other than pensions. While the aggregate replacement ratio has remained largely stable in the EU-27 region over the past 3 years,

Romania has experienced a drastic reduction in the ARR of its pensions, which have fallen rapidly from 66 in 2016 to 42 in 2019.⁴⁶ The European Commission's (2021) recent Pension Adequacy Report argues that this fall in the replacement ratio – the adequacy of pension income received relative to their previous work income – is due to a sharp increase in income from work among people aged 50-59 and has been affected by the 2018 reforms to Romania's social security systems. As part of the 2018 reform package, the Government promised to increase public sector gross wages accordingly (by approximately 20 per cent), to maintain the same level of net incomes.⁴⁷ In their latest Pension Adequacy Report, the European Commission (2021) expect a new reform to raise benefits across the board due to changes in the pension calculation formula and value of pension points. This may have been in response to reactions to the recent erosion in value.

Box 2: Defined contribution (DC) schemes in Georgia

The basic benefit provided by the social pension can be topped up by contributing additional money to privately managed defined contribution schemes. However, this is essentially a compulsory savings account which accrues interest and can be accessed as a lump sum, or, in some cases, an annuity. As such, it does not fulfil the income-replacement or consumption-smoothing function that a pension should. DC schemes shift the financing burden entirely onto the individual account holder to spread their own savings across their remaining years. Importantly, there is also no cross-subsidisation from higher earners to lower earners, as would be the case in a traditional defined benefit public pension system. The DC schemes were only implemented in 2019 in Georgia, so it will be another few decades before the first cohort can access it and any analysis of its benefit levels can take place. However, the sudden replacement of social insurance with a basic social pension supplemented by DC schemes is likely to impact the future adequacy of pensions for workers who have transitioned to this new system. Low-income workers will most likely have to rely almost entirely on the universal social pension, despite having contributed 2 per cent of their salary over their whole working lives (for more information see McClanahan (2021)).

⁴⁴ Value for minimum pension value in Romania from ISSA. Values for OECD and EU averages from OECD (2021).

⁴⁵ The ARR is the gross median individual pension income of the population aged 65-74, relative to gross median individual earnings from work of the population aged 50-59, excluding social benefits other than pensions.

⁴⁶ European Commission (2021).

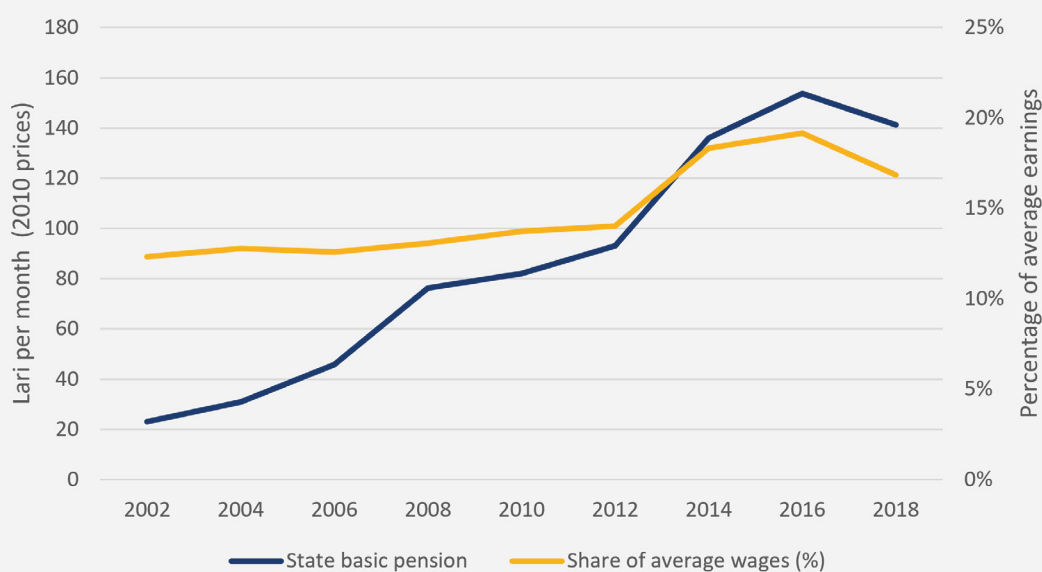
⁴⁷ Pop and Urse (2018).

In Georgia, the social insurance system has been completely dissolved and replaced by a flat rate 20 per cent income tax which goes directly to the central government budget. Since 2006, Georgia has provided a basic universal social pension for all residents reaching retirement age (65 years for men and 60 years for women). Instead of receiving their social insurance pension, formally employed persons contributing their 20 per cent income tax thus receive this basic social pension instead, just as all other residents do, whether they are eligible to pay the tax or not. Under this system, the workforce is shouldering the burden to finance everything, but are receiving very little in return. While the social pension provides a basic pension floor, the revenues are not in place to currently be able to provide universal access to protections for risks and contingencies in working age, such as maternity, sickness or child benefits. Workers have the option to contribute to defined contribution schemes, where a 2 per cent contribution by the employee is matched by an additional 2 per cent by the employer and 2 per cent by the Government, yet the new accumulation scheme is essentially a savings account which will not provide

longer-term income security, particularly for lower earners, including women (see Box 2). By removing the social insurance system, the Government have removed an important tier that, if provided as a complement to the basic social pension floor, would likely reduce the burden on the tax-financed pillar and provide a wider variety of benefits to support working age persons across the lifecycle. This would make formal work more attractive and affordable for younger workers.

While the benefit level received by workers (as well as the provision of additional benefits received for working age contingencies) could likely be improved if there was a complementary social insurance pillar, Georgia's state pension has increased in real terms since 2002 and up to 2016, as shown by Figure 3-4. It has also increased as a share of average wages up to 2016, although this growth rate is less steep than the growth in real value. However, as a share of average wages, it has declined from about 19.15 per cent in 2016 to 16.85 per cent in 2018, which are the latest available figures.

Figure 3-4:
Adequacy of Georgia's pension values since 2002



Source: ISSA (2002-2018) Social Security Programs Throughout the World

Overall, while pension systems in the region clearly face very real and multifaceted challenges, these challenges could have been met with more considered and incremental parametric reforms, such as changes to retirement age, benefit formula and contribution rates. As Ortiz et al (2018) point out, it is natural that the maturation of pension systems leads to an increase in overall benefit expenditure in the long-term. The experience of higher income countries demonstrates that

it is feasible to adapt pension systems through minor parametric reforms in order to make them sustainable throughout demographic change, pension schemes' maturation and other future challenges. Reforming contributory systems through parametric reforms may help to ensure the sustainability of the pension budget, maintain benefit levels and, importantly, avoid the broader social fall-out on income and inequality examined in the following section.⁴⁸

4 Broader impacts of reforms on welfare of national populations

Beyond the seeming failure to achieve its stated macro-economic and political objectives, it is also important to evaluate the social impact of the reforms and consider any ways in which they have affected welfare and equality. This section will examine these broader effects of the reforms on welfare in the four case study countries.

There is a growing awareness that taxation is a rights-based issue and that the design and implementation of taxation systems should be managed by states with careful consideration to fully uphold the entitlements of rights-bearers, just as is considered in other arenas such as healthcare and social protection. The Principles for Human Rights in Fiscal Policy (2021) lays out that states have an obligation to fulfil rights, by adopting “the necessary proactive fiscal policy measures to ensure the full realization of human rights as expeditiously as possible” and “to finance the provision of universal public services essential for guaranteeing rights that are financially and geographically accessible, acceptable, and of

good quality”. The Principles (2021) also note that International Financial Institutions (IFIs) also have a responsibility to protect these rights in the types of policies that they promote or influence and “must refrain from designing, adopting, financing and implementing fiscal measures that directly or indirectly hinder or affect the enjoyment of human rights”.

