

Economic Policy Review



October 2006

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Institute for Market Economics is a winner of a 2006 Templeton Freedom Award



On October 31st 2006 Krassen Stanchev was awarded the *Special Prize* for "overall contribution to the spirit of liberty". The award is recognition of the high quality hard work of the Institute for Market Economics, of the professionalism and Institute's independence throughout the years.

The newly established Georgi Vassilev Fund awarded the first award to Hristo Hristov, journalist in *Dennik* daily newspaper for his book "Kill the Tramp".

Congratulations!

Bulgaria Re-elected the President. So, What?

Krassen Stanchev

Run-off presidential elections in Bulgaria last Sunday have had a predictable winner, the incumbent president Georgy Parvanov. Why the predictability, and what this result would mean for the immediate future of the country?

On the second round, needed because in the first 45% of the voter took part, the competition was between the incumbent president and self-made chauvinist, Volen Siderov, leader of Ataka.

Ataka opposes privatization, trade liberalization, and EU and North-Atlantic identity of Bulgaria's foreign policy. It also claims that minorities of Bulgarian Turks and Roma *de facto* exploit the majority of the Bulgarian citizens through a) the party Muslim typically vote for, the Movement for Rights and Freedoms (MRF)*, which by tradition and due to consolidation of its voter constituency holds the swing vote in the parliament for already many years; and b) the free-riding on the governments and EU welfare programs. Ataka had surprised many if not all political observers' expectations for the last year general elections, by winning 15 seats in the 240-member parliament. Siderov's key electoral message than was to ban MRF, exit Iraq and NATO and renationalize privatized industries, thus "Giving Bulgaria Back to Bulgarians".¹ Those messages were not amended significantly this year, the accent, however, was put on "fighting" mafia that was allegedly rooted in the links with mainstream political parties, including Bulgarian Socialist Party (BSP), a successor of the Communists and MRF. Georgy Parvanov was a still remains informal leader of BSP.

Bulgarian citizen usually vote in relatively big numbers in presidential elections. The average voter turnout in 1992, 1996 and 2001 elections for a head of state was 60-70%. On October 29th, only 40% took part in the elections: Parvanov got ¾ of the vote or about 30% of the all votes.

There are four reasons that have made this outcome inevitable.

¹ See analysis of those elections in the respective issues of the *Economic Policy Review*.

1. Right of the center political parties have suffered a political disease that might be called "agenda exhaustion": they led reforms towards multi-party democracy, privatization, restitution of nationalized properties and market economy, towards joining NATO and the EU. All these is successfully accomplished, in 2005 and 2006 elections they had little to offer and proved unable to confront populist rhetoric of Parvanov and Siderov.

2. Bulgaria president is with almost ceremonial powers by constitution. He or she is to be elected by a popular vote, but the institutional functions are to represent the country, hand off the mandate to from an executive and set a caretaker cabinet in times of political crisis and call fresh elections as well as the right to return laws back to legislature (which than could be passed by 50+1 majority of all seats). President Zhelev in 1991 – 1996 managed to block BSP (holding a sizable majority in the parliament before 1997 and the executive in 1994 - 1997) attempts to reverse property restitution and crackdown on property rights and privatization. He and president Stoyanov (1997 – 2001), both democrats, have been instrumental securing rule of law and smooth power transfer in time of political crisis. President Parvanov pretended he is "social president", talked much about everything from family and raising kids, to migration, economic strategy, history and nuclear energy. He succeeded in emptying the constitutional content out of the presidential powers and substituted it with general policy talk. Right-wing candidate, Nedelcho Beronov, a former constitutional judge had no chance to compete on this grounds. Bulgarians simply disagreed with the substitution and get tired of the general talk and did not come out to vote.

3. Georgy Parvanov himself was not so long ago not very much different from Volen Siderov. In 1990-1991 he opposed returning the names to the Christianized Turks, sat on the board of an extremely; he openly opposed NATO accession, demonstrated in the streets on the issue and sent a letter of support to Milosevic in 1999. He would oppose privatization as well if his party were not cutting the gain.

4. So, the choice in the last October weekend was more between the somewhat normal populist rhetoric and abnormal populist rhetoric, when the former saves the

image of the country as mainstream EU political system. It was about political correctness, and the political correctness is the real winner of the elections.

