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Moldova: Taking Compliance Management Further

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Fiscal Affairs Department

MOLDOVA

TAKING COMPLIANCE MANAGEMENT FURTHER

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April 2012

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ACRONYMS

CCECC	Center for Combating Economic Crimes and Corruption
CIT	Corporate Income Tax
COTS	Commercial Off-The-Shelf Computerization Solution
FAD	Fiscal Affairs Department
HWI	High-Wealth Individuals
IAM	Indirect Audit Methods
IT	Information Technology
LTO	Large Taxpayer Office
MDL	Moldovan Lei
MoF	Ministry of Finance
MOL	Ministry of Labor
OECD	Organization for Economic Co-operation and Development
PIT	Personal Income Tax
PO	Prosecutor's Office
STI	State Tax Inspectorate
TA	Technical Assistance
VAT	Value Added Tax

PREFACE

This report concerns the delivery of a tax administration mission to Moldova during February 8 – 21, 2012 by the Fiscal Affairs Department (FAD) of the IMF as a component of implementing FAD's technical assistance strategy for Southeast Europe.

The mission was led by Mr. Allan Jensen (Chief) and comprised Mr. Norman Gillanders (FAD Regional Tax Administration Advisor); Mr. Enriko Aav (FAD); Mr. Frank Bosch and Mr. John Buchanan (both external experts). Invaluable input to the mission and the report was provided by Mr. Erik Hutton (FAD) on revenue performance analysis and Mr. Paul Martens (external expert) on large taxpayer management. Both happened to be on FAD assignments in Chisinau at the time of the mission.

The mission met with Mr. Veaceslav Negruta, Minister of Finance; Mr. Victor Barbaneagra, Deputy Minister of Finance; Mr. Nicolae Platon, Chief of the Main State Tax Inspectorate (STI); Mr. Gheorghe Cojocari, Mr. Adrian Timotin, Mr. Iuri Lichii, all Deputy Chiefs of the STI; Mr. Procopie Duca, Chief of the STI's Strategic Management and Innovation Directorate; Mr. Igor Ţurcanu, Chief of the STI's Large Taxpayer Office; Ms. Maia Tverdohleb, Chief of the STI's Innovation and Administration Methods Section, as well as many other managers and staff of the STI.

The mission also met with Mr. Vladimir Grosu, Deputy Minister, Ministry of Justice; Mr. Peter Menhard, Advisor to the Head of the State Tax Inspectorate in Moldova, from the EU's High-Level Policy Advisory Team to the Government in Moldova; and Mr. Vitalie Coceban, Director General, FiscServInform, a state enterprise that provides IT services to the STI.

To facilitate technical assistance coordination and encourage additional donor input to tax administration reform, the mission also met with Mr. Abdoulaye Seck, Country Manager, and Ms. Lillian Razzlog, Public Sector and Institutional Reform Specialist, both from the World Bank; Mr. Wolfgang Behrendt, Head of Political and Economic Section, and Mr. Oleg Hirbu, Project Manager, both from the Delegation of the European Union to Moldova.

The mission expresses its gratitude for the first-rate cooperation it received from all with whom it met at the Ministry of Finance and the STI. The mission is also very thankful for the support provided by Mr. Tokhir Mirzoev, IMF Resident Representative, and his staff before and during the mission. Finally, the mission appreciated the invaluable help provided by Ms. Lidia Dogaru, Mr. Serge Bufteac, Ms. Iulia Timotin, and Ms. Christina Umanet, the mission interpreters.

EXECUTIVE SUMMARY

Main conclusions

Supported by the Finance Minister, the STI continues to strengthen tax administration in line with IMF advice. Most importantly, to reduce tax evasion—and building on the Strategic Plan for 2011–15—the agency has come far with implementing a Compliance Risk Model (CRM), which is aligned with good international practices. A pilot testing of the model in 2011 showed encouraging results in terms of extra revenue. This has motivated the STI to roll out the model in full from January 1, 2012. However, effective implementation and long lasting compliance impact require considerable further improvements with regard to taxpayer services, audit, tax fraud investigations, information technology systems (IT), and the value-added tax (VAT) refund system. Of major concern is the current lack of prosecutions to deter tax fraud. In the medium term, this could seriously undermine the CRM efforts and the potentially large revenue gains from implementing the model. Continued technical assistance (TA) from the IMF and other TA providers during the next three–four years is essential to improve the areas mentioned.

Current situation and issues

The STI have come far in implementing a modern CRM. The pilot testing in 2011 of the CRM (which is based on the Organization for Economic Cooperation and Development(OECD)/EU compliance concept) was successful in increasing taxpayer compliance within the segments targeted by the pilot (e.g., about 20 percent revenue increase). The compliance plan for 2012 involves a full roll out of its use. The model uses a mixture of compliance approaches applied cohesively to an identified tax risk affecting a set of taxpayers. For example, in 2011, the STI contacted the riskier taxpayers in selected economic sectors with the aim to persuade them to improve their tax compliance voluntarily. Meetings were held with taxpayers and only later did the STI start to audit noncomplying businesses. As predicted, the vast bulk of tax recovered did not come from audit but from prompted voluntary compliance. The success of the 2011 pilot test suggests that the model has the potential to change taxpayer behavior, if implemented well. The compliance plan for 2012 further includes the compliance measures communicated in the Government’s letter of intent concerning the Fund program, including to increase compliance within the segment of high-wealth individuals (HWIs); pursue the use of indirect audit methods; and improve the collection of payroll taxes.

Successful implementation and long-lasting impact of the CRM require that a number of tax administration components be further strengthened. Addressing the remaining shortcomings in a range of key tax administration areas puts a significant focus on training and also requires considerable TA in excess of what can be provided by the Fund; in particular this is the case with the much needed IT reform. The main areas for attention are:

- ***Taxpayer services must be strengthened and used to promote compliance.*** The STI has put in place the standard approaches necessary to handle taxpayers' queries. It has also begun to use publicity and marketing techniques to make taxpayers more conscious of their compliance obligations and of the dangers of being detected if they evade tax. However, much more can be done and a dedicated taxpayer services unit must be established at the STI headquarters to take on this agenda.

- ***A simple but effective first step is for the STI to work more closely with tax professionals and business groups to promote compliance.*** This would foster a better understanding of mutual problems and attempt to find ways of simplifying tax administration. The report proposes establishing a compliance cooperation council to allow constructive collaboration on critical compliance and administrative issues.

- ***Improved compliance will also require enhanced audit skills.*** Auditors must learn how to identify unreported income (including hidden wages), how to recognize evidence of serious tax evasion and aggressive tax avoidance, and how to combat these abuses. Filling these knowledge gaps will require a higher level of technical training over a sustained period.

- ***The authorities must learn how to bring a small but well-selected group of tax evaders before the courts each year.*** This will require a radical re-evaluation of the anti-fraud arrangements involving the STI and other agencies. A significant amount of time is spent on processing dossiers across a number of organizational boundaries; but without any single court conviction within the last three years. Clearer procedures and role definitions must be brought to this area, as the system now used is broken.

- ***Organizational structures can be improved.*** The mission supports the STI management's intention to start planning a rationalized regional structure. This would improve the handling of the STI's risk portfolio by placing staff where they are most needed. Initiatives around HWIs and indirect audit methods will take effect in 2013 and require dedicated staff working in new units.

- ***The Large Taxpayer Office (LTO) must continue its evolution***. It should begin by grouping its taxpayers into administrative units based on economic sector and increase the focus on the "top 40" businesses. The LTO must quickly acquire skills in core aspects of big business taxation. Unless this happens, the LTO will struggle to reach the benchmark level of accounting for 50 percent of the STI's total collections.

- ***The reform agenda relies on better IT.*** Core tax processes are in need for better IT. The CRM model must be driven by good intelligence drawn from IT systems based on high quality, well-integrated data. The mission endorses the STI's plans to install new software quickly and cheaply, using off-the-shelf software with minimal customization.

- ***Handling of VAT needs improvement.*** VAT control will benefit from improved audit training and better risk analysis. The large-scale VAT refund audit program shows little wrongdoing by taxpayers. Other countries (including some of Moldova's neighbors) achieve similar levels of VAT security using risk-based methods at far lower costs in terms of staff time. Finally, moves in this direction should accompany a move towards a full-refund VAT system. The existing system has accumulated huge liabilities for the Government to the detriment of businesses.

I. ENHANCING THE STRATEGIC APPROACH TO COMPLIANCE MANAGEMENT

A. Introduction

1. **Tax revenue in 2011 fell short of expectations.** As is the case with many economies, tax revenue in Moldova was impacted by the financial crisis with the revenue downfall commencing in 2008. Table 1 shows tax revenue collection during 2007–11. In 2011, tax revenue—notably VAT and payroll taxes—fell short of what was expected from the now booming economy. Combined, revenue shortfalls across the various tax types are estimated at 0.7 percent of GDP (social and health fund contributions -0.4 percent; personal income tax (PIT) -0.1 percent; foreign trade tax -0.1 percent; and VAT -0.1 percent). It has been generally assumed that the shortfall is due to legislative loopholes and weak tax collection.

Table 1. Moldova: Tax Revenue by Nominal Value and Percent of GDP, 2007–11

	2007		2008		2009		2010		2011	
	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP
Tax revenue	**18.4**	**34.4**	**21.3**	**33.8**	**19.6**	**32.4**	**22.5**	**31.4**	**25.6**	**30.9**
1.1.1. Taxes on Income, Profits, and Capital Gains	2.7	5.1	2.2	3.5	1.9	3.2	2.0	2.8	2.3	2.8
Profit tax	1.4	2.6	0.7	1.1	0.4	0.7	0.5	0.7	0.6	0.7
Personal income tax	1.3	2.5	1.5	2.4	1.5	2.4	1.5	2.1	1.8	2.1
1.1.2. Taxes on Payroll and Workforce	5.2	9.7	6.6	10.5	7.0	11.5	7.5	10.4	8.2	9.9
Social Fund contributions	4.4	8.2	5.4	8.6	5.6	9.2	6.0	8.3	6.6	7.9
Health Fund contributions	0.8	1.6	1.2	1.8	1.4	2.3	1.5	2.1	1.6	2.0
1.1.3 Taxes on Property	0.2	0.4	0.3	0.4	0.3	0.4	0.3	0.4	0.3	0.3
1.1.4. Taxes on Goods and Services	9.0	16.8	10.7	17.0	9.1	15.1	11.2	15.6	13.1	15.8
VAT	7.6	14.2	9.1	14.5	7.6	12.6	9.1	12.7	10.5	12.6
Excises	1.4	2.6	1.6	2.5	1.5	2.5	2.1	2.9	2.7	3.2
1.1.5. Taxes on International Trade and Transactions	0.9	1.7	1.2	1.8	0.9	1.5	1.1	1.5	1.2	1.4
1.1.6. Other Taxes	0.4	0.7	0.4	0.7	0.4	0.7	0.5	0.6	0.4	0.5
GDP 1/	53.4		62.9		60.4		71.8		82.9	

Source: Moldova Ministry of Finance.

1/ Value for 2011 is a preliminary estimate.

2. **It appears that the decline in the VAT relative to the economy may not be due to weakened tax administration**. While the shortfall in payroll taxes is difficult to explain, the VAT shortfall is likely related to tax policy changes and booming exports and not a decline in taxpayer compliance. Preliminary analysis undertaken by this mission suggests that a very significant factor in the declining performance of the VAT is due to an increased proportion of reduced rate and zero-rate supplies (sales). While VAT revenue to GDP declined, the supplies declared by taxpayers on VAT returns increased relative to GDP—which may suggest an increase in tax compliance. The analyses show that the decrease in VAT to GDP

is due to a decline in the proportion of supplies that were taxed at the 20 percent standard rate against supplies that were taxed at the lower 8 percent rate (e.g., agricultural products) and the zero rate (e.g., export goods). Of course, it cannot be excluded that a portion of the shift by taxpayer to the 8 percent rate is related to evasion. To mitigate any risks in this direction, the tax agency's compliance plan includes activities to verify and tackle such problems. The mission's preliminary analyses are attached at Appendix 1.

3. **It is expected that the State Tax Inspectorate intensifies its compliance efforts.** Reflecting on the revenue shortfalls against budget expectations, the Government has requested the STI to step up further its efforts to strengthen tax collection to help safeguard budget deficit targets. The focus of this mission has been to assist the STI in its efforts to determine the most appropriate strategy and means to strengthen its capacity to increase revenue in the short to medium term.

B. Developing Strategies to Reduce the Tax Gap

4. **The STI began implementing a modern compliance management strategy during 2011.** In 2010, the STI management, with advice from FAD, developed a strategic plan for 2011–15. A December 2010 mission recommended further improvement in compliance management so that by end March 2011 there would also be in place a detailed plan governing the STI's compliance efforts for the remainder of the year. By April, the STI managers with some IMF expert input had developed a compliance plan for 2011.

5. **A clear attempt was made by the STI to apply CRM techniques.** In particular, the plan and its analytical underpinnings:

- ✓ analyzed the composition of tax revenues by taxpayer category (based on turnover ranges) and economic sector;
- ✓ subjected the tax revenue analysis to a tax gap calculation designed to identify the economic sectors contributing most to the gap—these proved to be public catering, IT services and the wholesale trade; and
- ✓ selected from within the three sectors the taxpayers who appeared to present the greatest risks of tax evasion.

Execution of the plan began in April 2011 against a backdrop where the STI already had in place a revised headquarters structure with a small risk analysis unit, a large taxpayer office, and a functional structure that largely follows previous FAD advice.

C. Assessing the Results

6. **By the end of 2011 the compliance plan had produced worthwhile results using new approaches**. In the course of implementation, a range of methods was used, including the issue of letters to taxpayers informing them of the STI focus on their sector. This was the first time the STI used “compliance marketing” techniques to attempt to influence taxpayers’ behavior. Information meetings with taxpayers were held urging them to review their own tax liabilities and to make any necessary corrections. By the end of the year, the STI had engaged with over 1,500 taxpayers in the three sectors. In about 500 cases, the STI accepted explanations from businesses setting out why they appeared to be risky but asserting that they were compliant. These businesses were spared the intrusion and cost of a tax audit. Over 1,000 taxpayers were subjected to audit, some 600 of whom produced, on average, quite modest tax recoveries.

7. **However, the general rise in tax payments from the taxpayers covered by the project was much greater than the amount recovered on audit**. In all, Moldovan Lei (MDL) 108.8 million was collected, of which only MDL 11.5 million arose from audit. There was an increase in tax payments of 24 percent from the taxpayer population covered by the sectoral compliance program against a 7.7 percent increase in total tax revenues collected by the STI. The main results from the 2011 sectoral program are summarized in Table 2.

Table 2. Moldova: Results of the 2011 Sectoral Compliance Program

Activity	Public Catering	Wholesale	IT Services	Total
Cases reviewed	842	500	214	1,556
O*f which*:				
Audited	653	302	97	1,052
Paid audit settlement	378	175	52	605
Cases paying extra tax including cases not audited	561	398	126	1,085
Total amount recovered from audit (in MDL millions) [1]	2.8	8.3	0.4	11.5
Total increase in revenues from the program (in MDL millions)	16.3	87.3	5.2	108.8

Source: State Tax Inspectorate.