The design of appropriate fiscal systems – which includes taxation and social security contributions – is linked to rights in two ways. Firstly, by ensuring the equitable distribution of tax burdens or responsibilities across different actors in a society so that everyone's right to a decent standard of living can be realised. After all, the living standards of people depend not only on their amount of income, but also on how much the state takes back in the form of taxes or how much of their salary they are obligated to contribute to social security funds. And, secondly, fiscal systems are linked to rights since sufficient revenues must be sourced to realise and expand citizens' right

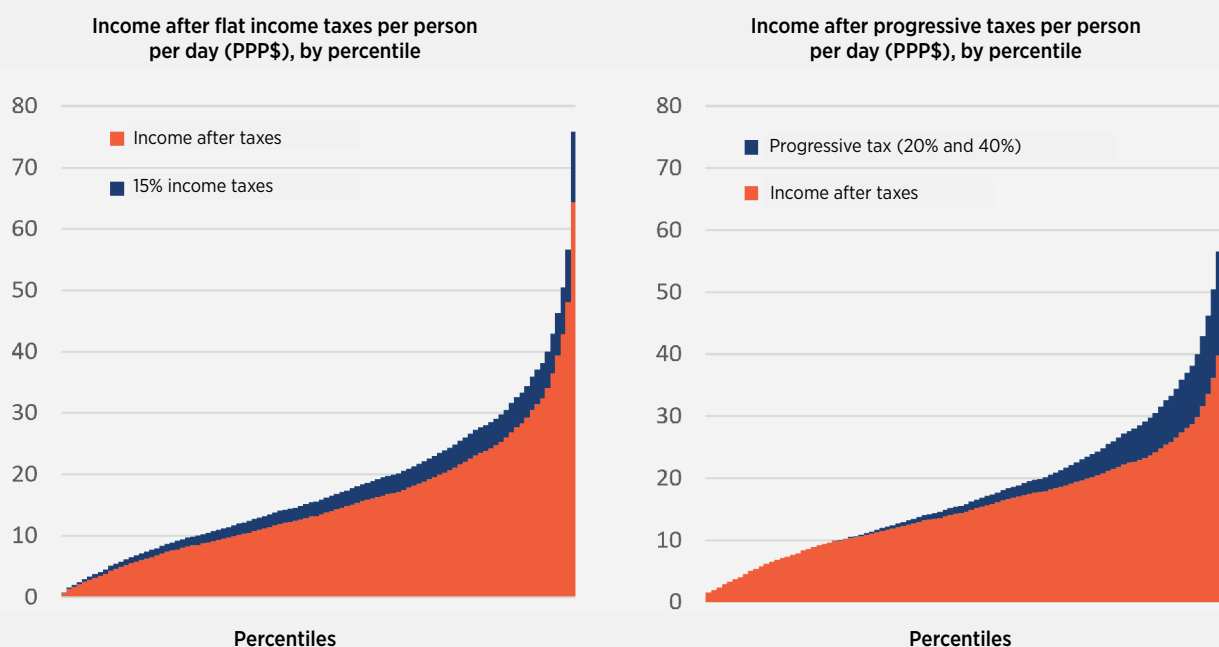
⁴⁸ Ortiz et al (2018).

to social protection and other public services. The intricate complexity of fiscal policy can be perceived as a highly technical and apolitical field, incomprehensible except to a small circle of technical experts. Yet, there is a danger that treating it as a technocratic exercise “obscures the direct link between fiscal policy and the lives and wellbeing of people and communities”.⁴⁹

Put simply, regressive tax systems – including the flat tax systems introduced in Ukraine and Moldova and the reforms to social security contributions in Georgia and Romania – require those on lower incomes to contribute a greater proportion of their disposable income compared to those on higher incomes. For example, while a flat rate tax of 15 per cent might imply equality at first glance, this will have drastically different impacts on post-tax income for different taxpayers in a reality of

uneven incomes. To illustrate this point, Figure 4-1 compares income after taxes under a flat tax system (Panel A) and under a progressive income tax system (Panel B) in a hypothetical country. Panel A shows the income by person per day in PPP after a flat 15 per cent income tax is levied (shown in blue). Assuming this is paid universally, the reduction in income is proportionately the same across all percentiles. Panel B shows the income after taxes in a simple progressive system with two income tax rates (20 per cent and 40 per cent) and a tax-exempt minimum income. The income thresholds are set such that the total tax revenue from the progressive system matches the total tax revenue from the flat system. In the progressive system, the rich pay significantly more than the poor, both in absolute levels and as a proportion of their overall income.

Figure 4-1:
Hypothetical changes to income after flat and progressive taxes



Source: calculations based on data from PovcalNet for Romania in 2018 (accessed March 2022). Notes: to match the total tax revenue from the flat system, the implied income thresholds for the two different income taxes in the progressive system is set at PPP\$ 9.77 and PPP\$19.54 per day per person. This means that all those with income under PPP\$ 9.77 pay 0 per cent of income tax, and all those with income between PPP\$ 9.77 and PPP\$19.54 pay 20 per cent for any income above PPP\$9.77, and anyone with income above PPP\$19.54 pay 40 per cent for any income above PPP\$19.54

⁴⁹ The Principles for Human Rights in Fiscal Policy (2021).

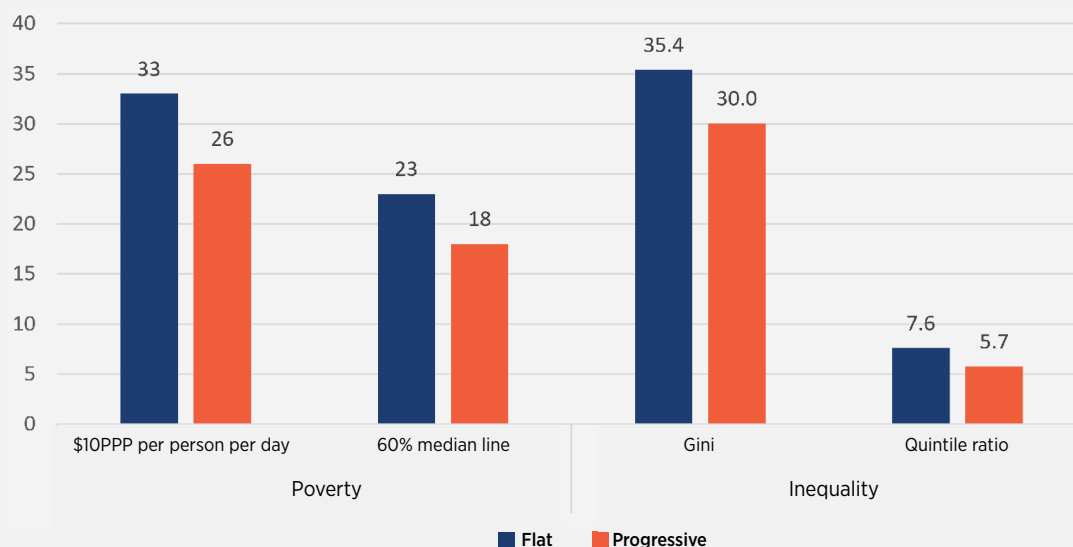
Box 3: Other studies on flat taxes and inequality in Romania

In Romania, Voinea and Mihaescu (2009) looked at the impact of the flat tax reform introduced from 2005 on inequality in Romania and found an increase in inequality determined by the flat tax across all inequality indicators. In their analysis, it is only the richest 20 per cent of the population that appear as the clear beneficiaries of the tax. Popescu et al (2019) simulated the impact of a change in the current personal income tax policy system from a 10 per cent flat-rate taxation to one of two possible alternative progressive tax systems. The findings show a modest but beneficial impact on both income inequalities and poverty in Romania, most significantly reducing the Gini coefficient by up to 0.53 per cent. They suggest that a change in the personal income taxation policy from a flat-rate tax to a progressive taxation system could bring slight improvements in terms of poverty and income inequalities, when the progressive taxation system assures a better consideration for the needs of poorer households as compared to the rest of the household income distribution, and especially to the richest households.