Bulgarian political observers imagined for a moment before the second round that the country resembles last presidential elections in France when Chirac defeated Le Pen with the help of the Socialist voters. Therefore, they believed Bulgaria right-wing voters should cast their votes in favor of Parvanov.

Voters did not listen.

What this constellation means for the future?

1. BSP and Parvanov himself have regained some confidence. They run the executive, on the MRF mandate², in coalition with MRF and the ex-king's party, National Movement Simeon the Second (NMSS). The coalition holds a 2/3 majority in the legislature and is able to amend the constitution of its own. Within the coalition MRF holds ministries that are believed lucrative in terms of EU subsidies. The Prime Minister, Mr. Stanishev, is personally weak but successfully holds the balance between BSP, MRF and NMSS interest thanks to the relative strength of BSP (with 1/5 of the vote there is no other political party to contest the leadership) and the help of the three-member (i.e. leaders) Coalition Council or "Polit-Bureau". The "Polit-Bureau" decides on tricky issues related to personal appointments, division of responsibilities between the parties and the balance of interest and influence.

2. The second term of the President Parvanov would certainly garnish a greater informal weight of BSP within the coalition. It would make NMSS tacit criticism on economic policies and socialist redistribution even more silent than it now. MRF strength is not likely to suffer at all. MRF have landed roughly 1/3 of the votes that elected Georgy Parvanov. Ahmed Dogan, the MRF leader, seems stronger within the coalition, less liked by the Bulgarian voters but more needed with the Polit-Bureau and the coalition to keep mandate.

3. The self-confidence of BSP and MRF has always been next to arrogance. In the first days after the election there are all signs of growing self-esteem and there are already attempt to

humiliate right-wing voters and parties. This "strength" would not translate, however, into a misuse of constitutional majority for lessening property rights or increased redistributionist policies. On one hand, most of the damage is already done and is related to: longer and comparatively more disadvantageous (for Bulgarian farmers and land owners viz-a-vie their palls in CEE) periods and processes of foreigners buying arable land in Bulgaria; constitutionally protected government monopolies and "exclusive rights"; inappropriate definition of judicial independency and the already enshrined multiple "social rights".

4. Besides the rhetoric, the rational and the political drive for further fiscal and quasi-fiscal reforms towards lowering taxes and reducing costs of dealing with the government – traditionally very high in Bulgaria – will be totally lost. Those reforms have suffered already but the reestablished political self-esteem would more likely support populist lawmaking than any other available alternative.

5. In the area of pure presidential prerogatives Mr. Parvanov will be reassured. He met with Mr. Putin more times than all post-Communist country leaders of Europe have met the Russia altogether. Mr. Putin is Mr. Parvanov's role model. Mr. Parvanov, in order to prevent campaign disclosures, has publicly admitted that he had worked for the Bulgaria analogue of KGB, KDS. "KDS" was in fact managed by "KGB". Now, like Putin, Georgy Parvanov is trying to glorify those years, gives state awards to KDS-collaborators, hoping thus to glorify himself and fellow-collaborators. He is perhaps the only head of EU state that speaks no EU language and attempts to speak Russian. His heart lies in Russia not in EU, and he is trying to benefit from these sympathies. That does not necessarily mean that the country will benefit, at least there not such sign after the first five meetings with Vladimir Putin.

6. All above said is no good political development. But it is not too bad, either. The fact right-wing voters did not support Mr. Parvanov, irrespectively the propaganda, means that in the country there is a strong public opinion that would support further market reforms. It did not find necessary to vote at all, especially on the second round. But this opinion is there to stay, and even the BSP-MRF-NMSS coalition and its president cannot ignore it.

² In July – August 2005 BSP and all other political parties had failed to elect a cabinet, see *EPR*.

* MRF's name and strength come from the Communist past, as a reaction to the stupid communist party policies of the mid-1980's to rename Bulgarian Turks, give them Christian or quasi-Christian names by force (other Muslims, the Pomacks – ethnic Bulgarian - were renamed in the 1970's), and expel from the country those who publicly disagree with that policy (which eventually happened in mid-1989, few months before the political change). The new constitution of 1991 restore the rights, almost all of 300,000 Bulgarian Turk who fled to Turkey in May-August 1989 have

returned back, and reclaimed their names and properties; they enjoy freedom of movement, many work or live in Turkey, and have the rights to vote in Bulgaria. The article 11.4 of the 1991 constitution banned political parties built on ethnic and religious grounds, thus securing a sort of MRF monopoly on the Muslim vote in Bulgaria's political affairs. More information and analysis on this background, including constellations of Bulgarian Roma, one could find in the IME English monthly, *Economic Policy Review* (EPR, www.ime.bg).