[1] MDL 19.5 million was assessed by auditors of which MDL 11.5 million was paid by December 31 and is included in the total increase in tax payments by the three sectors of MDL 108.8 million.

D. Preliminary Lessons

8. **Taking a strategic approach to CRM can improve the STI’s effectiveness.** The 2011sectoral compliance campaign can be seen as a large scale pilot project that produced a substantial percentage increase in payments from the taxpayers affected. It is significant that audit recoveries represent roughly only 10 percent of the total tax increase

from the taxpayers contacted during the project and that the overall increase in tax payments was far greater than the underlying national trend in tax revenues.

9. **Using national planning, publicity and taxpayer education seems to have changed taxpayer behavior in those sectors covered by the STI's action, at least temporarily.** A key presumption behind the CRM methodology is that audit, as part of a broader compliance approach (which includes the use of marketing techniques), provides leverage to ratchet up compliance across a wider group. The overall results from the compliance campaign are much better than when audit takes place on the basis of local decisions and unsupported by other measures. The STI pilot outcome for 2011 supports the CRM's logic.

10. **The challenge for the STI is to build credibility and competence so that taxpayers are convinced to make a *permanent* adjustment to their compliance behavior.** Improved risk analysis techniques have been developed and the STI's case selection process for inclusion in the 2012 compliance plan will be improved by their use. In 2011, the measured compliance uplift was limited to the taxpayers contacted directly by the tax agency, whether audited or not. Statistics could not be compiled on the impact of the compliance campaign on cases in the target sectors that were *not* directly affected by the STI campaign. In 2012, the challenge will be to find ways of increasing the leverage of the sectoral projects within the compliance plan to change the behavior of a wider circle of businesses and to measure the impact of the compliance campaign across the entire sectors affected.

11. **The STI's plan for 2012 is to influence the compliance behavior of 93,000 taxpayers by persuading them that compliance is the best option.** Using a well planned campaign, the STI plans to cover the following sectors: (1) wholesale and retail; (2) manufacturing; and (3) transport and communications. Estimates suggest that these sectors cover 56 percent of the tax gap, numbering some 93,000 businesses (the 1,500 businesses contacted in 2011 are a subset of this group).Taxpayers will be contacted and asked to voluntarily review their tax position with a view to self-correction. Avoiding the expense of audit and its intrusiveness in terms of running a business offers a voluntary compliance incentive.

12. **A systematic approach will demonstrate the serious intent of the STI.** Building on the experience already gained would suggest that the STI should:

- First make contact with the first tranche of taxpayers by letter. Craft the letter with great care to maximize its impact. It should not be a 'typical' tax agency letter.

- Accompany the issue of the letter with a media campaign to alert the wider membership of the industry groupings to the tax agency's activities in their sector.

- Monitor the compliance behavior, electronically within the STI, of the next 2,000 cases, defined by risk, to see if it changes and how. Identify any cases that begin to significantly change their tax paying behavior.

- Publicize the results of the first six months of the campaign and then contact the next 2,000 taxpayers inviting voluntary disclosures of any tax irregularities with the offer of a less penal settlement to those who come forward.

- Track the compliance trends across *all businesses* in the sectors treated and analyze in full the data collected in the course of the year to help design the following year's campaign.

13. **The STI should also leverage further the work done in 2011.** It would appear sensible to keep all or some of the 1,500 taxpayers reviewed in 2011 under a simple "control regime" and to try to nudge them towards continuing improved compliance. An obvious way of doing this would be to:

- Divide these cases at random into a treatment group and a control group.

- Write to the treatment group, reminding each taxpayer that he was examined under the 2011 program and stating that the STI will continue to observe his tax compliance patterns electronically.

- Do not write to the control group but monitor its members anyway.

- In the final quarter of 2012, assess the compliance outcomes of each group. Compare the outcomes using analytical statistics to determine if there was a statistically significant difference in the behavior of the treatment group.

- If so, issue the 'under observation' letter to the control group. Record and analyze the outcome after a period of months.

14. **The new compliance approach will continue into future years and will evolve.** This mission provided comprehensive input to fine tuning the 2012 compliance plan, which is attached to this report as an addendum. The plan is solidly based on a CRM model that is also recommended by the OECD and the EU with risk analysis guiding compliance work mainly on a taxpayer segment basis against a backdrop of planned improvements in service and taxpayer education.

15. **The CRM model is not restricted to categorization of taxpayers by economic sector.** Instead, a project could be devised to tackle the issue of payment of untaxed wages paid in cash. The methodology is the same: publicize the issue, contact a target group of taxpayers prompting them to self-correct their recent tax returns, and then begin an audit process. In the context of payroll tax fraud, training in new techniques of detection would

also be part of the plan. Similarly, the STI could gain a better understanding of the large number of VAT taxpayers registered voluntarily at turnover levels below the tax threshold by conducting a targeted compliance project. Box 1 provides a broad outline of the key compliance measures of the plan.

Box 1. Moldova: Key Measures of the State Tax Inspectorate 2012 Compliance Plan

- ✓ Sectoral compliance campaign selectively covering 93,000 taxpayers in the wholesale and retail, manufacturing, transport and communications.
- ✓ Partially compliant taxpayers—educate and assist them to become fully compliant through seminars, publications and the STI web site.
- ✓ Publish a broad set of risk indicators so that business taxpayers can assess and correct their behavior voluntarily.
- ✓ Identify persistently noncompliant taxpayers and develop a graduated scale of response ranging from assistance to audit and finally to "permanent" control.
- ✓ Focus on tax evasion, international issues, corporate restructuring, and major transactions with regard to large businesses.
- ✓ Improve assistance to large business.
- ✓ Extend the scope of the large taxpayer office to cover at least 50 percent of tax revenue.
- ✓ Establish a unit focusing on the compliance of high-wealth-individuals.
- ✓ Build the High-Wealth-Individual program for operation in 2013 to include the use of indirect methods of assessment of income.
- ✓ Deliver training, better information, and promotion of voluntary compliance for small- and medium-sized enterprises.

E. Other Considerations

16. **Work of this nature requires professional support.** The STI is fortunate to have the services of a United Nations Development Program/EU-funded expert analyst who works with the support of a professional economist. Such analytical skills are essential if this compliance risk management model is to be pursued. The STI must begin to build similar in-house capacity to undertake sophisticated analysis.

17. **Existing law does not fully support the CRM model.** More intensive monitoring and control of "badly behaved" or high risk taxpayers means that they will require more frequent audits. Others will require less attention by virtue of their fiscal insignificance or

their good compliance habits. It is understood that the law at present forbids full audit of a taxpayer more frequently than every second year. (It is unclear whether single issue audits are restricted in this way). Clarification of the position is needed - demonstrable evidence of the risk of significant revenue loss is normally the determining audit trigger. Law changes must be made to support a modern compliance management approach.

18. **It is possible to work with business groups using formal structures to improve tax compliance.** Other actors in the Moldovan business world have a valid interest in tax compliance. Over time, it will become possible to work with them in ways that support CRM. Many EU and OECD countries now use so-called horizontal monitoring or 'cooperative compliance' arrangements to reach understandings about the parameters of tax compliance for industry sectors or individual large companies. These are, in effect, self-managed compliance arrangements. They are lightly policed by the tax authority but the penalties for tax evasion, where it occurs, apply in full. These arrangements rely to a large extent on the active participation of competent third parties such as fully-qualified tax advisors.

19. **It is too soon to move towards this formalized model in Moldova because the necessary framework of trust is not yet in place.** However, the foundations could be put in place soon by creating a tax compliance council composed of representatives of the STI at senior level, industrial groups, chambers of commerce and tax professionals. Such a group would have:

- Clear terms of reference aimed at reaching a shared understanding of how tax compliance is managed in a modern society.
- The right to discuss in advance changes to tax procedures and administrative practices, tax forms, tax filing arrangements and so on.
- A limited annual menu of topics where improvements can be made to tax administration aimed at simplification of compliance.
- A manageable number of meetings per year tied to the fiscal cycle.
- A small secretariat within the STI to produce agreed agendas, minutes and action points.
- A limited number of sub-groups that contain topic experts. The sub-groups could be activated when a theme emerges that needs expert input.

20. **There is a willingness to participate in the work of a tax compliance cooperation council.** The mission met a group of business people and tax advisors in Chisinau and it is clear that they see the values of such arrangements. The long-term goal should be to observe and measure improvements in tax compliance and in the business climate. The tax gap should narrow as compliance costs fall.

21. **The time is right for the creation of such a body.** Moldova has long had a LTO and is developing a unit for the better management of the tax affairs of HWIs. A compliance cooperation council would be the ideal forum for exploring the complex tax issues that will surface as Moldova continues to develop. Important issues regarding LTO operations and HWI taxation could be explored and resolved within the compliance cooperation council avoiding poor administrative design and subsequent disputes and litigation.

22. **A compliance cooperation council would support the CRM.** By starting to foster a cooperative relationship with taxpayers and their advisors, the STI can demonstrate its understanding that there are compliance-building techniques that go beyond traditional audit. There is no need for this to have specific legal backing but it will need simple agreed procedures. Of course, the creation of such a body would, perhaps, create a channel for demands for high quality taxpayer services such as advance binding rulings for complex tax transactions and nonbinding rulings on more routine issues. But these demands are already being articulated and will become more urgent as the economy develops. The STI has, to some extent, prepared the ground for creating this council by co-hosting, with the IMF, a well-attended business round table at the end of 2011. Many of the issues raised by the business people and tax practitioners could be handled by a compliance cooperation council.

23. **It will be important for the compliance reforms now underway to permeate the LTO.** Its taxpayer base is markedly different from the plurality of taxpayers managed by the rest of the STI's operational areas, but the challenges it faces are the same. Work needs to start immediately on how to fully integrate the modern compliance risk management approach into the LTO. It must learn to identify distinct categories of tax risk. It must start treating each risk category with a tailored mix of treatments. To expend resources on programs that don't focus on particular identified compliance risks achieves less-than-best outcomes. Although, the changes needed in the LTO reflect the same problems evident in the wider STI, the solutions are more specialized. This stems from the nature of the entities managed by the LTO. More intensive scrutiny of the 40 biggest LTO cases is a challenge now emerging. Similarly, there are economies of scale in knowledge-sharing, should the LTO implement an organizational structure based on the sectoral distribution of its taxpayers.

24. **For the LTO to secure and maintain fifty percent of STI collections, it will have to update its skills.** This reasonable target has been accepted by the Government. Skills upgrading in the LTO is a matter of strategic importance for the STI and requiring prompt attention. Areas of concern would include audit skills, the use of electronic tools for audit, the tax management of de facto groups of commonly-owned companies, international taxation issues including transfer pricing, and taxpayer profiling skills. It must improve its audit skills in the key areas of VAT and payroll tax. Separately from the mission, an FAD expert on LTO issues has visited Moldova and completed the first part of his assignment. An interim expert report has been given to the LTO head and this will be finalized in April 2012 when the expert returns to the STI.

25. **A long-term vision for the large taxpayer operation is needed.** Such a vision should encompass the LTO's aims, methods, skills and scope. Formulating this vision is a job for the Deputy Head of the STI with LTO responsibilities. It would be useful if, in formulating this vision, the LTO could start a wide-ranging consultation process, perhaps beginning with the compliance cooperation council mentioned above.

26. **A wider concept of taxpayer service would also help to improve the compliance environment.** While it is important to have a competent response to taxpayer needs and queries, service should also be pro-active. Under the compliance risk model, service supports compliance and can be used to market it. For example, with the re-introduction of corporate income tax there is a need to remind companies of payment basis periods, the due dates for quarterly installments and so on. The wrong alternative is to wait and face the more difficult task of recovering these payments from defaulting taxpayers after the event. Default involves case-by-case contact and, in some instances, costly visits to taxpayers. Prevention through pro-active service is easier and can use mass *marketing techniques* such as mail shots, poster campaigns or television or radio advertising, The STI has already used some of these techniques. While it may be assumed that the taxpayers concerned will know about the reintroduction of corporate income tax (they have been obliged to keep records and submit nil returns while the tax was in abeyance), many may choose not to comply. In that circumstance, it is important to convey the impression that the STI is vigilant and ready to act.

27. **As a rule, marketing of compliance should include publicizing the results of sectoral campaigns**. This ought to extend to publishing the main features of the compliance plan. These activities leverage the value of audit which is just a quest for impact and not an end in itself. It is acknowledged that the 2011 compliance plan incorporated some of these insights. Treatments of taxpayer groups were not confined to audit and publicity was used successfully. The 2012 plan must build on these achievements, integrating compliance marketing and pro-active service into a continuum of graduated responses to the wide range of compliance problems. It would facilitate these developments if a taxpayer services unit with a wide brief were created in the STI headquarters. This could be achieved by redeployment of existing staff.

28. **Other proposals for improving compliance were made by STI managers during the mission.** Some suggestions were made in a series of workshop-type discussions and others in a short note given to the mission. However, the mission advised that some of the measures were not adequately linked to the core compliance strategy being pursued by the STI. As such, they could prove to be a distraction from what is emerging as a successful approach. In other cases, the results to be obtained from implementing the proposals were not fully obvious. Nevertheless, some of the issues discussed were clearly significant for the STI's future development. More detail is given in the following paragraphs.

29. **The STI is planning a major restructuring including its field offices and headquarters.** This change is an opportunity to adapt the structure to better serve the tax agency's mission and methods. If carried out carefully, restructuring can better align the STI's staff to pursue the revenues legally due, manage the compliance risks and serve the population. This issue is discussed in more detail in Section IV.

30. **The STI continues to plan improvements to its IT systems.** FAD advice has supported this objective in the past and the World Bank is now considering offering financial support for IT reform. The mission met STI personnel and local World Bank representatives to discuss the design methodology for the new system, reaching a consensus that the solution should focus on the acquisition of industry standard off-the-shelf software to which STI processes could be retro-fitted. Better IT is essential for improved compliance management. The issue is discussed in more detail in Section IV.

31. **Procedures are too inflexible**. Related to the IT issue is the extent to which administrative procedures can be adjusted as circumstances change. In the STI, administrative procedures are set out in tax procedures codes that have statutory force. Because of their statutory basis, changing internal procedures is difficult and time-consuming. A more effective STI will need to operate under a less rigid set of processes that are administratively determined. Safeguards against abuse of power can be provided through a simple informal dispute resolution process that relies on external reviewers working with an STI taxpayer champion, perhaps with further recourse to a tax ombudsman. An internal audit unit ought to be available to check from documents, files and computer systems that the standardized nonstatutory procedures are applied consistently across the organization.

32. **Inflexibility imposes costs**. Many procedures are in need of review already. Unless more flexible process design methodologies can be devised, there is a risk that the new IT system will have outdated processes engineered into it because they are mandated by statute. In that scenario, existing rigidly-designed processes would be carried forward into the new IT system combining extra development costs with the unnecessary preservation of inefficient working methods for many years to come. The STI management is committed to avoid this risk seeking statute changes where required.