As the simulations in Figure 4-2 show, these different distributions of tax burdens have significant implications for poverty and inequality. Assuming no other changes are observed, the flat rate tax system produces substantially worse social outcomes, and more people are likely to be living in poverty or vulnerable to poverty. Distributing the burden for the same overall tax revenues using the progressive scenario is simulated to result in a 7-percentage point decrease in the proportion of the population living precariously on less than US\$10 (PPP) per day and a 5-percentage point decrease in the poverty rate (proportion of people living below the 60 per cent median poverty line), compared to the flat rate scenario. These impacts

will be particularly significant for poverty among the working age population, which is important since this group typically benefits the least from social protection systems. In terms of inequality, the progressive scenario is simulated to have a greater effect, resulting in a Gini score that is roughly 5.4 percentage points lower than under the flat rate tax scenario. This result seems intuitive, since progressive systems play a clear redistributive role in shifting proportional tax burdens from those on lower incomes to those who have larger accumulated disposable income to tax, as other studies on flat taxes in Romania have found (see Box 3).

Figure 4-2:
Simulated poverty and inequality measures after hypothetical flat and progressive tax scenarios



Source: calculations based on data from PovcalNet for Romania in 2018 (accessed March 2022).

The findings of this hypothetical simulation are consistent with a wider literature that critiques the social aspects of the flat tax reforms as regressive and socially unjust. As Naidenko (2019) argues in the case of Ukraine, this system “does not allow us to fully implement the principle of social justice because in many cases it does not take into account the solvency of taxpayers”. Martynets (2015) points out that the material consequences of failing to address this social injustice is that the tax system “negatively affects the income of citizens, the level of welfare of the population of Ukraine and ensuring social living standards”.

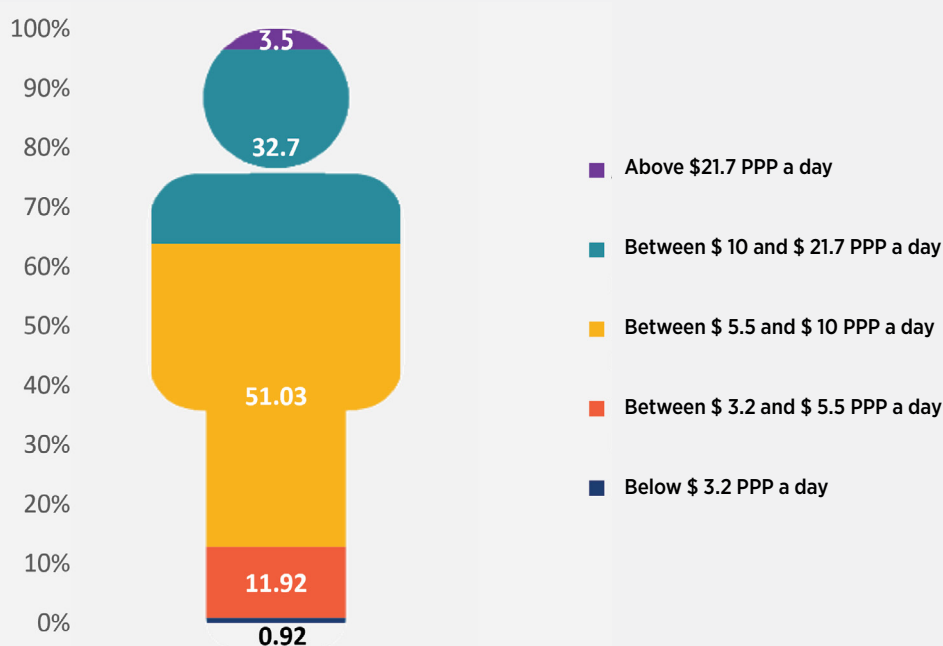
Indeed, living standards of people depend not only on their amount of income, but also on how much the state takes back in the form of taxes and, in contexts where most households are already struggling and living on precarious incomes, even a small adjustment of the tax rate can have a powerful impact on living standards. The Ukrainian economy is still recovering from the severe recession of 2014-2015, which has had a notable

negative effect on real incomes. Over one-quarter of the population are still not meeting their basic needs. Beyond basic needs,⁵⁰ most people are living on low and insecure incomes and are highly vulnerable to economic shocks. A quarter of the population were living on less than US\$10 (PPP) per day in 2019 (see Annex 2), indicating widespread low and insecure incomes.

Similarly, Moldova is one of the poorest countries in Europe, with a GDP per capita of just USD 4,523 in 2020. The country faces a number of challenges, including widespread low incomes (64 per cent of the population are living on less than US\$10 (PPP) per day as shown by Figure 4-3), high levels of informality and rising regional inequalities.⁵¹ Wages and employment rates are very low, with the level of employment only slightly above 40 per cent for the last ten years. As a result, the country has experienced significant out-migration, reflected in a population decline from 3.6 million in 2000 to less than 2.7 million in 2020, which is also partly explained by the country’s declining fertility rate.⁵²

Figure 4-3:

Share of Moldavian population living in households with consumption or income per person below different poverty lines, 2018



Source: Own calculations based on PovcalNet, Development Research Group of the World Bank (2022).

⁵⁰ Bornukova et al (2019).

⁵¹ World Bank (2018).

⁵² Barca (2020).

Box 4: The impact of reduced remittances

The global nature of the crisis also substantially reduced remittance inflows. Before the crisis, remittances provided considerable cash income for recipients in the case study countries. Romania, for example, ranked as the third most dependent country on remittances in the EU in 2020, with remittances making up 3.2 per cent of its GDP. States looked to tax these inflows to provide additional revenues, since remittances can be seen as complicating monetary policy by influencing demand in an acyclical fashion (IMF, 2022). This further demonstrates the opportunistic nature of fiscal policies. COVID-19 had undermined that source. However, there are signs that remittance inflows are beginning to recover post-crisis (Grzegorzczuk, 2021).

Widespread low and insecure incomes left a significant proportion of the population highly exposed to the severe economic crisis generated by COVID-19. A study by the United Nations (2020) on the impacts of the crisis in Ukraine found that 84 per cent of households lost income and 43 per cent had at least one family member who had lost a job, meaning that the majority of people had even less income to tax following the crisis. In Moldova, the economic crisis generated by the pandemic saw economic growth contract by 7 per cent as a result of measures introduced to contain the spread of the virus nationally and elsewhere in the global economy.⁵³ A period of severe drought in 2020 further compounded the effects of the economic crisis on livelihoods and the welfare and food security of households across the country.⁵⁴ In this context of widespread income insecurity, it is crucial that the structure of national taxation systems does not further exacerbate this by diminishing incomes that are already precarious. At the same time, it is also crucial that sufficient revenues are mobilised to invest in good-quality public services, inclusive social protection and productive industries, to stimulate broad-based economic growth.