10% Profit Tax – the Result of Eight Years of Efforts of the Institute for Market Economics

Svetla Kostadinova, Krassen Stanchev

Yesterday's achievement of the deputies has its prehistory. It is not their doing, but a result of the demand for such change in the society. A leading role in forming this demand has played our Institute. Here is a short overview of these efforts.

Present: From 2007 profit tax is set at 10%.

The Institute for Market Economics has been one of the major upholders of low taxes since its establishment in 1993. This is proved by the attempt for assessment of tax reforms in Bulgaria, Slovakia and Poland in 1997-1998 which also included testing the perspective for proportional (flat) low tax and by the permanent campaign since 2002 for a 10% proportional and generally applied tax. This issue has also been a major priority of IME and we have been popularizing the idea through analyses, suggestions and publications.

A remarkable part in these efforts had: in the period 1997-1998 Latchezar Bogdanov – now managing partner at Industry Watch consultancy agency, and from 2002 to 2005 Georgi Angelov, now working as a senior economist at the Open Society Institute.

IME's suggestions for tax reform are:

1. Introducing a single marginal rate of 10% for the income tax

For the period 2003 – 2006 the number of marginal rates of this tax was reduced, as well as the rates themselves.

2. Reduction of social security contributions to 10%

IME was the first and until recently the only organization to claim that a reduction of social and health insurances is (completely) possible. In 2006 they were reduced for the first time in years by 6% and a new reduction has been discussed for 2007.

3. Reduction of profit tax to 10%

This goal was achieved yesterday, October 12, 2006 when the change in the law was passed at second reading.

What did we do in the last four years?

2003

On October 3, 2003, as suggested by Georgi Angelov, IME presented for the first time in its bulletin an [Alternative Budget](#), which would underlie an alternative government policy which would accelerate the rates of economic development and would lead to an increase in the welfare of Bulgarian citizens. The reason was the elapsing of the emblematic 800 days of the government. A fundamental role in this policy has the reduction of taxes and contributions and for this reason we prepared an alternative budget, which envisioned a reduction of the income tax and the profit tax to 10% and of the contributions to 16.7 %.

Again in 2003 IME addressed through [open letters](#) the prime-minister, the deputy prime-minister and minister of economy, the newly elected director of the Bulgarian National Bank Mr. Iskrov, and Mr. Dogan, whose role for the stability of the majority in the parliament could not be undervalued. Our aim was to provoke reflection on some long term aspects of the taxes laid at that time, the budget and the financial (monetary and fiscal) policy. A similar letter was

issued on the next year by some leading Bulgarian economists. This act of support is a matter of appreciation not only by us in IME but by the Bulgarian citizens and firms. (Bulgarian citizens and firms also owe them such recognition.) As a result of these letters, we received an answer from some of the addressees.

The Minister of Finance: *"If we are speaking of reduction of taxes, then I am a supporter for them to fall even to 5%, and why not 2%. But let us be realistic. I am confident that only in a few days you will hear from representatives of the opposition how little funds are set aside for pensions, healthcare, education, for this and that. But we should be fully aware of a balance between all state expenses and have a responsible approach."*

On November 10, 2003, IME gave a press conference on the topic of *Evaluation of the possibilities and perspectives for reduction of the taxes in Bulgaria, for the benefits of such policy*. At this conference for the first time in Bulgaria were presented accounts for the real burden on a taxpayer, the effect of reducing the taxes on the incomes from salaries and the incomes of the self-employed was evaluated.

Realized change: Reduction of profit tax from 23.5% to 19.5% from 2004.

Realized change: Reduction of the lowest marginal rate on the income tax from 15% to 12% from 2004.

2004

In March 2004 more than 100 economists, analysts, researchers, finance experts and intellectuals sent through IME an [open letter](#) to the Minister of Finance Milen Velchev and the Prime Minister Simeon Saxe-Coburg-Gotha, declaring the position that a reform, related to tax reduction is necessary to be undertaken. More particularly, they insisted on the introduction from 2005 of a single marginal rate of 10% for all direct taxes – income tax, profit tax and contributions payments.