33. **The STI still performs a wide range of tasks for other government agencies.** These activities divert vital resources from core compliance functions. These tasks include such things as collecting unpaid loans made by state agencies to businesses, collecting fines levied on unlicensed or illegal business activities, auditing the payment of dividends due to the state from companies it owns, carrying out audits mandated by other state bodies, and policing price controls on staple foods. There is always a temptation for governments to make the revenue agency the regulator of choice, and for good reasons. In most cases, the revenue agency with the support of the finance ministry tries to fend off these extensions to its remit. Where it does not succeed in doing so, the opportunity cost in terms of its own programs is likely to be high. Some of the nontax activities performed by the STI utilize its

core competencies and are unlikely to be too costly. However, many others are far off the mark and should be performed elsewhere. Appendix 2 lists some of these tasks.

34. **The challenges ahead are difficult and meeting them will require strong political backing.** Implementing a CRM strategy is difficult. It requires leaving behind methods that, while familiar, have relatively limited effect on tax outcomes. It requires a more entrepreneurial style of management that can communicate goals clearly to staff and motivate them to deliver. It requires flexibility in the choice of compliance tools and the deployment of staff. In short, it appears to be more risky than maintaining the status quo. However, by adopting some key elements of the compliance risk management model the STI management has shown that it takes the opposite view and regards the status quo as too risky. The changed way of working that has been endorsed and deployed in 2011 will deliver more effective tax management from a given resource. It will have more impact on the crucial goal of reducing the tax gap and will be far less intrusive for the generality of business taxpayers.

F. Training is Key to Future Success

35. **A major training program is urgently needed**. As the remaining parts of this report show, progress in the STI will require extensive training and ongoing technical assistance in areas such as audit—including payroll tax audit, VAT management, tax fraud investigation and the pursuit of arrears. In the LTO, these training needs are even more complex given the nature of its taxpayers. Other difficult new issues are emerging onto the agenda such as the taxation of HWIs and the related technical issue of the deployment of indirect audit methods. Tackling these training needs is central to the future development of the STI. New skills do not have to be learned all at once but a medium term training plan is needed to permit their orderly acquisition. The task of devising this plan should begin at once with assistance from the IMF and other donors.

G. Recommendations

36. These are the recommendations related to enhancing the strategic approach to compliance management:

- Use a wide range of treatment methods to improve the compliance of business sectors selected for compliance programs in 2012 and beyond. Treatments should include "compliance marketing," taxpayer education, taxpayer monitoring, behavioral experiments, and audit.[1]

- Maintain a focus in 2012 on the businesses treated in the 2011 program to sustain their improved compliance rates.

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[1] The aim is to achieve "whole sector impact" extending far beyond the audited taxpayers.

- Ensure that the STI risk unit has a small group of numerate analysts whose skills are required to make the compliance risk model work in collaboration with business experts from the STI.

- Identify and repeal any laws that prescribe or restrict the frequency of audit as the compliance risk model requires close control of risky businesses and light control of small or compliant businesses.

- Institute formal cooperation on compliance and administrative aspects of taxation between the STI, industry representatives, chambers of commerce and tax professionals.

- Develop a vision for the future aims, methods, skills and scope of the LTO more in line with the CRM model.

- Use compliance marketing as a tool to facilitate the reintroduction of corporate income tax.

- Carefully restructure the STI to better align its resources to its risk portfolio and to maximize the impact of its new compliance approaches.

- Build the planned new IT system as quickly as possible with the minimum possible level of customization of “off-the-shelf” software.

- Move away from the statutory definition of internal STI administrative procedures.

- Seek Government support to release the STI from a number of tasks performed for other government agencies.

- Develop a strategic training plan to prioritize and implement the training requirements identified in this report.

- Obtain unambiguous political backing for these changes.

II. Strengthening Personal Income Tax Compliance

A. Addressing Unreported Cash Wage Payments

Current situation

37. **In nominal value, the collection of personal income tax withheld on wages, social security contributions, and health insurance contributions have continued to increase into 2011**. Table 3 summarizes collections since 2007. In 2011, PIT on wages, social security contributions, and health insurance contributions totaled MDL 9,9 billion and made up 34.4 percent of the overall collection of tax in Moldova.

Table 3. Moldova: Collection of Personal Income Tax and Social Contributions

(MDL millions)

Revenue Type	2007	2008	2009	2010	2011
Personal income tax—wages	1,322	1,480	1,465	1,544	1,769
Social security contribution	3,947	5,398	5,575	5,987	6,551
Health insurance contribution	760	1,122	1,339	1,447	1,578
Total	6,029	8,000	8,379	8,978	9,898

Source: State Tax Inspectorate.

38. **The STI and the Ministry of Labor (MOL) share responsibility for overseeing the reporting and collecting of wage and social contribution withholdings.** The MOL generally handles processing and the STI has the main responsibility for collection. Table 4 compares 2009 and 2010 data provided by the MOL. In 2010, the number of employees fell by 2.7 percent, but the reported wages increased by 5.4 percent and the average wage per employee increased by 8 percent.

Table 4. Moldova: Employee Count and Wage Reported Data

	2009	2010	Percent
Total employee count[2]	1,140,473	1,110,021	-2.7
Wages reported (MDL millions)	20,715	21,906	5.4
Average wage per employee (MDL)	18,164	19,735	8.0

Source: Moldovan authorities.

Issues

39. **The STI has committed to initiating a compliance strategy to strengthen compliance for the wage and social contribution collections.** This strategy results from the realization that wage reporting and withholding is a primary revenue source and needs to be

[2] The employee count is the total of employees reported by all companies. If an employee works for more than one company, then that employee will be counted more than once in the above count.

protected. The strategy was announced in the "*Taxpayer Compliance Program for 2012*." The strategy will initially focus on unreported salary payments, often referred to as the "brown envelope" payments.[3] This is a new initiative that is in its initial planning stages. STI officials told the mission that it is common for many employees to be reported as earning the minimum wage of MDL 766 per month when real wages are much higher. The unreported wages are paid in cash (brown envelopes). STI officials mentioned that this is the case in particular in the construction industry and the catering and restaurant businesses.

40. **A cross-agency compliance strategy to improve wage-reporting compliance is required**. In June 2011, the authorities announced a plan to address wage envelope payments, with MOL having the lead responsibility. The STI and several other agencies are supposed to support MOL in this effort. The STI's and the MOL's joint responsibility for wage reporting requires cooperation between the two agencies to allow their experience, knowledge, and abilities to be focused on effective actions to address this high risk area.

41. **The cross agency strategy should include the classic aspects of a compliance risk strategy.** These include articulating the risk, establishing desired outcomes, designing a strategy to achieve those outcomes, and a system to measure the outcomes. These classic phases of a compliance project are detailed further in Section II.B in the context of developing strategies for improving the compliance of high-wealth-individuals.

42. **The strategy should seek to increase public understanding of the size and nature of the problem.** To raise awareness, the STI and the MOL should mount media campaigns to publicize the problem and make the public recognize that it as a national priority. In the case of social contributions, this would include highlighting the pension and other benefits available to those registered for contributions and the consequences of not being covered. The nonpayment of contributions means that employees will eventually receive reduced benefits. Television and newspaper companies may be interested in focusing on this issue for some time to mobilize general public pressure on employers to submit correct contribution returns. This may contribute to a higher level of labor union and employee confidence with regard to pursuing these matters with employers.

43. **A strategy would include a program to educate employers about their obligations.** Steps would also be taken to make it as simple as possible for employers to register for the first time and pay any tax or contributions owing. This might include reviewing the registration process, simplifying declarations, and producing new leaflets for employers.

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[3] The reference "brown envelope" originates in the practice of placing unreported cash wage payments into brown envelopes and discreetly passing these on to employees.

44. **STI auditors could benefit from focused training on how to identify and substantiate unreported cash wage payments.** Past measures attempting to curb unreported cash payments have largely been ineffective. To some degree this can be related to weak audit techniques. In 2011 the STI reported completing 797 LTO audits and identifying MDL 3.6 million in additional employment tax. This is a relatively small return of employment tax for this effort. STI officials advised that in 2011, audits of non LTO businesses also resulted in very few employment tax adjustments.[4] The low recovery of tax from employment tax audits may result from poor audit planning, outdated audit techniques, weak audit skills, and ineffective training. The mission recommends that the STI update training programs and audit procedures to allow for more effective identification of unreported cash wage payments. Employment tax training should be offered to STI auditors periodically during 2012 and 2013.

45. **Expert assistance could be very helpful in the employment tax area**. This should be in relation to the development of the compliance risk strategy, updating of audit procedures, and implementing a new training emphasis. Many countries have wrestled with this same area of noncompliance and some expertise has developed from these efforts. Identifying and bringing in experienced expert assistance can be very valuable for addressing employment tax noncompliance and should be considered.

B. Building a High-Wealth-Individual Compliance Program

Current situation

46. **The STI has commenced the development of a compliance strategy concerning HWI.** This strategy initially was announced in "*The Development Plan for 2011–2015*" and again in the "*Taxpayer Compliance Program for 2012*." This is a new initiative and much needs to be done to make the compliance strategy a reality for use in 2012 and beyond.

47. **The authorities introduced indirect audit methods as a new audit tool to strengthen PIT compliance in legislation passed January 2012.** The new legislation requires individuals to file a "Statement of Financial Assets" by December 31, 2012 where an individual has in excess of MDL 1 million in assets or MDL 300,000 in personal expenditures. The legislation allows for the use of indirect audit methods (IAM) commencing in 2013 for PIT returns due for 2012. The introduction of IAM as a compliance tool will require significant preparation work during the next 15 months to allow for the methods to be put into practice in 2013.

[4] The STI is preparing an analysis of PIT results for 2011, but the analysis was not completed at the time of this mission.

48. **Both the HWI strategy and the IAM initiative have strong potential to improve PIT collections.** Wages and dividends combined, provided 90.2 percent of PIT reported for 2010, as seen in Appendix 3. Reporting and collection from other sources, particularly international income (.047 percent) and capital gains (.347 percent) appear weak. Both the HWI and IAM efforts provide new tactics and methods for encouraging compliance in these and other PIT income streams that have not been historically emphasized within the STI and that appear to have significant tax risks and tax benefits associated with them.

Issues

49. **The HWI initiative would require the establishment of a dedicated organizational unit.** At this stage, a working group has been formed for the implementation of the recently passed legislation on IAM. The working group provides some energy toward organizing an HWI initiative, but better and quicker progress would be achieved by establishing a dedicated and permanent headquarters unit or project office to organize and manage HWI efforts. The unit would require adequate knowledge, skills, authority, staffing, budget, equipment, workspace, approval processes, and cooperation to carry out numerous activities. Chief among these would be:

- Gather and analyze high income tax data.
- Develop risk information for high-income taxpayers.
- Design and recommend a process for appropriate approval of high-income projects, project teams, and/or specialized units to STI management.
- Recruit project managers for specific projects/initiatives being considered for implementation.
- Recommend the implementation to appropriate STI management regarding project teams, audit projects, and/or special high-income tax units to address high-risk areas determined under the risk analysis process.
- Coordinate proposed changes in operating manuals and procedures necessary to establish a functional HWI initiative with appropriate units within STI and at the Ministry of Finance (MoF).
- Implement recruitment and training of staffing to ensure that knowledge and skills are adequate for all phases of a project office and among the auditors, IT staff, managers, and others who will support a HWI income risk-based compliance approach.
- Recommend procedures for selection and audit of project cases.
- Coordinate joint approaches with STI units from operations, methodologies, support services, IT, and others that have substantial parts to play in improving compliance and services for the HWI taxpayer.

50. **The HWI unit would need to be staffed appropriately.** At least five people will be required at its initiation. The staff should be well versed in the use of risk-based techniques and the use of compliance strategy approaches to strengthen compliance. The unit should also include experienced compliance staff. Project management skills will be valuable for this operation. Knowledge regarding data analysis techniques would also be helpful. A close working relationship with IT is highly desirable.

51. **A formal HWI compliance strategy is necessary to outline and set the parameters for quality efforts.** The strategy drafting process should commence as soon as possible. If an HWI unit is established, then this unit may be charged with drafting the strategy. However, if the establishment of the unit is delayed, or is determined unnecessary, appropriate officials should be charged with drafting this strategy. It is recommended that a HWI Compliance Strategy be drafted within the next 60 days.

52. **It is desirable that an HWI compliance strategy address the following four phases of a project of this type:**

Phase 1: Articulate the compliance risks;

Phase 2: Develop a listing of intended outcomes and a strategy to deliver these desired outcomes to address the compliance risks;

Phase 3: Implement a business plan to support delivery of the strategy; and

Phase 4*:* Create a system of measurement to determine actual outcomes and compare with projected outcomes.

53. **Articulating the compliance risk that is attached to the HWI tax sector will require a five-step process.** These steps include: (1) define what constitutes an HWI for project purposes; (2) determine the population of taxpayers that meet this definition; (3) gather available data on the HWI population; (4) analyze data and quantify the attributes and characteristics of this population; and (5) complete a review and summarize the pertinent information gathered with emphasis on HWI compliance behavior, characteristics, trends, tax gap projection, and a summary of the compliance risk and risk groups. Appendix 4 provides a suggested action plan outlining the steps to articulate the risks.

54. **The strategy would initially focus on a small number of taxpayers.** The initial HWI population should be limited to approximately 200 taxpayers. Recent legislation provides a legal definition for the use of IAM. The legislation establishes MDL 300,000 in personal expenditures and MDL 1 million in assets as benchmarks for indirect audits. However, these benchmarks are too low in an HWI context, as they would draw in a taxpayer population far exceeding the STI's capacity at this stage. The number of taxpayers included in the initial stages of the HWI project should not exceed 200. The definition of a HWI

taxpayer should therefore be descriptive enough to identify a group of individuals that represent the wealthiest citizens while at the same time keeping the population of taxpayers that would be initially targeted by the project at a manageable number.

55. **A good HWI compliance strategy requires the STI to determine the desired outcome of implementing the strategy.** As a crucial component of developing the strategy, the development team should answer two key questions:

a) What short-term and long-term outcomes are reasonably expected by addressing the compliance risk?

b) What treatment strategies will be required to deliver these outcomes?

56. **The implementation of the HWI strategy would be facilitated through a comprehensive business plan.** An HWI strategy and the resourcing of HWI operations require a business plan to facilitate resourcing, staffing, facilities, IT needs, training, work plans, etc. Many of the supporting actions necessary for an HWI effort will require their own action plans to assist with their completion on a timely basis. The supporting action plans are then drawn together in an overall HWI business plan. The business plan is designed to provide a map on how the HWI strategy, outcomes, and measurements will be resourced and completed. The business plan process commences in earnest, once the outcomes and strategy have been determined.

57. **A measurement system to monitor the achievement of the desired outcomes established in the HWI strategy is an important feature for this project.** To justify and administer the effectiveness of the HWI program, the tax administrators must be able to state the compliance benefits being achieved through the strategy as well as determine whether predicted outcomes are being accomplished. If the tax administrators do not measure the effectiveness of the HWI strategy, they run the risk of taking actions that do not align with their stated objectives and they lose an opportunity to make necessary adjustments to improve the strategy or identify new treatments for noncompliance.