Indeed, cuts to key sources of tax revenue is particularly concerning in the context of the recent economic crisis generated by the COVID-19 pandemic, which has suddenly hit economies and

has required an upsurge in public spending, on health and social security responses to mitigate the impact of widespread job and income loss and the closure of whole industries, and the increased pressure on the healthcare sector. Such a universal and widespread economic crisis also necessitates an increase in public spending, not just to meet increased public need, but also to provide a fiscal stimulus to lower the depth of recession and aid economic recovery.⁵⁵ The Moldovan fiscal situation, having implemented widespread cuts to tax, reducing the rate for taxing high income earners from 18 per cent to a flat-rate of 12 per cent, was not in a strong position to respond effectively. As a result, the economic crisis has hit Moldova hard and the impacts on living standards and social welfare of the majority of households has been devastating.⁵⁶

Ultimately, the net winners of flat rate taxes are the wealthy. For example, the reform in Moldova favours employees with higher incomes, since the rate was effectively reduced from 18 per cent to 12 per cent for incomes over MDL 24,000 (US\$1,411). Similarly, in Ukraine, the reforms mean that the proportion of tax paid by those on higher incomes has effectively reduced, from 20 per cent to the flat rate of 18 per cent for income exceeding ten minimal statutory wages (US\$2,042). As a consequence, those on lower incomes pay a higher proportion of their income as taxes and those on

⁵³ IMF (2022).

⁵⁴ World Bank (2021).

⁵⁵ IMF (2020).

⁵⁶ UNDP and World Bank (2020).

higher incomes pay a lower proportion, which is likely to be exacerbating inequality.

In Georgia, the removal of the social insurance system and the introduction of a flat 20 per cent income tax implies that lower earners are contributing a higher share of their disposable income for the same benefits. The flat income tax is not only regressive but also invites doubt about the locus of responsibility since employers are responsible for filing the tax (according to an interview with the Georgia Employers' Association).⁵⁷ Employers also pay a 20 per cent tax on all profits that are not reinvested (Godar et al, 2018). Given these extreme fluctuations and confusion about who bears the responsibility for financing, it is not surprising that many stakeholders are apprehensive about the possibility of reintroducing social contributions.⁵⁸

Moldova's trade unions successfully lobbied for a tax-exempt minimum income, an important measure to protect the precious incomes of those earning below official minimum subsistence level (MDL 24,000 per year). This contrasts with the flat-rate tax rate that is still applied universally without such protections in Ukraine, for example. However, since the reform in Moldova has effectively raised the tax rate for the majority of the population on lower incomes while only benefitted the wealthy, the reform remains decidedly pro-rich, not least because tax cuts for the wealthy and the fall in public revenue and spending that this implies will particularly hit the poor who are most likely to rely on public services.

Further, it is unclear whether the value of this income threshold will be updated annually in line with inflation to reflect changes in the real value of incomes. If this is not automatically updated, this would mean that, as their incomes rise above the threshold of MDL 24,000 as a result of inflation,

new families would begin to be taxed, despite the real value of their incomes not increasing. This would result in low incomes becoming even more squeezed over time, deepening the impact of the reform on living standards.

In Romania, it is likely that the shift of the tax burden from the employer onto the employee (in addition to the earlier imposition of a flat-rate tax from 2005) disproportionately negatively impacts those on lower incomes and has had adverse impacts for welfare and living standards. Before the implementation of the reforms, Romania had the seventh highest social contributions costs among the countries of the European Economic Area⁵⁹ While the cumulated rate of contribution has decreased from 39.25 per cent to 37.25 per cent, the reforms have seen responsibility for social contributions shift almost entirely to employees, with employees responsible for paying 94 per cent of the total social contributions at a contribution rate of 35 per cent of their gross wage. This is a significant increase in the income being deducted from their take home pay since, prior to 2018, employees paid 42 per cent of the total social contributions, paying 16.5 per cent of their gross wages. The proportion of their salary that employees are required to contribute more than doubled overnight. While the personal income tax rate has decreased from 16 per cent to 10 per cent, this still results in an overall reduction in net pay for employees at current rates of gross pay. The government increased public sector wages as part of the fiscal package, to offset the increase in contributions for workers, in acknowledgement that the higher contribution burden would reduce their net wage. However, this does not apply to the private sector, where employers are not obliged to increase wages. The reforms leave private sector employers in a unique position within Europe of not being required by law to contribute in any way to the social security systems of their employees.

⁵⁷ Interview conducted in January 2020 for Development Pathways' assessment of Georgia's social protection system, carried out for the ILO. See McClanahan et al. (2021).

⁵⁸ McClanahan et al (2021).

⁵⁹ Tache (2017).

In the context of Romania, where the majority of the population already live on low and insecure incomes, this increasing burden to finance their own social security protections without any support from their employer is likely to have had significant impacts on the living standards of most households.

A situation of widespread low incomes and high levels of inequality – and the exacerbation of these issues by the COVID-19 economic crisis – has made social protection coverage and support more important than ever. Yet, the fiscal measures have also had a negative impact on the pension system, leading to an increase in the uninsured working population and a deepening of the already existing (future) pension gap between workers in standard employment and those in non-standard employment (full-time employment versus part-time employment, employees versus self-employed) as well as between workers in the

public and private sectors, as discussed previously in Section 2.2.⁶⁰ The erosion of the pension system is likely to further undermine the income security and wellbeing of the majority of the population who will require social protection support in the later stages of their lives. Similarly, in Georgia, the dissolution of the social insurance system and its replacement with a flat rate 20 per cent income tax removes much-needed social insurance support for working age contingencies, including maternity and unemployment benefits, which will undermine the capacities of workers and their families to manage risk, smooth household consumption and maintain their living standards. When tax and social security reforms effectively entail the removal of much-needed support and a decline in take-home income and, therefore, living standards among low and middle-income workers, this is likely to undermine trust in government and harm social contracts, as examined in the following section.

5 The impact of reforms on national social contracts

The equitable design and proper implementation of national tax systems and contributory social security systems also plays a key role in building a strong national social contract. When citizens perceive that the way in which taxation and contribution responsibilities are distributed across members of society is unfair, this can undermine citizens' trust in government and damage social cohesion. Across many countries in the region, this is the case. Tax administration is marred by corruption and there is a strong sense of perceived injustice about tax systems disproportionately targeting those who are worse off in society

and favouring the wealthy. Over time, this can erode social contracts and even contribute to or trigger social unrest. Indeed, this is consistent with the stories of many countries in the region, for example Ukraine, which has suffered a major crisis of confidence in government in recent years, contributing to the Ukrainian crisis of 2013-14, with instability still ongoing today. As the IMF has warned, the widespread income and job loss precipitated by the COVID-19 crisis – and the resultant worsening of inequalities within societies – threatens to exacerbate social unrest if left unaddressed by governments.⁶¹

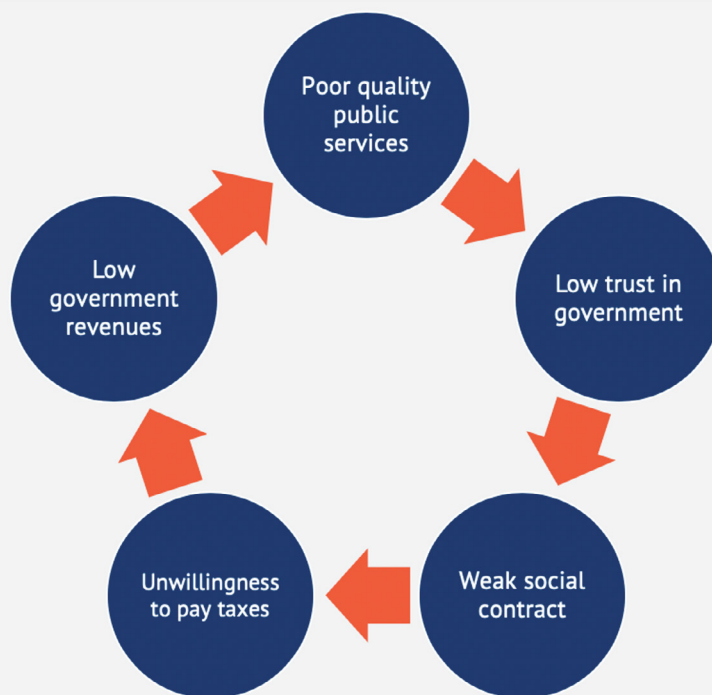
⁶⁰ Pop and Urse (2018)

⁶¹ IMF (2021).

Tax administration in the case study countries is generally poor, with high levels of corruption. This is fatally undermining trust in government and, as a result, is likely making people less willing to pay their taxes and formalise employment. This can spur a vicious cycle, whereby low trust in government discourages citizens from paying their taxes which results in less revenues to invest in high-quality public services, which in turn continues to undermine trust in government. As Rothstein (2018) points out, the willingness of citizens to pay taxes is conditioned on a number of leaps of faith: trust in the impartiality and fairness

of tax collection; trust that the taxes collected will be spent with transparency on public goods instead of disappearing to corruption; trust that a service or benefit will be delivered when one needs it; and, crucially, trust that when a service or benefit is delivered, it will be done in a way that respects their integrity and dignity. If citizens are discouraged from paying taxes, this leads to low government revenues and, therefore, low investment in public services, which further undermines trust, and so the vicious cycle (depicted in Figure 5-1) continues.

Figure 5-1:
The vicious circle of a low trust in government and low government revenues



Source: Kidd et al (2020).

By undermining trust in government, corruption is having significant negative impacts on countries' economies and revenue mobilisation. In Ukraine, for example, research from the World Bank by Fan (2015) shows that every government tax inspector is responsible for only 73 taxpayers, fuelling the

expectation by more than half of companies that they will have to pay bribes. Research from the IMF by Ari and Pula (2017) establishes a link between the extent of corruption and growth and claims that reducing corruption to the EU average would increase GDP per capita above 50 percent of the

EU level by 2040 (from the current 20 percent).⁶² Weak tax administration combined with low trust in government is also likely to exacerbate the problem of un-declared employment, whereby a formal employer pays a formal employee an official declared wage but also an additional undeclared ('envelope') wage in order to evade the full social insurance and tax liabilities owed.⁶³ The circumvention of the tax system in this way reduces tax revenues and damages economic growth even further.

A tax system that is perceived as unfair by the majority of the population living on insecure incomes is likely to further undermine trust in government and weaken an already fragile social contract. In a context like Ukraine with a weak and corrupt political system that is already experiencing conflict, this risks exacerbating political instability: pursuing tax policy that explicitly favours a wealthy minority in a context where most of the country is struggling is akin to pouring petrol onto the fire. Even the World Bank (2018) have recommended moving away from regressive taxation systems to repair trust in government since taxation systems in these case study countries are deemed increasingly unfair: "many people are expressing concern about the rising number of billionaires and the increasing influence exerted by elites on government decision making. Raising top income tax rates would be a key signal that governments care about the growing unfairness in the distribution of income".

In the context of these case study countries' history as centrally planned economies until the end of the Soviet-era in the early 1990s, the imposition of a flat-rate taxes and contribution rates that disproportionately puts the tax burden onto the majority of lower income households is especially harsh and damaging for national social contracts. As Criclivaia (2016) points out in the case of Moldova (but also relevant to the other case study

countries), there wasn't really such thing as proper taxation before transition to a market economy: "the state played a dual role in the system as a tax collector and taxpayer...The population was unaware of tax procedures or even of tax burdens". Only a few select state technocrats knew about the role of taxes within Moldova's public finances and the concept of taxation had not entered into public consciousness.

On the one hand, it could be argued that a flat-rate tax is simpler and easier to be understood in this context. More likely, however, is the reality that a flat-rate income tax that favours the wealthy over the majority of households on lower incomes risks further undermining trust in government. In Moldova, trust in government has always been lower than the European average.⁶⁴ This is, in large part, due to widespread low incomes, poor public services, a weak social protection system and high levels of corruption. It is quite rational that a flat-rate income tax rate is likely to be perceived as unfair. High levels of corruption and the misuse of public funds have already endemically undermined public trust in government. In 2014, for example, a bank fraud scandal in Moldova saw the misappropriation of over a billion dollars from public finances.⁶⁵ One of the country's richest people, Vladimir Plahotniuc, was eventually found guilty of the theft. In this context of significant wealth inequalities and a culture of high-level corruption, a radical move to a flat-rate 12 per cent tax rate for all taxpayers that effectively implies tax cuts for the rich is likely to fuel resentment at the wealthy and further undermine trust in government.

It is also important to consider how the reforms' effect on social security benefits may further undermine social contracts. If these reforms erode the scope, quality and adequacy of the benefits provided by the state but, at the same time, tax systems are becoming increasingly regressive and hitting those low- and middle-incomes the

⁶² Ari and Pula (2021).

⁶³ Williams and Horodnic (2017).

⁶⁴ Negura et al (2021).

⁶⁵ Reuters (2020).

hardest, one might ask: what are workers getting in exchange for their increasing taxation contributions and is this fair? A social contract is a delicate balance between citizens' rights and their responsibilities and, stretching the income of workers by increasing their taxation responsibilities relative to higher earners, without properly realising their right to social security and a decent standard of living, could have detrimental impacts on national social contracts and workers' trust in governments. As discussed previously, this is likely to provide strong disincentives for labour market formalisation, which will only entrench the vicious cycle of weak trust in government and low revenues.

Alternatively, social protection benefits and the expansion of high-quality lifecycle systems can be used to actively build trust in governments and encourage informal economy workers into the tax system. If governments provide a wide range of inclusive benefits that cover risks and

vulnerabilities that citizens may face across the lifecycle – such as child benefits, maternity benefits, unemployment benefits, disability benefits and pensions – this is likely to build trust in government.⁶⁶ The case study countries do already provide some benefits, but they vary widely in their scope and inclusivity: Georgia, for example, is leading the way with its universal disability benefits and social pension. Further, if governments were to make receipt of benefits conditional on making an annual income declaration – even though their income levels would not necessarily have any impact on their eligibility for the benefits – this could encourage the formalisation of the labour force by providing a powerful incentive to start paying taxes when (or if) they become eligible to.⁶⁷ Whether they link it to income declarations or not, by providing universal benefits, governments are choosing to nurture a culture of trust whereby citizens can make a more confident connection between their responsibilities to the state and their entitlements.

6 Conclusion

There is little evidence that flat-rate taxes, and the tax cuts for the wealthy that they imply, can stimulate the kind of economic growth that is used to justify them. There is also little evidence that structural reforms to contributory systems can necessarily boost their sustainability and the adequacy of benefits. Yet, countries in Eastern Europe and Central Asia have continued to implement these kinds of reforms over the past decade. The case studies of Moldova, Ukraine, Romania and Georgia support the existing literature on the subject, showing that the promised positive impacts on the formalisation of the labour market,

the expansion of the tax base and economic growth have seemingly not been delivered. In addition, it remains unclear if the pension reforms in Romania and Georgia have been able to deliver on their objectives to enhance the sustainability of the pension budget and the adequacy of benefits with initial analysis suggesting that the reforms may have actually had negative impacts on the overall pension system.