58. **Data and information available on wealth is limited.** There is currently a lack of information sources, especially electronic data that can be used to identify, case build, research, select, and support compliance activities. Most tax data comes from several basic sources, such as:

- Third-party information providers of wage, interest, dividends, and real estate transactions. These providers forward income and withholding information.

- Form CET08. Data from these forms record entity information and information germane to the computing of personal income tax. There is no significant data on wealth or assets included in these filings.

- Corporate income tax (CIT) filing database by legal entities, as well as the registration database for these entities.

- Ad hoc data is available on real estate, auto sales, high-end consumer goods, etc., which can be procured and used for project purposes.

59. **HWI project relevant data should be expanded.** The data currently available should be “data mined” and correlated into a profile of HWI taxpayers to determine a starting point. There has been some work completed in this regard, but it is insufficient to identify a potential population of HWI taxpayers. Additional data sources need to be determined and brought to bear to identify HWI taxpayers and to determine possible compliance issues. The STI will need to gather and analyze a wider range of publicly available information. The mandated statement of financial assets due at the end of 2012 will provide additional data to enhance the STI’s understanding of the HWI population.

C. Introducing Indirect Audit Methods as a Personal Income Tax Compliance Tool

Issues

60. **The STI is currently drafting additional fiscal procedures to clarify some aspects of indirect audit methods.** These procedures are mandated by the January 2012 legislation and it is anticipated they will be issued in April 2012. In addition, the new law requires a filing of a financial statement of assets by qualified individuals by December 31, 2012. The drafting process has just begun on the procedures, so there were no drafts available for review. However, a draft version of the form to obtain the financial statement of assets was available and was reviewed and discussed with the working group.

61. **It is essential to develop a strategy to state IAM objectives and how these audit techniques will be applied.** The issues and organizational support requirement for implementation of indirect methods are numerous and often include:

- Organizational procedures to augment the requirements of the new legislation.

- Guidance on when and who within the STI will be authorized to commence an indirect audit.

- Development of a selection process to pre-determine possible individual audits for use of indirect techniques.

- Media and communication materials to educate taxpayers on indirect methods.

- Monitoring and audit feedback processes to insure proper use of indirect methods and to track results of audits completed.

- Identification of information sources to support auditors to obtain necessary data to complete an indirect method.
- Agreements with IT to build systems and develop support systems for indirect audits.
- A determination whether to have indirect audit specialists, where to locate specialists, and how many specialists would be necessary.
- The issuance of guidance on the application of indirect methods for identified compliance risk areas such as: (1) HWI; (2) rich owners of poor companies; and (3) high-income-individuals with no filing history.
- Implement a training plan to build indirect audit skills among selected examiners.
- Identification of resources, support, and mentoring available for introduction of indirect audits from EU partners, World Bank, IMF, and other organizations.

62. **There is an approximate 15-month window of opportunity to prepare for the application of indirect audit methods.** The first individual tax period that will be subject to the use of indirect audits, will be tax year 2012 (March 2013 filing). These 2012 tax returns generally will not be fully processed until mid-summer 2013. Therefore, it will be late-summer 2013 before the first indirect audits could be initiated and it would likely be 2014 before any substantial results could be reasonably expected.

63. **Ideally, the preparation for the implementation should start soon.** To commence using indirect audit methods in 2013, there is a need to complete the strategic, procedural, tactical, staffing, and training planning within the next 180 days (October 2012 completion date). This would allow for a rollout of indirect audit methods in 2013. The timely completion of strategic and business planning will allow for a window of opportunity in the spring of 2013 to deliver these plans. This is particularly true for training, as the bulk of training of auditors should be completed by May 2013. Appendix 5 provides a proposed action plan discussed with the working group to ensure delivery of necessary training in time to start indirect audits in late-summer 2013.

64. **A dedicated project must be established.** The inclusion of indirect methods as a compliance tool within the audit program is a complex endeavor and requires a full-time project coordinator/manager and several project support members. At the time of this mission, no official has been designated, rather it is a collateral assignment for several staff personnel and managers.

65. **Indirect audit techniques need not be limited to only HWI audits.** Indirect audit methodologies are a powerful technique and have value in combating noncompliance by individual taxpayers, individual owners of legal entities, and individuals of moderate wealth who fail to report any source of income. Based on tax official comments, these additional

areas have a high compliance risk and would be worthy of projects designed to address noncompliance. Consideration should be given on how to apply the new audit tools for identified problem areas within the Indirect Methods Compliance Plan. Through a workshop, the mission provided the STI working group with comprehensive advice and material on IAM.[5]

D. Technical Assistance

66. **Experienced guidance and support will expedite and improve the introduction of HWI and IAM.** The Government's interest in addressing compliance problems with the HWI taxpayer segment is encouraging. However, for any tax administration, this is a complex and difficult task. Most of the recommendations in this report are geared toward: (1) establishing an HWI unit in 2012; and (2) having indirect methods in productive use by 2013. Establishing both programs requires 2012 to be the year of identifying the desired outcomes, drawing up strategies supportive of these outcomes, developing and implementing business plans, and designing systems to help evaluate progress. The tasks involved are often confusing and are made simpler if experienced guidance and expertise can be accessed. While preparations should commence, it is recommended that the STI seek additional expert assistance on these topics prior to the role out of these programs

E. Recommendations

67. These are the recommendations related to:

Addressing compliance issues concerning unreported cash wage payments

- Coordinate a compliance strategy for unreported cash wages with the Ministry of Labor.
- Develop a compliance risk strategy/plan to address wage-reporting concerns.
- Utilize media and education tools to support the compliance strategy.
- Update employment tax audit techniques and renew employment tax training efforts.

Establish an HWI compliance capacity

- Establish an HWI compliance unit.

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[5] Hand out material included: FAD Technical Notes "Revenue Administration: Tax Audit—Use of Indirect Methods," April 2010; the OECD's "Strengthening Tax Audit Capabilities: Innovative Approaches to Improve Efficiency and Effectiveness of Indirect Income Measurement Methods," October 2006; and "Audit Toolkit—Individual Income," April 2011, J. Buchanan; three audit lead sheet prototypes on personal living expenses; cash-T techniques; minimum income probes; and the workshop power point presentation .

- Develop an HWI income tax compliance strategy.
- Identify additional HWI income sources of information

Implementing indirect audit methods

- Designate a fulltime project team/manager to coordinate the strategy and actions to implement IAM.
- Develop a strategy on how IAM will be used.
- Establish an implementation plan for IAM that includes a training plan.

Technical assistance

- Seek expert support to expedite implementation of HWI and IAM initiatives.

III. Improving Operational Tools to Implement the Compliance Strategy

A. Taxpayer Services

Introduction

68. **Providing taxpayer services is a core function of a tax administration operating a tax system based on the principle of voluntary compliance.** Based on the principle of voluntary compliance, the majority of taxpayers will comply with their obligations under the tax laws, if they know what their obligations are and they are able to comply with them. Taxpayer service therefore plays a critical role in the STI's objective to maximize voluntary compliance, by delivering taxpayers the information and assistance they need to enable them to meet their tax obligations. Box 2 shows the international trend in taxpayer services.

69. **Taxpayer services are a key tool for addressing priority compliance risks under a compliance management strategy.** Many compliance problems arise from unawareness and ignorance of tax obligations and are much more efficiently resolved through application of taxpayer service initiatives than through the application of enforcement measures. Building a strong taxpayers service capability usually receives great attention in modern tax administration.

70. **The STI has implemented a number of good initiatives to improve services to taxpayers.** Since the previous mission in 2010, new initiatives include:

Box 2. International Trends in Taxpayer Services

- Understanding that an appropriate balance of resources between enforcement and service is a critical tool in achieving higher overall tax compliance as a measure to reduce the tax gap.
- Treating taxpayers as clients with rights that are codified in the form of charters, etc., and publicized.
- Public Agencies work together to provide coordinated services to clients.
- Tailored approach of service delivery to match the needs of various taxpayer segments and the risk to revenue.
- Modern marketing techniques are extensively utilized to influence on taxpayer behavior.
- Services staff are highly qualified in terms of being able to match the expectations of taxpayers and those of their professional tax accountants and advisors.
- Establishment of client call centers and a move towards larger and more centralized service centers to ensure delivery of consistent, high quality service that enables specialization (e.g., by taxpayer segment or tax type and procedure).
- Services are available independent of time and place in step with the growing possibilities for electronic services (e.g., interactive telephones, e-services and web pages).
- Provision of dedicated inquiry services for tax professionals.
- Taxpayer services (excluding staff involved with returns filing and coding) consume about 10 percent of tax agencies' human resources.
- Goal to move customers to web and e-services with compulsory e-filing and payments requirements for certain taxpayer segments (e.g., large taxpayers) and annual targets for take up rate.
- Consulting widely with taxpayers and/or their representatives prior to the implementation of changes.
- Establishing and monitoring service delivery performance according to prescribed performance standards; measuring client satisfaction; and demonstrating accountability by publicizing the levels of performance achieved against service standards set.

- Introduction of an on-line database containing frequently asked questions and answers on legal requirements under the tax laws, including a helpdesk (located within Fiscservinform[6]) to assist taxpayers access and use this facility;

- Expansion of the STI website to allow taxpayers access to their personal tax information (e.g., accounts information, types of taxes they are registered for); and

- On-line self-generated assessment notices for property tax (taxpayers can choose between an electronic and a paper notification).

Strengthening service capabilities

71. **Despite improvements through the introduction of new technology, much remains to be done to improve services to taxpayers**. If the STI is to capitalize on the full potential of taxpayer services as a tool for improving taxpayers' compliance, a more ambitious approach to improving services to taxpayers needs to be adopted. The first step should be to instill the appropriate service mentality in STI Officers. Providing service to taxpayers is a critical task to facilitate voluntary compliance. Respectful and fair treatment of taxpayers will help build trust in the STI and will in turn lead to improved compliance. Modern tax administrations monitor the level of trust taxpayers have in the tax administration through surveys.[7]

72. **Non optimal organizational structures at both headquarters and field offices limit the STI's ability to deliver focused and effective taxpayer services**. As such, responsibility for taxpayer services within headquarters are spread between a number of units in the Methodology Department, which also have responsibility for operational delivery in respect of the service center that responds to telephone calls and correspondence from taxpayers. Delivery of taxpayer services in the field offices lies with the administration divisions that are also responsible for a range of other tasks, including arrears collection. The international trend is to deliver taxpayer services through units that are fully dedicated to this task. In field offices, a separate area would be designated as a "shop front" where the public can come to raise their issues, rather than allowing the public to wander through the tax office to try to find a relevant official. Taxpayer services staff would be service specialists who are trained to deal with taxpayers' information needs.

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[6]Fiscservinform is the state enterprise responsible for managing and developing the State Tax Service's IT systems.

[7] In Estonia for example, the Tax and Customs Administration consistently rates as between the third and fifth most trusted Government institution, with some 80 percent of surveyed taxpayers believing the organization is trustworthy.

73. **Current taxpayer services activities are not designed well enough to effectively help mitigating the key compliance risk identified in the STI' compliance strategy.** To its credit, the STI does provide some proactive taxpayer services through conducting seminars to inform taxpayers about changes in the tax laws and how these may affect them[8]. However, most services activities are simply in response to taxpayer initiated contacts. There is little evidence that taxpayer services place any focus on addressing key compliance risks - either proactively or reactively. Neither is any attempt made to measure the effectiveness of taxpayer services with regard to influencing compliance behaviors. While improvements in taxpayer services alone are unlikely to be a sufficient response to serious noncompliance such as tax evasion and fraud, they nevertheless play a crucial role in maintaining and encouraging compliance by the majority of taxpayers. This would allow the STI to designate a bigger portion of its compliance resources on those who remain unwilling to comply. The first step in addressing high compliance risks identified through the compliance strategy should be to consider the impact that targeted taxpayer services could have on taxpayer compliance behavior prior to deciding to make use of the much more expensive audit and enforcement options. Taxpayer services can also influence on taxpayers' behavior by using "marketing techniques." For example, they could inform the public about the STI's audit and enforcement successes to make taxpayers aware that it is not worthwhile to engage in tax evasion and fraudulent activity.

74. **Taxpayers' compliance costs appear to get insufficient attention in the context of business procedures and processes design.** It is generally accepted that high compliance costs discourages taxpayers from meeting their obligations. Therefore, the STI ought to analyze the compliance aspects when introducing new laws, procedures, and processes. A current and relevant example is the introduction of the requirement that taxpayers shall acquire a digital signature to enable them to e-file tax returns. While the service is free for individuals, businesses have to pay a fee to obtain the digital signature with VAT taxpayers even paying a higher rate.[9] That taxpayers must pay for using the e-filing option may be a deterrent to compliance. The STI should reconsider this fee, in particular taking into account that it is planned to make e-filing obligatory for all taxpayers.

75. **Closer cooperation with the business community would facilitate taxpayer compliance.** A taxpayer satisfaction survey was recently undertaken and the STI has expressed a desire to undertake such surveys on a more regular basis. However, there appears to be no plan for using the survey results to develop and implement initiatives to improve taxpayer satisfaction. The STI ought to use the results of the surveys to improve tax administration and thereby increase the level of taxpayer satisfaction. In addition, they should

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[8] During a year around 450 seminars to the taxpayers were organized throughout a country to explain various tax law implementation aspects.

[9]https://servicii.fisc.md/TarifeDeclaratiaElectronica.aspx.

learn from other tax administrations that have established close dialog and cooperation with representatives of the business community. These initiatives often means establishing a "Consultative Counsel" where senior managers of the tax administration meet on a regular basis (e.g., quarterly) with representative of the business community (e.g., Chamber of Commerce, large taxpayers, Banker's Association, Employers' Association, large accounting firms) to discuss issues that are relevant for both parties with regard to facilitating compliance with the tax laws. Feedback provided through such a forum typically would initiative actions that reduce taxpayers' compliance cost and at the same time facilitates a higher level of compliance. It also serves to create greater public acceptance of changes, as the business community have a better understanding of the issues and see their views heard.

Recommendations

76. The following is recommended for taxpayer services:

- Establish a dedicated unit in the STI Methodology Department to be responsible for program and product design, planning and coordination of taxpayer services.
- Develop a comprehensive taxpayer services strategy linked to the STI's taxpayer compliance strategy taking account of taxpayer demands and needs, geography, service channel options; and staffing requirements, etc.
- Establish taxpayer *"shop fronts,"* at field offices to provide quality services to taxpayers, taking account of (1) the conclusions of the taxpayer service strategy (once developed) and (2) the need to substantially reduce the number of field offices over time, as discussed in Section IV.
- Utilize modern marketing techniques ("*compliance marketing"*), including public relations, to influence on taxpayer behavior with the aim to mitigate key compliance risks identified by the STI's compliance plan.
- Ensure results of taxpayer satisfaction surveys are used to develop satisfaction improvement initiatives and measure the effectiveness of those measures through subsequent surveys.
- Establish a Compliance Cooperation Council comprising senior STI officials and representatives of the business community as a means of seeking the business community's input into significant tax administration initiatives to improve compliance.