Beyond a seeming failure to stimulate economies and labour markets in the way advocates hoped, the reforms have also generated net social harms.

⁶⁶ Kidd et al (2020).

⁶⁷ Kidd et al (2020).

The reforms are regressive, requiring those on lower incomes to contribute a greater proportion of their income compared to those on higher incomes. Analysis simulating the impact of a hypothetical flat rate tax scenario compared to a progressive tax scenario shows clearly and intuitively that these different distributions of tax burdens have significant implications on poverty and inequality. The flat rate tax system produces substantially worse social outcomes, and more people are likely to be living in poverty or vulnerable to poverty. The flat rate tax is also expected to lead to greater inequality across all indicators when compared to a more progressive system, which is supported by a wider literature. Additionally, the erosion of contributory social security systems that the reforms in Romania and Georgia imply are likely to further undermine living standards. When tax and social security reforms effectively entail a decline in take-home income and the removal of much-needed support and, therefore, a decline in living standards among low and middle-income workers, this is likely to undermine trust in government and harm social contracts. This is particularly salient in contexts with weak tax administration and high levels of political and economic corruption. Low trust in government, when addressed, can lead to a vicious cycle of weak trust in government and low revenues, which is further exacerbated by weak incentives for labour formalisation.

Since the decision to introduce flat-rate taxes and pension privatisation is not backed by strong evidence that supports its impact on economic growth and is a policy that disproportionately favours the wealthy within a society, it is arguably largely a political and ideological decision. In terms of whether the impacts of reforms can be addressed, this may be more of a question of political will.

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Annex 1 Macro-economic indicators in each of the reform case study countries

Annex 1.1 Moldova

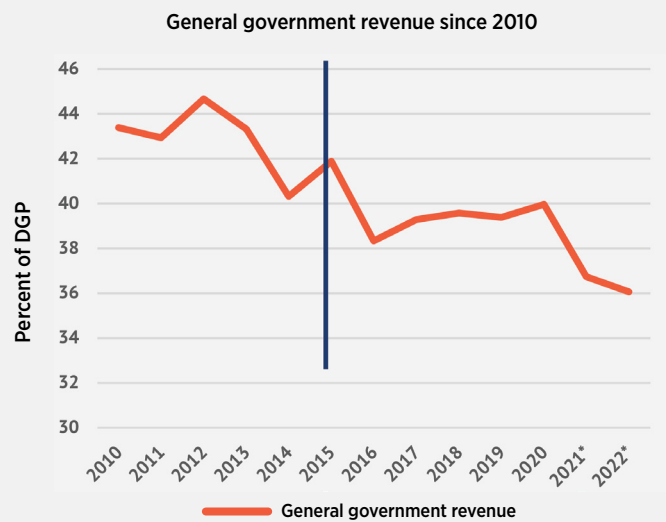
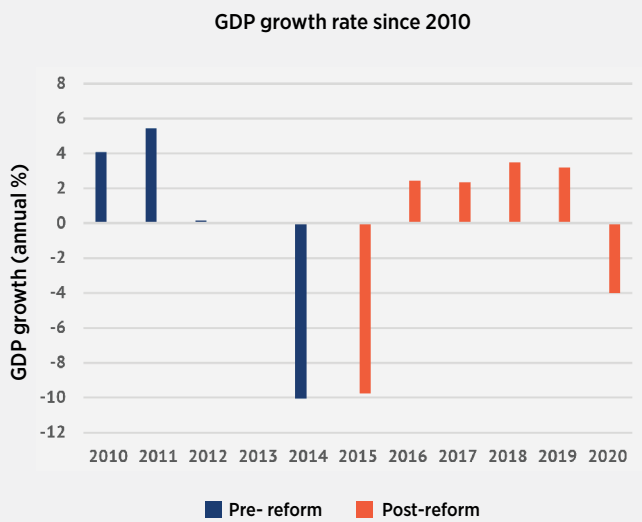
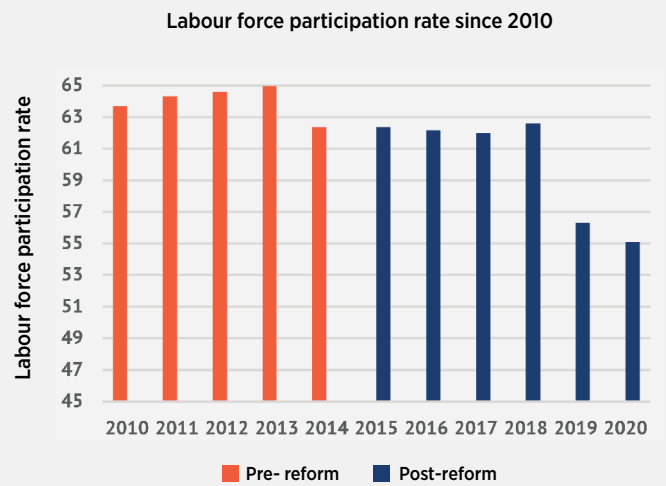
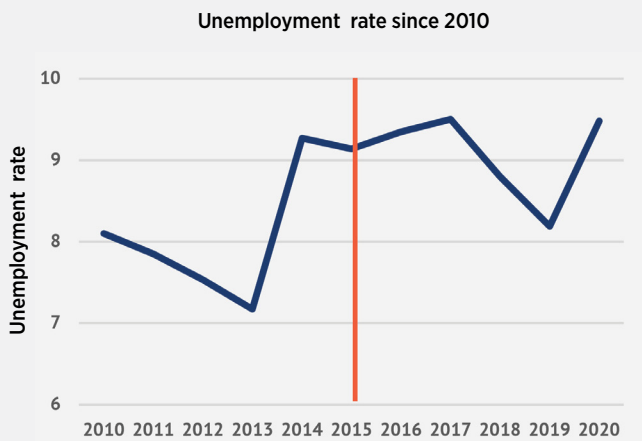
Figure A 1:

Moldova's Macro-economic Main Indicators



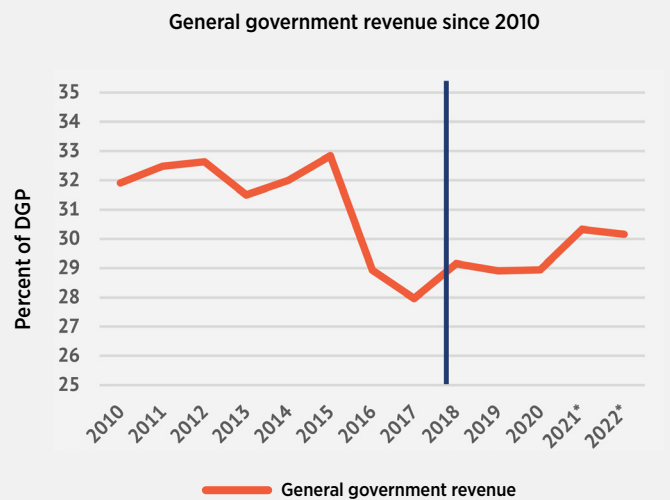
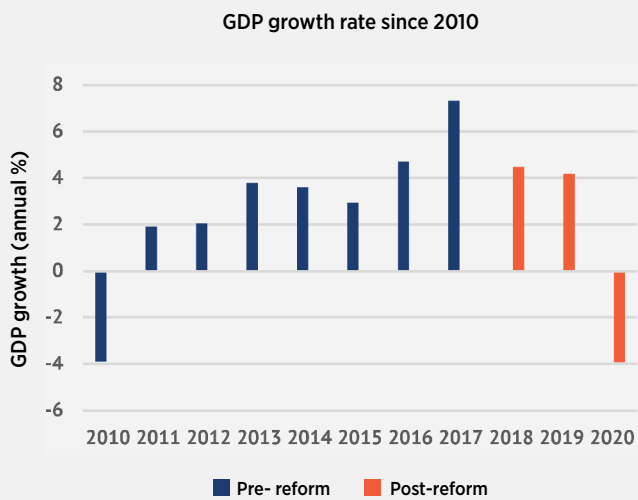
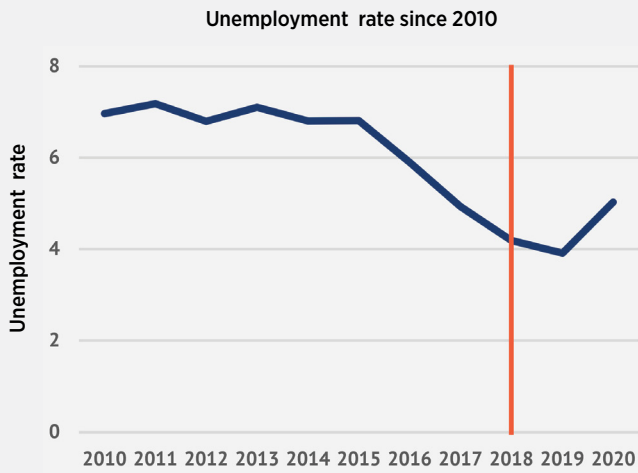
Source: (top) ILO-STATISTICS (2021); (bottom-left) World Bank Development Indicators Database (2021); (bottom-right) International Monetary Fund, World Economic Outlook Database (2021). Note: * demarks projected estimates

Figure A 2:
Macro-economic indicators in Ukraine during the reform period



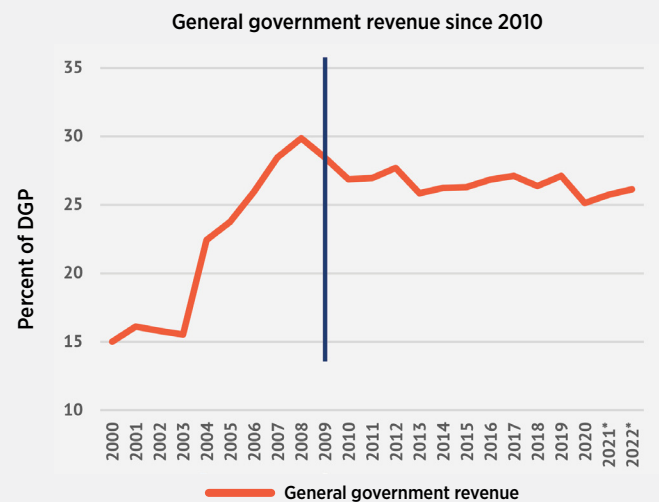
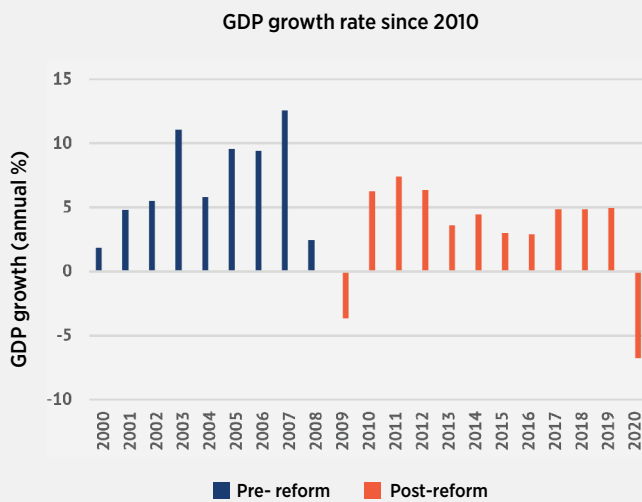
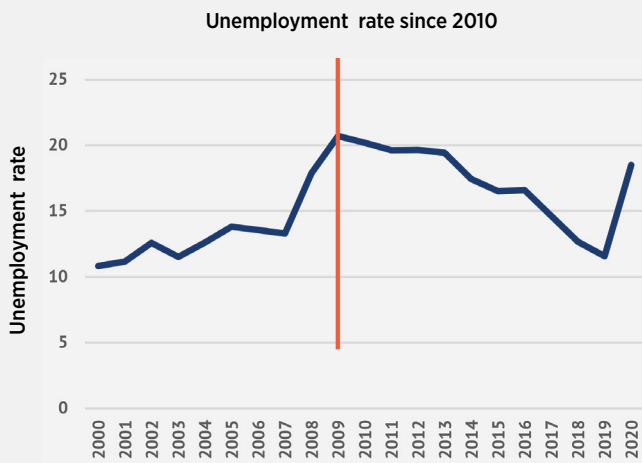
Source: (top) ILO-STATISTICS (2021); (bottom-left) World Bank Development Indicators Database (2021); (bottom right) International Monetary Fund, World Economic Outlook Database (2021).
Note: * sign demarks projected estimates

Figure A 3:
Macro-economic indicators in Romania during the reform period



Source: (top) ILO-STATISTICS (2021); (bottom-left) World Bank Development Indicators Database (2021); (bottom right) International Monetary Fund, World Economic Outlook Database (2021). Note: * demarks projected estimates

Figure A 4:
Macro-economic indicators in Georgia during the reform period



Source: (top) ILO-STATISTICS (2021); (bottom-left) World Bank Development Indicators Database (2021); (bottom right) International Monetary Fund, World Economic Outlook Database (2021). Note: * demarks projected estimates

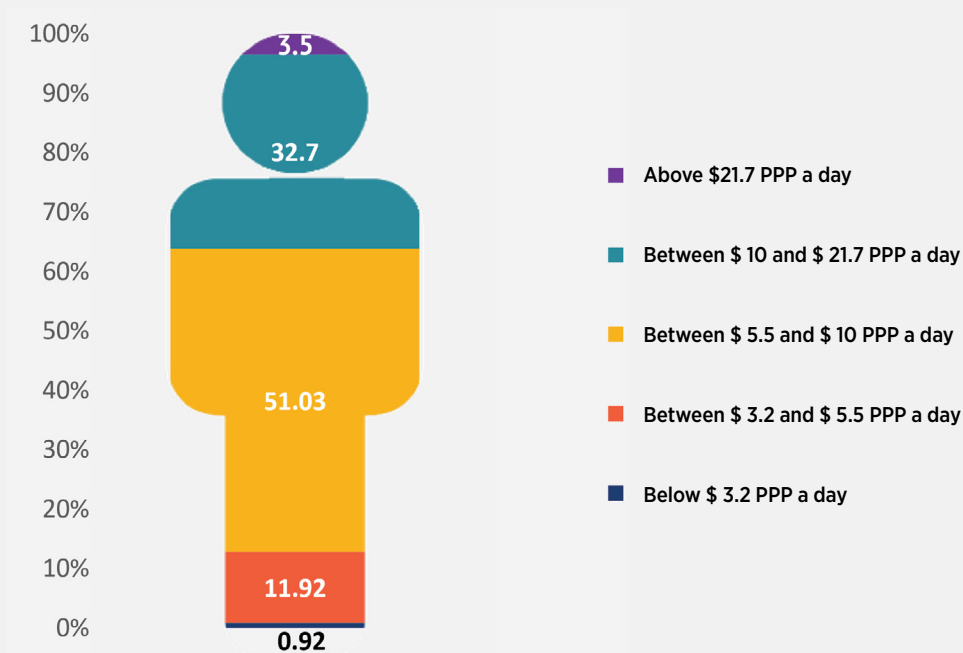
Annex 2

Distribution of per capita income or consumption across the population in the case study countries

Annex 2.1 Moldova

Figure A 5:

Share of Moldavian population living in households with consumption or income per person below different poverty lines, 2018.