B. Audit

77. **The audit program is a core tax administration function that features prominently in any tax agency's compliance management strategy.** Modern tax administrations give strong emphasis to risk-based audit programs aimed at broad coverage of taxpayer groups and compliance issues, with intense focus on high risk areas to combat

abuse. With similar objectives in mind, the STI has shown a gradual move away from comprehensive audits in favor of more focused audit activities that are concentrated on areas of highest compliance risk. As can be seen from Table 5, the number of comprehensive (full) audits has been reduced and the number of single-issue audits increased over the period from 2010 to 2011.

Table 5. Moldova: Audit Results (Not including Large Taxpayers)

(MDL millions)

	2010			2011		
Type of audit	Number of Audits	Percent with Results	Additional Tax	Number of Audits	Percent with Results	Additional Tax
Registration checks	294	67	4,1	308	71	4.0
VAT refund	1,157	53	9.9	1,344	50	8.9
Single issue	24,236	66	151.4	27,190	62	93.0
Comprehensive	5,436	84	200.0	4,721	82	238.3
Total	**31,123**		**365.4**	**33,563**		**344.2**

Source: State Tax Inspectorate.

78. **Management of the audit program is the responsibility of the Audit Division in the STI headquarters.** The responsible division is the Division for Organization of Tax Audit, which comprises three sections: (1) Audit Methodology; (2) Planning and Analysis; and (3) Cash Registers. Until June 2011, the planning and analysis section was primarily engaged on identifying high risk taxpayer who would be targeted for comprehensive audits by the field offices. Since the second quarter of 2011, this section has been engaged on implementation of the STI's compliance strategy. This shifted the focus away from undertaking audits to a "partnership" approach, which involved intensive compliance monitoring by the field offices of some 1,553 taxpayer who were chosen from three high-risk industry sectors (catering, telecommunications/IT, and wholesales).[10] These taxpayers were encouraged and supported to comply with their tax obligations and audits initiated only in cases of persistent noncompliance.

79. **Significant potential remains to strengthen the audit function.** Although, the greater focus on compliance risks achieved through the implementation of a more strategic approach to compliance management is strongly endorsed and will undoubtedly lead to improved results, much remains to be done to strengthen the STI's capabilities in the audit function. In particular, concerns remain over the STI's ability to undertake in-depth tax audits

[10] Refer Section I.

and therefore its capability for detecting more complex tax abuses, such as tax avoidance arrangements. Building this capacity should therefore remain a key priority for the STI and requires the delivery of more in-depth training for auditors. The range of skills and knowledge needed by competent auditors is vast and includes issues such as (1) audit techniques; (2) tax technical and legal issues; (3) interviewing skills; (4) report writing; (5) litigation; and (6) court appearance techniques. This may require a progressive training strategy, whereby staff can progress through multiple levels (e.g., beginner, intermediate and advanced) of training in order to achieve the highest skill levels needed for effective dealings with taxpayers' affairs. Box 3 sets out the elements of a typical progressive training strategy for audit staff.

Box 3. Elements of a Progressive Training Strategy for Audit Staff

Beginner	Intermediate	Advanced
▪ The tax equation	▪ Dispute resolution	▪ International tax
▪ Definitions	▪ Introduction to accounting	▪ Foreign tax credits
▪ Structure of tax law	▪ Financial analysis	▪ Taxation planning
▪ Concepts of Income	▪ The business context	▪ Research techniques
▪ Concepts of Deductions	▪ Legal persons	▪ Case law
▪ Assessable income	▪ Companies and partnerships	
▪ Concepts of credits	▪ Trusts	

80. **The introduction of the compliance strategy presents an opportunity to focus training in priority areas**. The present initiative to focus on three high-risk sectors as described above, presents an opportunity for the STI to identify a selected pool of auditors to work on these sectors. These auditors can be targeted for specialist training, including training on the industry sector in which their work will be concentrated—to enhance effectiveness of the compliance enforcement effort.

81. **A significant component of audit activity is focused on nontax issues**. Although, the STI has been successful in broadening the audit coverage by increasing the number of single-issue audits, these efforts are undermined by the extent of nontax related audits, which do not identify tax discrepancies. Such audits include checking on the origin of goods, checking compliance with price controls on socially important products, such as milk and bread, and checking whether cash registers have been properly registered with the STI. Violations detected during the course of such inspections lead to fines being charged, but have no tax compliance implications and are resource consuming. Such inspections should not be part of an effective tax audit program and should easily be undertaken by other government agencies.

82. **Extensive control over cash registers is not an adequate substitute for a proper risk-based compliance program**. Traders are required to register cash machines with the STI, who currently have some 79,000 of these logged nationally. In addition, certain taxpayers (currently some 1,600 exchange bureaus[11]) have their cash registers linked on-line to the STS that receive daily reports of all cash transactions. These transactions are checked against tax returns for discrepancies. The STI is presently considering the expansion of this initiative to a larger group of taxpayers. Similar initiatives have been implemented in various countries, including former soviet states (e.g., Armenia) who report positive results. However, the sustainability of such results remains questionable, as taxpayers inevitably find ways to circumvent the controls. In addition, great care must be taken to avoid the imposition of excessive compliance costs on small taxpayers, who may be driven back into the shadow economy as a result. The risk that the STI places undue confidence in such controls as a substitute for a robust risk-based compliance enforcement program must be avoided.

Recommendations

83. The following is recommended for audit:

- Continue, and where possible increase, efforts to improve skills of auditors to undertake more in-depth tax audits.
- Implement a progressive training strategy to up skill auditors.
- Identify selected auditors to concentrate on the high-risk sectors identified in the compliance strategy and provide these auditors with targeted training to ensure their effectiveness.
- Focus the audit program on detection of noncompliance with tax obligations by removing all nontax related tasks.
- Maintain focus on implementing a risk-based compliance program rather than increasing reliance on micro-level controls such as on-line case registers.

C. Establishing Capacity to Investigate Tax Fraud

Introduction

84. **The Criminal Code prescribes thresholds for cases that the STI must refer to relevant authorities for possible fraud investigation and prosecution.** These are MDL

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[11] Ironically, these exchange bureaus have not been liable to tax and the information gathered through this process has been of little use to improve tax compliance.

30,000 in unreported taxes for legal entities (companies) and MDL 20,000 for natural persons (individuals). Until January 12, 2012, the threshold was MDL 50,000.

85. **All potential tax fraud cases meeting these thresholds are referred either to the local prosecutor office or to the Center for Combating Economic Crimes and Corruption (CCECC).** Local STI offices do the processing of cases under MDL 500,000 directly with the local prosecutor offices (PO), while cases of MDL 500,000 and above are referred to the CCECC by the STI's anti-fraud unit. Both the PO and the CCECC are independent and have their own investigative staff and mandate to prosecute tax crimes.

Issues

86. **The current system of selecting, transferring, and investigating potential tax fraud does not seem to produce prosecutions and convictions**. According to statistics provided to the mission (Table 6), a total of 437 cases were referred to the above authorities in 2011 based on the described thresholds. Out of these, 134 were accepted for investigation, and only 1 was placed for prosecution. The situation is similar in previous years. The mission was not able to document any tax fraud convictions during the last three years. Provided, the statistics reflect the factual situation, the system is broken and must be reviewed and fixed. The inability to develop or prosecute tax fraud cases seriously hampers the STI's efforts to deliver on the Government's expectation of improved taxpayer compliance to strengthen Moldova's economy. The absence of a tax fraud deterrent undermines current efforts to address risks to revenue in a strategic way and build trust between the tax authority and taxpayers. Compliance strategies that are currently being developed to address compliance problems related to large businesses, high-wealth-individuals, and unreported payroll taxes lose their impact if there is an inability to prosecute taxpayers who intentionally under-report their tax liabilities.

Table 6. Moldova: Tax Fraud Cases, 2009–11

(In thousands of MDL)

	2009			2010			2011		
	PO > 50	CECC >500	Total	PO >50	CECC > 500	Total	PO >50	CECC >500	Total
Cases referred	181	184	365	166	124	290	230	207	437
Investigations	...	...	...	11	55	66	7	127	134
Prosecutions	2	0	2	3	1	4	1	0	1

Source: State Tax Inspectorate.

87. **The authorities should consider the establishment of a joint agency-working group to identify and fix the barriers preventing prosecution and conviction of tax evaders.** This process would be enhanced if the stakeholders of the criminal tax fraud

process are all participating. This would, for example, include the MoF, the Ministry of Justice, POs, the CCECC, the judiciary, as well as the STI. Until the barriers are identified and fixes agreed upon and implemented, it would appear that even serious fraud cases will go unprosecuted. The MoF may want to initiate such an effort. The participation of an external moderator or discussion leader with experience in criminal tax fraud investigation and prosecution may facilitate the process.

88. **The STI does not investigate for tax fraud**. The 2006 FAD mission recommended that a criminal investigation capacity be established within the STI. The STI did establish an antifraud unit in 2007 to review and process audit cases that exceed MDL 500,000. However, the project never materialized and this unit does not investigate tax fraud; rather it reviews for accuracy and prepares the case files for referral to the CCECC.

89. **Tax compliance might be better served if the investigation of tax fraud was placed with the STI.** Currently, the STI has responsibility only for determining the tax obligation. The actual investigation to determine fraud is outsourced to the PO and the CECC. In many countries, tax administrations have specially trained criminal investigation units that are mandated to investigate tax fraud. It is the responsibility of these units to develop the case and gather evidence that proves intent to evade taxes. These bars of proof are set high, but if met, then the unit refers the case to the appropriate office for prosecution. A similar situation may work well in Moldova, provided that there is appropriate oversight, adequate technical facilities, and training of personnel.

Recommendation

90. The following is recommended concerning tax fraud investigation.

- MoF to initiate a joint working group of key agencies to identify barriers and find solutions to enable successful investigation, prosecution, and conviction of taxpayers who intentionally and materially evade tax laws. In this context consider placing the mandate for tax fraud investigations with the STI.

D. Arrears Collection

Introduction

91. **The stock of tax arrears continues to grow.** Although, the current level of tax arrears, when expressed as a percentage of total STI collections,[12] does not present cause for immediate alarm, the level continues to show an upward trend. The current level of arrears

[12] The total level of arrears (tax and social/health contributions) was 11 percent at the end of 2010, which was the latest full year for which data was available. Total arrears were MDL 1,639.3 million against total collections of MDL 14,790 million.

still reflects the effects of the 2007 tax amnesty[13] rather than being the result of an effective collection enforcement program on the part of the STI. Table 7 below sets out the tax arrears for each tax type for 2009–11. Note that 2011 data is for part of the year (to December 1 only). As can be seen, the largest component of the stock of arrears is accumulated penalties and interest, followed by VAT and social contributions[14]. The imminent reinstatement of a positive rate of corporate income tax has the potential to further accelerate the growth in tax arrears. Strengthening the collections enforcement program in the STI may therefore become an increasing priority.

Table 7. Moldova: Tax Arrears by Type of Tax 2009–11

(In millions of MDL)

	2009		2010		2011 1/	
Tax Type	Arrears	% of Total	Arrears	% of Total	Arrears	% of Total
Corporate income	49	3.5	42	2.6	44	3.2
Personal income	37	2,5	38	2.3	48	3.5
VAT	246	17.4	256	15.6	300	21.9
Excises	2	0.1	6	0.3	6	0.4
Social Fund	618	43.8	684	41.8	249	18.2
Health Fund	10	0.7	14	0.8	15	1.1
Fines and penalties	363	25,8	493	30.1	616	44.9
Others	88	6.2	106	6.5	94	6.8
Total	**1,413**	**100**	**1,639**	**100**	**1,372**	**100**

Source: State Tax Inspectorate.

1/ As at December 1, 2011.

Management of tax arrears

92. **Headquarters staff is responsible for the preparation of the annual arrears collection plan.** The first of such plans was produced for 2011 and included an analysis of tax arrears at the start of the year and monitored the collection results throughout the year. The main aim was to obtain better information for setting realistic collection targets for the

[13] Tax arrears (taxes, social and health contributions, penalties, interest, etc.) totaling approximately MDL 4.4 billion by the end of 2006 were eliminated at large by a tax amnesty implemented in mid-2007. The amnesty applied to all pre-2007 state budget taxes that remained unpaid by the time of publication of the amnesty law (May 11, 2007), irrespective of the collectability of the arrears.

[14] As the data for 2011 reflects 11 months activities, direct comparison between 2010 and 2011 requires caution, as the payments for the final month of the year are likely to significantly alter the relative components of the total arrears. In particular, the relative size of the stock of penalties and interest is likely to be less.

field offices. The 2012 plan is still a skeletal plan in respect of which work is continuing. The STI's strategic plan contains initiatives to arrest the growth in tax arrears, but it is not clear how these initiatives are being built into operational plans for the debt management function.

93. **In addition, the STI has implemented a number of operational improvements.** These include the computerized identification of debtors, automated addition of penalties and interest, and automated prioritization of arrears cases for action by collection officers. Arrears cases are prioritized on the basis of age and size, so that priority is given to collection of the largest debts and new cases where the probability of successful collection remains high. These initiatives are considered good international practice.

Collection methods

94. **Collection procedures are generally sound.** The law provides a good range of collection powers, including the ability to freeze bank accounts, arrest of assets, garnish bank accounts, confiscate property, etc. Counterproductive legal restrictions on the use of payment arrangements continue to apply**.** The law authorizes the use of installment payment arrangements for recovery of tax arrears over periods up to two years, but does not allow the use of this recovery mechanism in relation to social security contributions, which represent a significant component of the total arrears (see Table 7).

95. **Write off procedures are not applied**. The law provides for writing off of uncollectible tax arrears, but only after the statutory period for collections has expired. This period is presently six years, after which the STI is statutorily barred from collecting a debt. Since the 2007 tax amnesty effectively wiped all arrears existing at that time off the books, there are no arrears currently on the books that are older than six years. The write off provisions are therefore effectively redundant until 2013, when collection of arrears accrued for the 2008 tax year become statute barred. Since there are a multitude of reasons for tax debts becoming uncollectible, the current write off authority are too restrictive. In addition, many tax administrations automatically and routinely write off small arrears balances, where these are considered uneconomic to collect. Given the large proportion of interest and penalties that make up the stock of arrears in Moldova, it is likely that these comprise many small balances that may be better removed from the debtor's ledger to allow effective use of collections resources.

Resourcing

96. **Collection of tax arrears in the field offices is the responsibility of the Administration Division**. In the larger offices, this work is performed by a separate collections enforcement section within the Division, but in smaller offices the collection work is part of a wider range of tasks performed by administration staff. Collection enforcement is one of the core tax administration functions and requires dedicated staff that are specifically trained to undertake payment recoveries work. While the difficulties in maintaining dedicated specialists in small offices is acknowledged, centralizing the collection

effort in fewer tax offices may prove to be a more effective alternative than allocating the collection tasks to nonspecialist staff.

Recommendations

97. The following is recommended in respect of the recoveries of arrears:

- Ensure measures for arresting the growth in tax arrears contained in the strategic plan are reflected in operational plans.
- Authorize the use of installment payment arrangements in respect of all types of arrears in cases where this is considered the most appropriate method for recovery.
- Extend the write off provisions to cover all debts that are considered uncollectible.
- Implement an automated process for writing off small balances that are considered to be uneconomic to pursue.
- Consolidate tax arrears operations into significantly fewer sites and ensure dedicated and specialist trained staff are engaged on the recovery effort.

IV. Other Tax Administration Issues

A. Value-Added Tax Refunds

Introduction

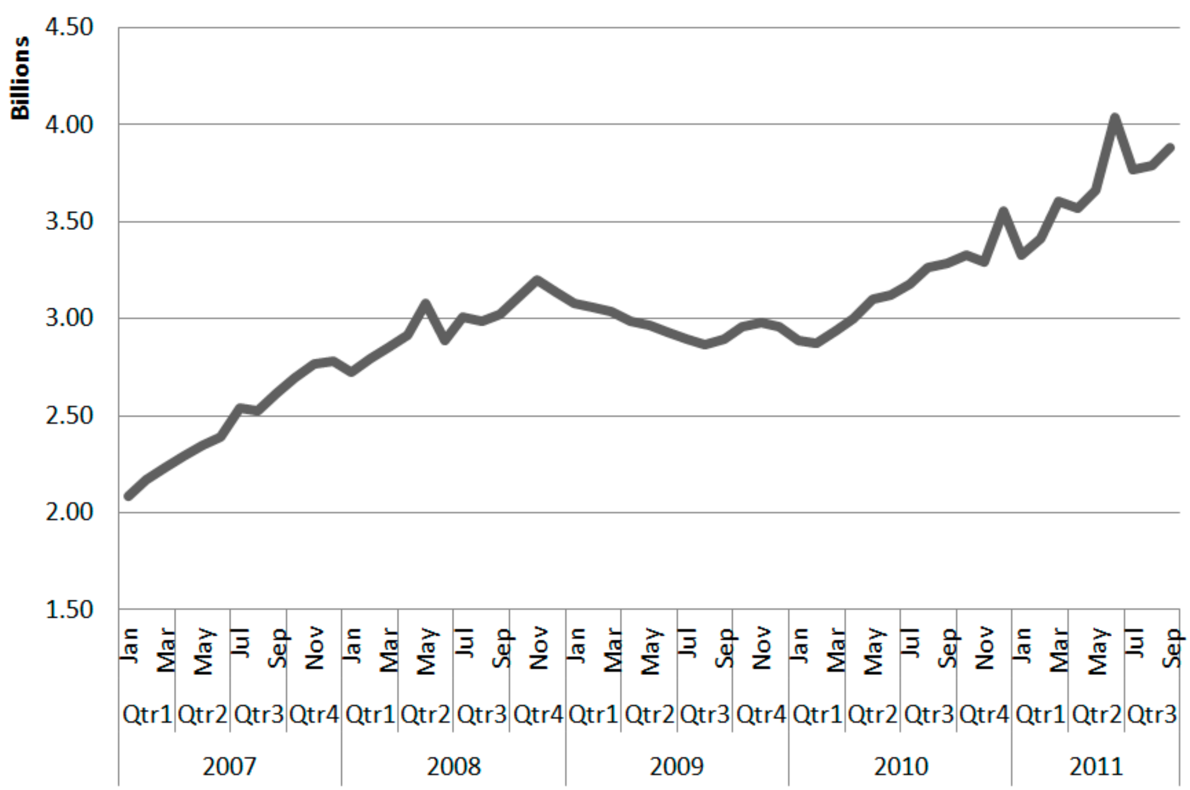
98. **VAT refunds continue to be a highly problematic issue**. This topic has been discussed by successive IMF missions over the years, but despite numerous recommendations for improvements, no discernable progress has been made. The law continues to require that all excess input credits must be carried forward for offsetting against future VAT liabilities. Refunds are available only for exporters and investors in respect of the acquisition of capital goods other than vehicles and furnishings. This has led to a buildup of considerable amounts of excess VAT credits which effectively represent an involuntary loan by taxpayers to the Government and which must at some point be repaid. For those who are eligible, the refund claims process continues to be cumbersome and claims subjected to excessive and unproductive audit scrutiny, resulting in significant administrative and compliance costs.

Accumulation of value-added tax credits

99. **The stock of un-refunded VAT credits is increasing at an alarming rate**. By the end of the third quarter of 2011, the accumulated total had reached a staggering MDL 3.9 billion and continues to rise as shown in figure 1. This is a "fiscal time bomb," as the total amount grows at a rate where eventual repayment becomes ever more problematic. This

said, the extension of cash VAT refunds to purchases of investment goods in the two largest cities should help somewhat to reverse the trend in accumulation of VAT refund credits. Moreover, a big part of the problem stems from the proliferation of reduced-rate supplies (at 8 percent), which benefit from input credit at the standard rate (20 percent). The Government may want to consider gradually raising the reduced rate and/or limiting the scope of supplies subject to the reduced rate. This could both arrest further accumulation of VAT refund credits and generate the funds for their gradual repayment.

Figure 1. Accumulated Value-Added Tax Credits to be Carried Forward, 2007–11



100. **When refunds of excess input credits are denied, the nature of the VAT is effectively altered, in part, from a tax on final consumption to a tax on production**. The denial of refunds of excess input credits primarily stems from concerns about revenue leakage due to fraudulent refund claims, particularly in the face of Moldova's underdeveloped "tax culture" and relatively weak tax administration. However, in addressing these concerns, inadequate weight is evidently given to the economic costs and reduced revenue flows resulting from the detrimental impacts that denied refunds have on business cash flows and therefore investment and growth.

101. **Refunds are a normal feature of the invoice credit form of VAT and can be substantial**. As shown in Table 8, the amount of VAT refunds as a percentage of gross VAT is substantial in most regions. Even in the former Soviet Union countries refunds amount to almost 30 percent of gross VAT collections on average. At 10.6 percent in 2011, refunds in Moldova are clearly much below this average, mostly as a result of the legal restrictions that prevent refunds being paid.

Table 8. Value of Value-Added Tax Refunds by Country/Region

(In percent of gross VAT collections)

	Average [1]
Canada	50.3
EU	38.1
Eastern Europe	36.8
New Zealand	35.5
Former Soviet Union countries	29.6
Latin America	17.4
Middle East	16.2

Sources: IMF survey responses; IMF staff estimates; and *World Economic Outlook*.

[1] Average refund level over a four-year period (1998 to 2001).

102. **Although, VAT refunds are undoubtedly a high compliance risk, denial of refunds is not necessarily the best way to manage that risk**. The denial of refunds and overbearing audit scrutiny of refund claims appear to reflect a misguided view that refunding a Lei (which is treated as public expenditure) is somehow more detrimental to the revenue effort that foregoing a Lei through underpayment of accurate VAT liabilities through under reporting or other means (i.e., lost revenue receipts). In the case of Moldova, the various legal provisions that are aimed at combating abuse of the VAT refund system have resulted in a cumbersome system that has created high administrative costs for the STI and high compliance costs for taxpayers.[15] Verification of input credits that are carried forward to be set off against future VAT liabilities on the other hand are subjected to significantly less scrutiny. Advanced tax administrations adopt a different approach by giving strong emphasis

[15] In particular, the present requirement that a VAT refund cannot be made until the STI has confirmed that the input tax in respect of any transaction has in fact been declared and paid as output tax by the other party to the transaction, poses an unreasonable verification burden on the STI, which is effectively required to audit each refund claim as a consequence. Similarly, the restriction of refunds to exporters to 20 percent of the value of exported goods in the tax period also complicates the refund calculation and requires significant supporting documentation. (This latter restriction exists to ensure refunds to exporters are restricted to the proportion of their production that is actually exported so that they do not receive a more favourable treatment than domestic producers in respect of goods destined for the domestic market.)

to risk-based audit programs aimed at broad coverage of taxpayer groups and compliance issues to combat abuse, rather than relying on legislative restrictions than frequently have unintended consequences. In this way, compliance efforts are targeted at high risk taxpayers while compliant taxpayers are left to conduct their business and contribute to growth and employment, without the additional costs that universal restrictions and overbearing scrutiny bring.

103. **An efficient VAT system would facilitate refunds to all taxpayers as soon as possible.** This means paying refunds as a matter of course, subject of course to appropriate risk-based controls, and as soon as possible. The stock of accumulated VAT credits presents a significant transition problem for adopting such a full refunding approach. Given the high value of accumulated VAT credits, a structured program will be needed to transition to a full refunding approach. A first priority of such a program should be to arrest the growth in accumulating credits, by allowing full refunding of excess input credits arising in the current and future tax periods. The accumulated stock of credits can then be isolated and an ordered and phased refunding program developed that can be accommodated within existing fiscal constraints.

Claiming value-added tax refunds

104. **The process for claiming VAT refunds is unnecessarily cumbersome**. There is considerable scope for simplifying the refund claims system if full refunding is implemented. In particular, no separate claims should be necessary, as taxpayers could simply indicate on the VAT return how they want their refund treated (paid to their bank account, set off against other tax liabilities, etc.). While the ability to set a refund entitlement against future tax liabilities could be retained on a voluntary basis, this will require the necessary functionality to be available in the taxpayer accounting system to accurately track the offsetting across multiple tax periods.

105. **Audit scrutiny of VAT refunds could also be simplified**. Selective verification of VAT refunds is simply one of many components of a wide-ranging audit program. Advanced tax administrations (i.e., those applying principles of self-assessment and administering domestic VAT along with income tax in a function-based organizational structure) give strong emphasis to risk-based audit programs aimed at broad coverage of taxpayer groups and compliance issues. The effectiveness of the current VAT refund audit strategy on the other hand must be doubtful, as audit results are modest. As can be seen from Table 9 below, despite purportedly high strike rates, VAT refund audits conducted during 2010 and 2011 only yielded MDL 12.2 million and MDL 13.5 million respectively. These results are hardly consistent with the high fraud risks attributed to VAT refunds.

Table 9. Moldova: Value-Added Tax Refunds Audit Results, 2010–11

	2010			2011		
	Number	Percent Adjusted	Additional Tax (mil)	Number	Percent Adjusted	Additional Tax (mil)
Large taxpayers	93	62	2.3	85	65	4.6
Other taxpayers	1,157	53	9.9	1,344	50	8.9
Total	**1,250**		**12.2**	**1,429**		**13.5**

Source: State Tax Inspectorate.

Budgeting for VAT refunds

106. **Payments of refunds are sometimes delayed due to budget constraints**. Although approval of refund claims is the responsibility of the STI, actual disbursement of refund entitlements is the responsibility of the Ministry of Finance. Existing instructions allow the STI 37 days to approve or disallow a refund claim and the Ministry of Finance 8 days to facilitate disbursement of the refund amount. However, the disbursement is sometimes delayed due to lack of funds, as Moldova treats refunds as expenditure rather than a revenue item.[16] By following the example of many other countries, including countries in Europe (Ireland, Denmark, Netherlands, United Kingdom, and others) and adopting the approach of paying VAT refunds from gross VAT receipts, such funding problems can be avoided.

Recommendations

107. The following is recommended in respect of the administration of VAT refunds:

- Remove all restrictions on VAT refund entitlements by allowing all VAT payers to receive a full refund of excess input credits arising in the current and future tax periods, subject to risk-based audit controls, which may require law changes.

[16] There are two methods of budgeting for VAT refunds: (1) making payments from gross VAT revenue; or (2) paying from budget expenditure appropriations. With the latter method, an accurate forecast of refunds has to be made to ensure adequate funds are appropriated to meet refund expenditures throughout the tax year, which is invariably problematic and leads to an inability to meet refund claims when appropriated funds have been exhausted.

- Consider gradually raising the reduced rate and/or limiting the scope of supplies subject to the reduced rate.

- Develop a structured program for repayment of accumulated credits that have arisen in previous tax periods that allows the current stock of accumulated credits to be depleted over a number of years and in a way that can be accommodated within fiscal constraints.

- Once refund entitlement restrictions are removed, remove the need for taxpayers to make a separate application to receive their refund entitlement by treating the tax return as the application in any case where an excess of input tax over output tax occurs.

- Remove the requirement that all VAT refunds are audited (whether before or after payment of the refund) in favor of a targeted risk-based audit program.

- Remove the requirement that VAT refunds are treated as an expenditure that requires a budget appropriation and pay VAT refunds from gross VAT receipts.

B. Streamlining Headquarters and Field Offices Organization Structures

Introduction

108. **The mission was asked to again consider the organizational structures of the STI.** Previous FAD missions have made key recommendations on STI structures for both the headquarters and field offices. In particular, it was recommended that the STI: (1) strengthen headquarters by implementing a headquarters organized according to functions with key supporting departments; and (2) develop options for the rationalization and merger of local tax offices into a consolidated regional delivery network. The observations and recommendations on organizational matters made by previous missions are still valid and are largely repeated here.

109. **The current organization of the STI is not markedly different from the structure reviewed by previous FAD missions.** The STI has 1,986 employees spread across headquarters (232 staff), a large taxpayer office (59 staff), a call center (13 staff) and a network of 35 regional tax offices (1,682 staff). In addition, a state enterprise "Fiscservinform" has been established to manage IT related issues on behalf of the STI. This enterprise employs 117 staff, including 65 staff that deal with returns filing, data processing and payments operations. The STI's headquarters organization remains a hybrid largely

reflecting a functional organization design, with some features pertaining to taxpayer segmentation and some remnants of "tax type" approaches.[17]

Field Offices

110. **The number of offices within the delivery network remains unusually high in comparison to the number of taxpayers** The 2008 mission reported that, based on the 2007 FAD mission's recommendations, the STI had developed a number of organizational models that reduced the number of field offices to approximately eight. A reorganization proposal was forwarded to the Government for consideration. However, the STI had at that stage not obtained approval to proceed with the implementation. Today, the network of field offices remains the same and no progress has been made on this issue. A radical overhaul and slimming down of the network of field offices remains necessary. The aim of such a structural reform is to make tax administration delivery more efficient and effective. In this context, the STI should use an appropriate mix of re-organization methods, including: merging offices and centralizing tasks.

111. **The STI should seek, over time, to merge the current 35 local tax offices into a much reduced number of modernized facilities.** Perhaps not more than six–eight such offices will be required. This would effectively establish regional offices that are large enough to operate effectively across a number of municipalities. It is not only costly to uphold the current number of rather small tax offices, it also imposes a risk to a uniform implementation of tax laws throughout Moldova, as small offices cannot develop and maintain sufficient knowledge, experience, and specialization in all aspects of tax administration. The current infrastructure situation in Moldova may necessitate, though, that limited tax administration presence be maintained in remote areas. This could be either in the form of a permanent tax administration presence (small satellite offices) or an arrangement where tax administration personnel are present a few days a month (mobile offices). Each satellite office would report to the regional tax office in its geographic area. Merging tax offices is a sensitive issue in most countries. Nevertheless, it is inconsistent with best administrative practice and increasingly costly for the authorities to maintain small and unviable offices when more efficient tax administration, with economies of scale, can be achieved by consolidating tasks in fewer and more effective offices.