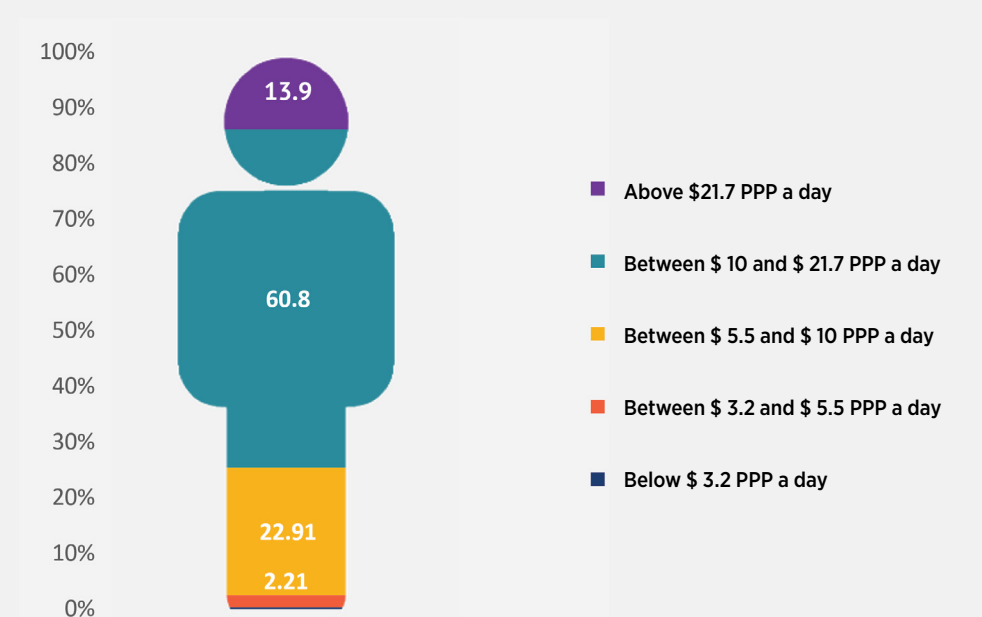


Source: Own calculations based on PovcalNet, Development Research Group of the World Bank (2022).

Annex 2.2 Ukraine

Figure A 6:

Share of Ukrainian population living in households with consumption or income per person below different poverty lines, 2019.

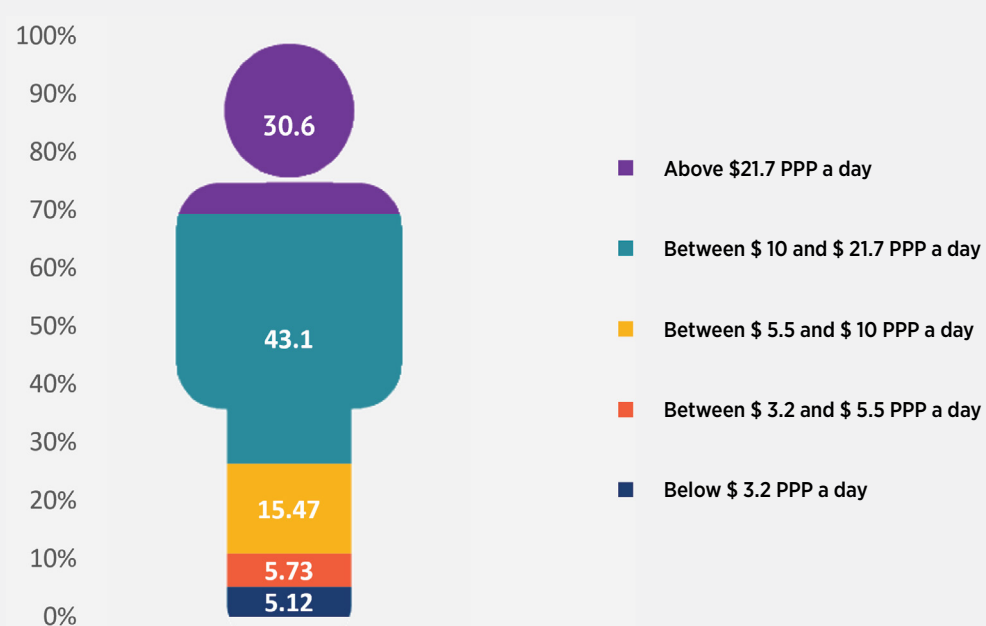


Source: Own calculations based on PovcalNet, Development Research Group of the World Bank (2022).

Annex 2.3 Romania

Figure A 7:

Share of Romanian population living in households with consumption or income per person below different poverty lines, 2018.

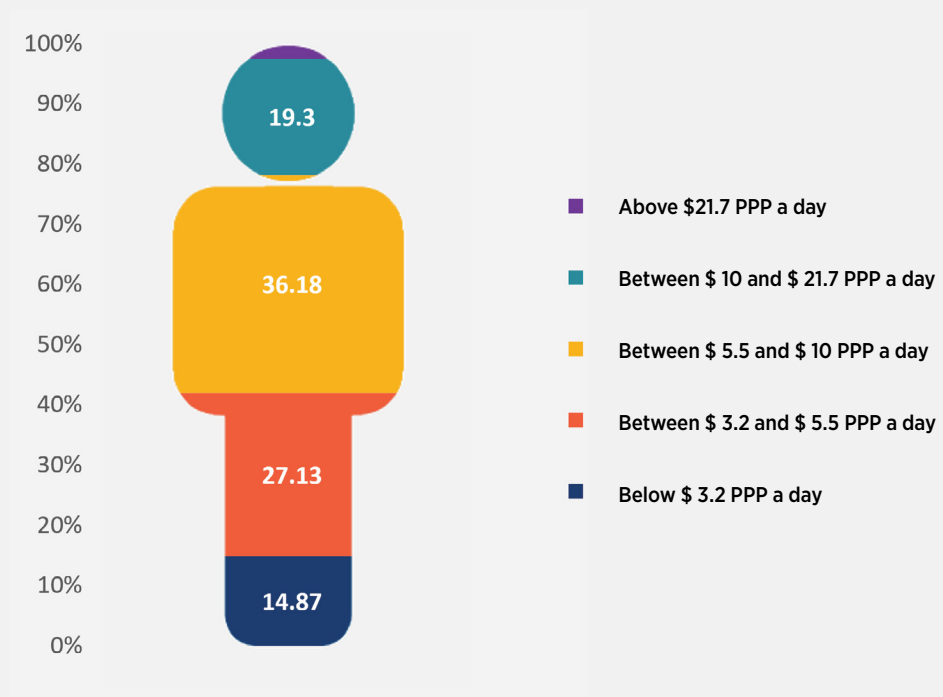


Source: PovcalNet, Development Research Group of the World Bank (2022).

Annex 2.4 Georgia

Figure A 8:

Share of Georgian population living in households with consumption or income per person below different poverty lines, 2019.



Source: Own calculations based on PovcalNet, Development Research Group of the World Bank (2022)

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