112. **Centralization of tasks should also be considered.** The STI has already achieved important efficiency gains by centralizing national processing of tax returns to exploit economies of scale over large volumes of processing.[18] A centralized contact center has also been established in Chisinau to facilitate taxpayers' service needs. These are very

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[17] The Tax Administration Methodology Directorate still has separate sections for direct and indirect taxes.

[18] This task is performed by Fiscservinform.

commendable initiatives; the STI should continue in that direction and explore other areas of tax administration where efficiency gains can be achieved by concentrating work in either a single or a few places. This may involve, for example, that one specific task be performed by one of the regional offices on behalf of all regional offices. Other tasks may be performed by 2- 4 regional offices on behalf of all regional offices.[19]

113. **As a transitional measure, all field activities except taxpayer services could be centralized into regional centers.** The STI could determine the six–eight offices that will become the regional centers for tax administration and centralize all activities except taxpayer services that require face-to-face contact with taxpayers, into those regional centers; this would leave the remaining centers as small satellite offices that report to one of the regions. The longer term future of these satellite offices can be determined later on the basis of their cost viability.

Headquarters

114. **Previous missions also made a number of observations about the STI headquarters.** In particular (1) the headquarters appeared overly fragmented—there are multiple accountabilities for delivery functions spread across deputy heads and there is a lack of clarity between organizational units concerning some of the key tax administration functions; and (2) there was not a clear delineation between headquarters and the field operation. Although the STI has moved some way to redress these issues, further improvements remain possible.

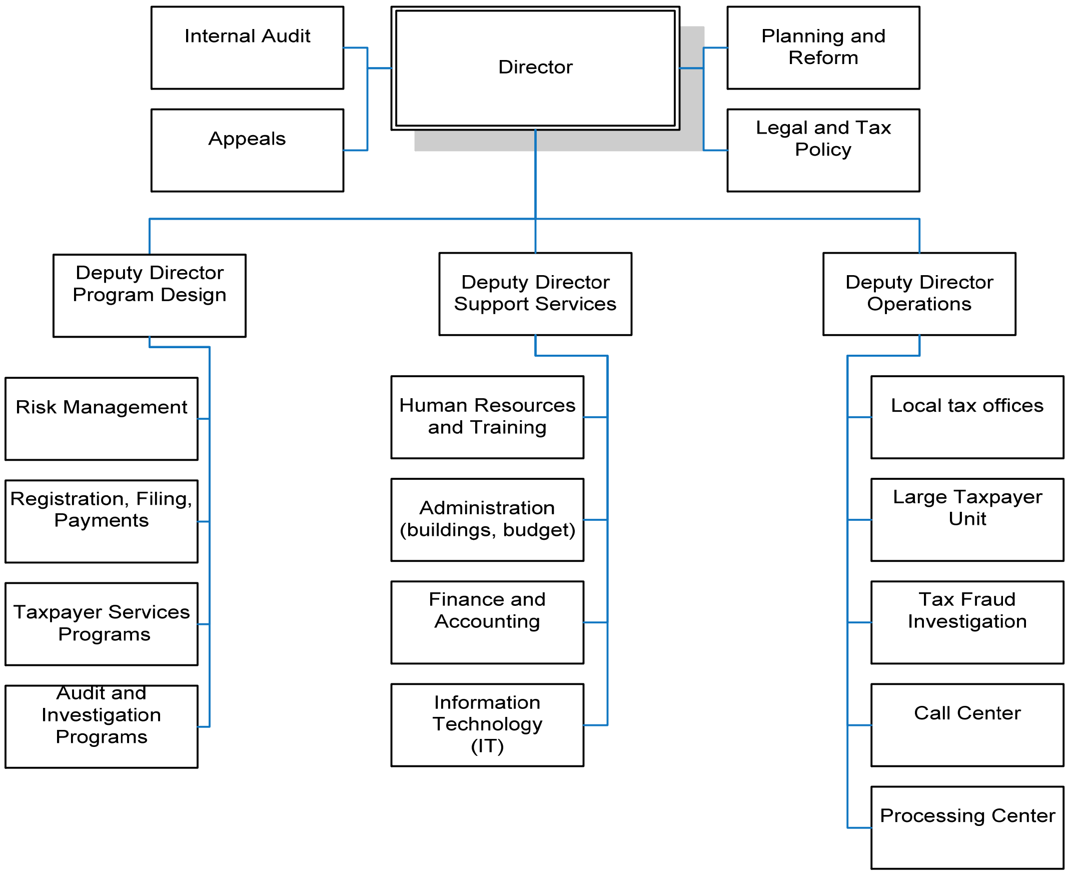
115. **The mission therefore reiterates the advice provided by previous missions.** It recommends the STI to consider amending its structure to conform better to the structure set out in Figure 2 below. This organization chart also incorporates current STI intentions to establish units for Planning and Reform and Risk Management Analysis (both fully supported by this mission) and this and previous FAD missions' recommendations to establish a unit dedicated to taxpayer services (program and product design).

116. **The proposal has taken account of current Government regulations, which allow the tax agency to employ three deputy directors only**. Otherwise, the organization chart would have shown four deputy director positions in that LTO would also be managed by a deputy director. This is due to the importance of this unit to the overall collection of budget

[19] For example, in Denmark regional offices all perform identical core activities. However, a number of specialized tasks (e.g., the administration of excises) are not performed at all regional offices. Instead, five regional offices manage these tasks on behalf of all regional offices on top of their core tasks. To increase corporate expertise and become "centers for excellence" on each particular issue, they collaborate and exchange experience in a horizontal network; the networking may also include joint training activities to further improve staff expertise and, thus, improve the quality of tax administration delivery. Other specialized tasks are concentrated within other regional offices (two–eight), similarly working in a network.

revenue and the complexity and sensitivity of the work of the unit, which justifies and necessitates a short reporting line to the STI Head. There is an urgent need to ease the mentioned and other restrictions that limit the STI in establishing its organization structure on the basis of its business needs.

Figure 2. Moldova: Proposed Structure of Headquarters Organization



Recommendations

117. These are the recommendations on organization structures, which are identical to these made by previous missions:

- Rationalize the network of field offices into six to eight regional centers.
- Strengthen headquarters by implementing a headquarters structure organized according to function with key supporting departments.

C. Modernizing Information Technology Systems

118. **The STI's IT system is outdated and does not adequately support core tax administration functions.** Previous FAD missions have expressed concerns about the capabilities of the STI's IT system, which severely constrains ongoing reform efforts. As noted in these reports, various functional areas are desperately in need of improved IT support, and the inflexibility of those systems currently in place is also a significant impediment to the much needed organizational streamlining of the STI's field structure. Many reform initiatives simply cannot be implemented in the current IT environment. These missions have recommended that the IT system be upgraded or replaced with a new system. In this context, the authorities are now with the World Bank exploring the possibilities for launching a major project to reform the IT system and streamline all the associated business processes, etc.

119. **It has been concluded that upgrading the current IT system is not a viable option and a new system would need to be procured.** The procurement of a new IT system is a significant undertaking, which will require substantial time and funding. The intention is to acquire a Commercial Off-The-Shelf System (COTS)—a proven software package consisting of a suite of products which are specifically designed for tax administration, along with expert implementation staff. The project would require some customization of the COTS software, the acquisition of hardware, the establishment of an appropriate network, comprehensive re-engineer of the STI's business processes to match the capabilities of a modern IT system, and the training of STI personnel and the taxpayer community.

120. **There are major differences between implementing a COTS solution and a project which involves major in-house software development of modifications to a COTS solution.** The cost is known prior to making a decision to proceed. This is contrary to projects involving major in-house design and build/integrate efforts, which are much harder to estimate. Many such large-scale projects fail because of underestimation of both cost and time-to-market factors. Another significant difference can be with business processes. Implementation of a COTS product can deliberately adopt those business processes inherent to the product. That is, the way the tax administration works is changed to match the product selected. In cases where existing business processes in tax administration are far from best practice (as is the case in Moldova), this style of implementation can also have the benefit of automatically introducing best practice processes as well as systems.

121. **The STI is determined to move quickly with the IT modernization and major work has been done to develop a strategy for the reform.** Based on FAD advice and with significant assistance of the resident EU tax administration advisor, efforts have been made

to develop major components of an IT strategy[20] for the reform in that the current state has been fully documented. Efforts should now commence on defining the user requirements to a new system (the future state report). In this context, it must be ensured that the STI's business units (e.g., taxpayer registration, returns processing, payment and arrears management, audit, investigation, appeals, legal, human resource management, statistics) are fully involved in the process, as it is critical that the business units" fully endorse the final software package solution chosen. By including the business units in all stages, the project will be recognized within the STI as a business led project and not just an IT initiative.

122. **Care should be taken to minimize any customization of the new software packet.** Typically, businesses or government institutions who opt for COTS for their IT needs, consider all options for adapting their internal business processes before contemplating customization of the new software**.** Similarly, the STI should make every effort to ensure that the level of software customization is kept to an essential minimum as customization will defeat the purpose of selecting an off the shelf software package solution and will greatly increase the cost of the overall IT systems modernization. Since modern tax administration package systems accommodate modern tax administration business processes, the STI's business processes (and likely also a number of laws) should be redesigned to ensure the necessary alignment with the new system – effectively a reverse re-engineering of the business processes. The need for customization of the new system to the STI's business processes would consequently be reduced. This approach will therefore significantly curtail the procurement and implementation timeframes and is likely to be less expensive.

123. **There is a range of specialized COTS products available on the market.** These can fulfill more granular functionalities such as tax accounting, rules/processing engines, document management, reporting, analysis, workflow etc., and modern architecture can facilitate integration of these products with already custom built items, which the STI may want to maintain. The use of COTS products in high-risk, high dependency areas such as accounting is the direction adopted generally across many industries/organizations and commoditized products such as document management, and risk management; print/channel management solutions also are generally used rather than custom made developments. Similarly, packaged suites of integration tools are almost universally used rather than attempting to reproduce functionality locally.

124. **The current project governance framework within the STI will need to be significantly strengthened to support the IT modernization reform.** While the WB may likely undertake the tender activity to procure the new IT system, it is essential that the STI

[20] An IT strategy normally comprises five components: (1) the business context and IT architecture positions; (2) a current state report; (3) a future state report; (4) a transition plan; and (5) a maintenance plan. The end product would be a comprehensive document containing the detailed user requirements for the new system. This document would be critical for developing the tender to procure the new system.

manages the implementation of the IT system and the subsequent modernization of the business processes. Therefore it is important that an appropriate governance framework is in place in order to (1) ensure the most optimal use of resources by assessing project risks and their impact on the overall program; (2) assign roles and responsibilities and demand accountability; (3) balance and resolve possible conflicts between competing resource needs of current revenue operations and reform activities; and (4) assure program/project financiers that there is a sound accountability mechanism. It is recognized best practice to have all projects managed by a central project office regardless of whether or not they are business or IT related projects. Experienced project managers' work across functions and in some cases manage more than one project at a time in order to avoid duplication across the organization.

125. **The role of business managers as owners of their part of the IT system will need to be maintained within the STI.** While the responsibility for care and maintenance of the IT systems may be outsourced to FiscServInform, ownership of the systems should be vested in the various STI business managers whose business the IT system support. For example, the registration component of the system should be owned by the manager in the STI headquarters who is responsible for design issues relating to the service and registration processes. Similarly, the collections system should be owned by the director for collections and the audit case selection system by the audit director. The acceptance and performance of their role as system owners will be critical for the introduction of a new IT system. A more detailed description of the role and responsibilities of business managers as IT systems owners is set out in Appendix 6. For illustration purposes only, the mission provided the STI with a copy of recently established user requirements for an identical IT project in a tax administration in Europe.

Recommendations

126. These are the recommendations related to IT reform:

- Develop user requirements to a new system that will require minimal customization of the future selected COTS software.
- Ensure an adequate modernization program governance framework is in place.
- Maintain the "business owner" role for IT systems across all STI business units.

Appendix 1. Moldova: Preliminary Review of Tax Revenue Performance

Overview of revenue performance

Tax revenue, as a percent of GDP, has been declining. Table 10, below, displays the tax revenue collection performance for the years 2007 through 2011 in both value terms and as a percent of GDP, organized into Government Finance Statistics categories. From 2007 to 2011 tax revenue has shown a decline of approximately 3.5 percentage points of GDP, or roughly 10 percent.

Table 10. Tax Revenue by Value and as a Percent of GDP, 2007–11.

	2007		2008		2009		2010		2011	
	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP	MDL (billions)	% of GDP
Tax revenue	**18.4**	**34.4**	**21.3**	**33.8**	**19.6**	**32.4**	**22.5**	**31.4**	**25.6**	**30.9**
1.1.1. Taxes on Income, Profits, and Capital Gains	2.7	5.1	2.2	3.5	1.9	3.2	2.0	2.8	2.3	2.8
Profit tax	1.4	2.6	0.7	1.1	0.4	0.7	0.5	0.7	0.6	0.7
Personal income tax	1.3	2.5	1.5	2.4	1.5	2.4	1.5	2.1	1.8	2.1
1.1.2. Taxes on Payroll and Workforce	5.2	9.7	6.6	10.5	7.0	11.5	7.5	10.4	8.2	9.9
Social Fund contributions	4.4	8.2	5.4	8.6	5.6	9.2	6.0	8.3	6.6	7.9
Health Fund contributions	0.8	1.6	1.2	1.8	1.4	2.3	1.5	2.1	1.6	2.0
1.1.3 Taxes on Property	0.2	0.4	0.3	0.4	0.3	0.4	0.3	0.4	0.3	0.3
1.1.4. Taxes on Goods and Services	9.0	16.8	10.7	17.0	9.1	15.1	11.2	15.6	13.1	15.8
VAT	7.6	14.2	9.1	14.5	7.6	12.6	9.1	12.7	10.5	12.6
Excises	1.4	2.6	1.6	2.5	1.5	2.5	2.1	2.9	2.7	3.2
1.1.5. Taxes on International Trade and Transactions	0.9	1.7	1.2	1.8	0.9	1.5	1.1	1.5	1.2	1.4
1.1.6. Other Taxes	0.4	0.7	0.4	0.7	0.4	0.7	0.5	0.6	0.4	0.5
GDP 1/	53.4		62.9		60.4		71.8		82.9	

Source: Moldova Ministry of Finance.
1/ Value for 2011 is a preliminary estimate.

Of particular concern has been the decline in the performance of the VAT and the social fund payroll tax. Together these two taxes comprised 66 percent of tax revenues in 2011. In order to analyze the contributing factors to their declining performance relative to GDP, the authorities have been asked to provide detailed breakdowns on the collections. As of the time of the submission of this report only detailed data on domestic VAT collections for the years 2008–11 has been assembled. Data on customs collections of VAT, social fund contributions collections data, and additional data on domestic collections of VAT is pending. Obtaining data from customs has proceeded slowly due to the necessity for following protocols. The social insurance data might not be available until June, as the due date for the 2011 detailed annual return is April 25.[21] On receipt of this data a report with a more complete revenue performance analysis will be produced.

Preliminary Results of Analysis of Domestic VAT Collections

Over the period 2009 to 2011, while VAT collections were falling in relation to GDP, the amount of output declared on VAT returns actually increased in relation to GDP. Total declared output (taxable, zero-rated, and exempt supplies) grew in relation to GDP from a ratio of 2.49 output to GDP to 2.54 output to GDP. This statistic reveals that the reduced revenue performance may not be due to undeclared output of taxpayers, but more relates to the nature of the output being declared. The VAT return data allows for decomposing the output declared by taxpayers into supplies subject to the normal VAT rate, supplies taxed at the reduced rate, zero-rated supplies, and exempt supplies. By analyzing the changes in the proportions each of these supplies to total output estimates of the revenue impacts of the changing proportions of each of these components of output can be assessed.

It is estimated that from 2009 to 2011, the increased proportion of reduced rate supplies being declared reduced potential output tax on supplies by MDL 1.3 billion. This was estimated by comparing the proportion of reduced rate supplies to total output for each month in 2011 to the corresponding month in 2009, for each sector of activity. On average, reduced rate supplies grew from 8.4 percent of total output to 14.5 percent. The difference in the amount of 2011 output which would have been taxable at the full rate using the change in proportion of reduced rate output was then multiplied by the difference between the normal rate and the reduced rate to estimate the potential change in output tax.[22] For 2010 the increased proportion of reduced rate supplies, as compared to 2009, reduced potential output tax by MDL 1.0 billion.

It is also estimated that the increased proportion of zero-rated supplies in 2011, as compared to 2009, reduced potential output tax by MDL 1.1 billion. Again, this estimate was performed by comparing the ratio of zero-rated supplies to total output in 2009 and 2011, and applying the difference in the rates to the net change in volume of such supplies. On average the proportion of zero-rated supplies to total output grew from an average of 12.9 percent to 15.3 percent. For 2010 the increase proportion of zero-rated supplies reduced potential output tax by MDL 0.5 billion.

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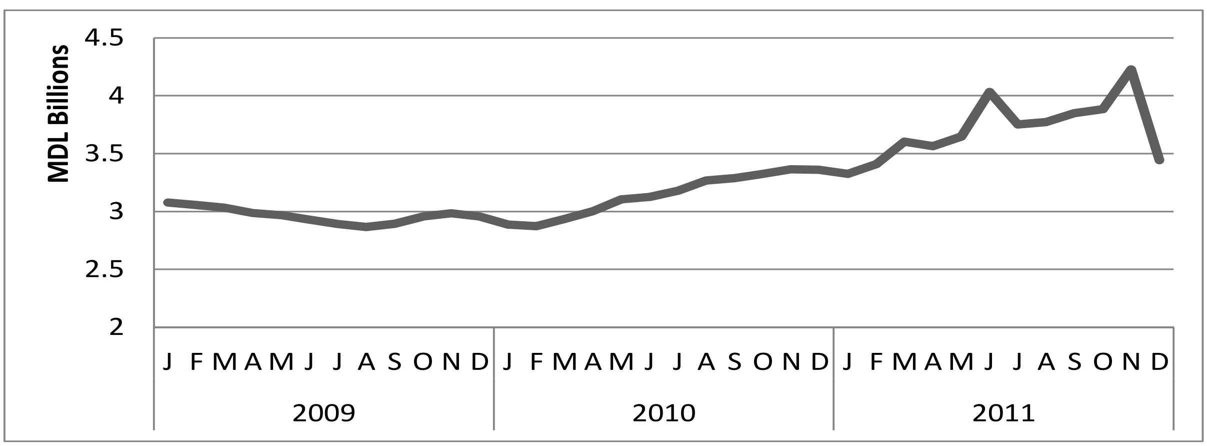
[21] Following receipt of the returns, it could take six to eight weeks to capture and verify the data in the system.

[22] The electricity, gas, and water sector was excluded from this analysis, due to the separate, lower, reduced rate supply for gas supplies.

Offsetting these two reductions in output tax it is estimated that shifts in the composition of output resulted in a slight decrease in credits for input tax of MDL 0.1 billion. Input tax credits would have been affected over the period by two factors: increased output of reduced rate supplies may have resulted in reduced tax on inputs, while there was a decrease in the amount of exempt output, which would have increased claims for input tax credits. Unfortunately the impact of these two factors on input tax credits claimed cannot be easily isolated, and so only a joint estimate can be performed. The impact on input tax credits was estimated by calculating the input tax credit to output ratio for 2009 (by tax period and sector) and applying it to the 2011 returns data to estimate the change in input tax credits.[23] For 2010 the impact on input tax credits would have been greater, resulting in a net decrease in input tax credits of MDL 0.4 billion.

The combined resultant impact on net VAT for 2011 is estimated to be MDL 2.3 billion, or roughly 2.7 percent of GDP.[24] For 2010 the combined impact on net VAT is estimated to have been MDL 1.1 billion, or around 1.6 percent of GDP. Part of the revenue decrease would have also been offset by reduced support to farmers that was implemented in 2010 as part of the package which increased the schedule of supplies taxable at a reduced rate.

Figure 3. Moldova: Stock of Value-Added Tax Credit, As Reported on Line 21 of the Value-Added Tax Return



[23] While it would be better to use the input tax credit to inputs ratio, large anomalies were discovered in the values reported for inputs, yielding highly inconsistent ratio values. A more thorough examination of this and other data issues will be provided in the final report on the revenue performance analysis.

[24] This is the reduce output tax from the increased proportion of reduced rate supplies, plus the reduced output tax from increased zero-rated supplies, minus the drop in input tax credits.

Of the estimated MDL 2.3 billion reduction in net VAT for 2011, MDL 0.8 billion reduced VAT payable (or 0.9 percent of GDP), while MDL 1.5 billion (1.8 percent of GDP) resulted in increased refundable VAT or additional excess-credit carry-forward. The decrease in net VAT impacts both the VAT payable as well as the VAT refundable, or available to taxpayers as excess credit carry-forwards. As there was no notable increase in the value of VAT refunds for 2011 (MDL 1.2 billion in 2009 and 2011), the bulk of the impact of these changes would have been realized in the accumulation of excess credits. As can be seen in Figure 3, while the stock of excess credits declined in 2009, they grew substantially through 2010 and 2011.

Appendix 2. Moldova: Nontax Administration Tasks Handled by the State Tax Inspectorate

- Disposal of seized goods, goods retained as evidence of crime and other property that has fallen into state ownership.
- Collecting unpaid loans made by the State or its agencies to business borrowers.
- Collecting fines imposed on businesses or people who have carried out unlicensed or banned economic activities.
- Carrying out audits to ensure that dividends due from state-owned companies to the State have actually been paid.
- Checking the accuracy of settling state tax.
- Collecting a levy on the incomes of those opting for an alternative form of compulsory military service.
- Collecting a special levy on natural gas supplies from a gas company.
- Monitoring aspects of international trade or finance at individual company level where goods or funds end up in Moldova as a result of these trades.
- Collecting a levy on capital investment in the construction industry.
- Preventing and detecting specified illegal activity involving motor cars.
- Working with the Agriculture Ministry to police the sealing of containers used in production of alcohol.
- Carrying out tax audits as requested by other state bodies as well as at the request filed by the citizens.
- Certifying and auditing court-controlled bank accounts.
- Policing certain price controls on staple foods.
- Acting as a paying agent for certain State debts.
- Auditing businesses to determine the mark up rates and transport costs of imported goods.

Appendix 3. Moldova: Personal Income Tax Reporting for 2010

(A)	(B) Type of Income 1/	(C) Statutory Tax Rates for 2010	(D) Gross Income Reported (in MDL)	(E) PIT Reported (in MDL)	(G) Percent of Gross Income (D)/Total (D)	(H) Percent of Total PIT (E)/ Total (E)
1	Wages	7/18 Percent	23,206	1,489.46	82.8967	74.0933
2	Dividends	15 Percent	2,109	286.62	7.5371	14.2578
3	Rental and real estate income	10 Percent	532	53.01	1.9009	2.6369
4	Article 71 payments to nonresidents	Various	290	39.89	1.0365	1.9845
5	Interest	15 Percent	405	35.07	1.4473	1.7446
6	Patent payments	5 Percent	838	27.56	2.9945	1.3710
7	Royalties	15 Percent	257	27.18	.9167	1.2524
8	Other income	Various	141	21.15	.5037	1.0521
9	Capital gains	7/18 Percent	97	14.55	.3465	.7238
10	Gambling and prizes	18 Percent	36	6.63	.1290	.3298
11	Payments settled by nonresidents	15 Percent	30	4.47	.1063	.2222
12	Promotional campaign income	10 Percent	24	2.57	.0867	.1280
13	International income	15 Percent	13	1.97	.0470	.0981
14	Settlements with founders	15 Percent	7	1.07	.0255	.0532
15	Enterprises – natural persons	15 Percent	5	.68	.0161	.0336
16	Equity draws from corporations	15 percent	3	.37	.0094	.0183
17	Annuities	18 Percent	.03	.01	.0001	.0003
	Total		27,994	2,010.25		

1/ Income and tax figures provided by STI.

2/ STI withholding information program and CET08 (PIT return) information for 2010 have been combined to determine gross income and PIT totals.

Appendix 4. Moldova: Illustration of a Potential High-Wealth Individuals Project Plan (Phase 1)

The first phase is to develop a working definition of a HWI taxpayer, identify taxpayers that meet this definition, and complete the compliance risk assessment for identified HWI taxpayers. This assignment should be the responsibility of HWI Project Team.

Task Name	Estimated Start Date	Accumulated Calendar Days	Estimated Completion Date
PHASE 1: ARTICULATE THE RISK (Start date: April 2012)			
1) Define what constitutes a high-wealth individual (HWI)	March 2012	30 days	April 2012
2) Determine the HWI population based on the HWI definition	April 2012	90 days	May 2012
3) Gather available data on the HWI population	March 2012	90 days	May 2012
a) Identify data sources			
b) Complete a compilation and description of each data source			
c) Determine IT capability to electronically access data			
d) Will a capacity to store HWI electronic data (e-data) be possible?			
i) If no, conventional file and storage methods will need to be provided.			
ii) If yes, an e-file for each HWI taxpayer will need to be created within a master database.			
e) Data entry from identified data sources to be completed			

Task Name	Estimated Start Date	Accumulated Calendar Days	Estimated Completion Date
4) Analyze data and quantify the attributes and characteristics of this population	May 2012	150 days	June 2012
a) Develop analytical process appropriate to review and summarize data compiled			
b) Complete analysis/review of data and compile into a usable summary of HWI taxpayers			
5) Complete a written summary highlighting:	June 2012	210 days	August 2012
a) HWI attributes and characteristics			
b) HWI trends			
c) HWI PIT contributions for 2008, 2009, & 2010			
d) HWI tax gap projections			
e) HWI risk compliance projections			
f) Identify likely HWI taxpayers that high-risk for noncompliance			

Appendix 5. Moldova: Illustration of a Potential Indirect Audit Training Schedule

Implementation of Training for the Examination of Income:

1. A training development team consisting of a project lead, an experienced auditor, a HQ person, and a training officer would be recommended to coordinate necessary training of auditors to implement indirect audit methodologies within STI.

2. As the training materials are being prepared, the team will make recommendations and decisions to support training delivery, such as approvals, budget, location, facilities, number of participants, instructors, testing, and certification.

3. Establish planned delivery dates for the training.

Major projected actions and timeline to ensure delivery of indirect training in 2013 are outlined below.

Action	Timeline Estimate Calendar Days	Accumulated Time Calendar Days	Estimated Completion Date
1) Obtain necessary approvals for funding and development of indirect methods training. Include in 2012/2013 training plan.	30 days	30 days	March 2012
2) Establish training development team for approved course(s)	30 days	60 days	April 2012
3) Gather training guides, technical materials, and internal procedures for preparing the training materials	60 days	120 days	June 2012
4) Draft training materials	60 days	180 days	August 2012
5) Review and approve training materials	60 days	240 days	October 2012
6) Schedule training and technical support/instructors	30 days	270 days	November 2012
7) Start indirect training	120 days	480 days	March 2013
8) Estimated Completion Date	30 days	510 days	April 2013

Delivery Dates:

Completion of indirect training in the spring of 2013 would allow skilled examiners to be available for the expected audits of 2012 PIT using indirect methods to start in July/August of 2013.

Appendix 6. Moldova: Roles and Responsibilities of a Business Owner for Information Technology Systems

General

- Defines the scope and strategic objectives of the business system. Establishes objectives and plans for the ongoing support, maintenance and enhancement of the application.

- Learns and understands the overall purpose and sufficient details of the IT system to manage or direct the day-to-day business operations of the system for their unit's area of responsibility.

- Conducts periodic reviews of the system operations in conjunction with IT to ensure system is working as intended.

- When systems issues arise, ensures appropriate root cause problem resolution has occurred and that system issues are addressed and communicated accordingly.

- Makes final decisions in situations where stored system data is inaccurate after appraising the impact to system customers versus resources and time available to fix the problem.

- Collaborates with IT to develop and maintain a system business continuity plan including business-operating procedures to support the IT disaster recovery plan.

System Changes and Enhancements

- Defines system requirements for new systems and system enhancements.

- Reviews and prioritizes requests for new systems and system enhancements and considers options including business process reengineering prior to recommending an IT system change.

- For approved system changes, coordinates with their business analysts to ensure an appropriate test plan is prepared and executed, and monitors the testing and review of the system during development.

- Provides final approval for implementing changes to the production system and formally accepts the system as complete and ready for production.

- Ensures the implementation of effective system roll-out plans to include, (1) adequate user communications, (2) quality of user training and the related training documents, and (3) preparedness of help desk support.

- Communicates planned and completed changes, improvements, and other important information about the system to users and support personnel as needed.

- Participates in planning for enterprise system-wide upgrades.

User Access Control

- Establishes criteria for controlling user access to the various features of the system including the prerequisites for users who need read/write access.

- Controls access to personal identity information.

User Training and Support

- Establishes and maintains a training program for all staff updating data in the system and provide other training as needed for users who will be accessing and reviewing information in the system.

- Ensures the availability and quality of user training and related materials, reliability and the preparedness of help desk and other technical support processes and personnel.

Data Integrity

- Ensures the availability, reliability and security of the business data stored in the system.

- Recommends improvements to the system to maintain an efficient and accurate process for providing taxpayer-oriented information.

- Oversees the maintenance and reviews data security, reliability, and integrity.

- Conducts periodic reviews with IT of the data to ensure data is accurate and secure.

- Ensures data input controls are documented, effective, and tested periodically.

- Reviews and, if acceptable, approves requests to use data in standard management reports, or as inputs to other systems. Participates in the development and maintenance of standard management reports based on system data.