The Minister of Finance [answered](#) the open letter, expressing partial support:

"I fully agree with you that high taxes have a negative social effect, as a result of which the unscrupulous businesses cross into the grey economy. I also agree that lower taxes

"facilitate entrepreneurship and taking risk", and increase the ability to attract foreign investment...With a continuing financial and economic stability in the next years, it is logical and expedient to think in the direction set out by you."

The open letter and the answer from the Minister of Finance and other political figures and administrators (Jordan Hristoskov, Aliosman Imamov, Alexander Bozhkov and other opponents to the changes) raised a public debate with multiple articles and opinions from different points of view.

In August 2004 representatives of IME and the Center for Liberal Strategies gave a [press conference](#) on the taxes in 2005 and on. The conference, like all similar events during the years, provoked a powerful response and was widely reflected in the media. Two organizations – the first one a department of the Ministry of Finance and the other one a private economic institute – tried to disprove our arguments and even to organize a conference against the changes proposed by us, but gave up.

Since 2004, with the assistance of Georgi Vassilev – a banker in Geneva and founder of a prize for contribution to the freedom of thought in Bulgaria (which will be announced later this year), IME started issuing a monthly [Bulletin for low taxes: Flat tax](#). An editor of the edition from 2004 to the beginning of 2006 was Georgi Angelov, and now it is Svetla Kostadinova.

Besides being distributed through the e-mail, the bulletin is sent by post to all deputies, as well as to political parties, media, business organizations, trade unions, all ministries, state agencies, universities and non-governmental organizations.

In order that people can understand the real effect of the changes proposed in the tax laws, IME prepared a [tax calculator](#), which shows how will the suggestions of the leading political parties for changes in taxation impact the income of the individuals. It immediately makes clear the effect of the suggestions of the ruling party National Movement Simeon II, the opposition in the face of the Union of Democratic Forces, Democrats for Strong Bulgaria, Bulgarian Socialist Party, and The New Time and makes possible a comparison with the suggestion for a flat tax of 10%, made by more than 100 economists and intellectuals.

On October 29 and 30 the first annual meeting of the European Resource Bank (ERB) was held in Borovetz. In order to improve the strategies of the liberal institutes and to increase the interaction between them, a resource bank was established in Europe on the analogy of those in the United States, Africa and Asia. At the meeting there were representatives from France, Germany, USA, Italy, Sweden, Great Britain, Georgia, Israel, Denmark, Switzerland, Turkey, Spain, the Netherlands, Austria, India, Belgium, Romania, Lithuania and Russia. Problems regarding the encouragement of economic freedom as a whole, reduction and simplification of taxation, competition between countries over marginal rates and its consequences, reduction of state expenses through cutting down of the administration and introduction of e-government, fiscal decentralization were discussed at the conference.

In 2004, 2005 and 2006 IME together with ERB members – brain trusts sharing a philosophy close to ours, often under the auspices of the Institute for Research of Economy and Fisc (IREF, www.irefeurope.org) – has been one of the leading advocates of taxation competition in Europe and around the world.

At the meeting in Borovetz in 2004 a statement was made at the gala dinner by the Minister of Finance Milen Velchev: *“It is a challenge for me to be the first minister of finance to endorse the recent appeal of Professor Victoria Curzon-Price, president of Mont Pelerin Society, for abolition of the corporate profit tax in the whole world. Of course, Bulgaria can afford that in coordination with the EU. This is a way of achieving a harmonization of corporate marginal rates in community at a minimum level”*.

At a round table, organized by the Union of Democratic Forces, on October 28, 2004, Georgi Angelov presented the possibilities for reduction of the social contributions burden from 42.7%, as it was then, to 10%.

At the beginning of November 2004, by tradition, IME prepared and presented [An Alternative Budget for 2005](#). The budget envisioned income accounting to 34.5% of the gross domestic product, expenses accounting to 32.8% of the gross domestic product and a surplus of 1.7%. The basic reforms it contained were:

- Reduction of direct taxes to 10% - profit tax, income tax, contributions payments.

- Reduction of state expenses through cutting down of the administration and budget employees, optimization of the spending on state administrations, reduction of the subsidies for activities incurring losses, reduction of ineffective interference with the labor market, transfer of expenses to the private sector and faster privatization.

- Using of the budget surpluses for carrying out a pension reform, capitalization of social security contributions and other structural reforms, as well as for covering any eventual unexpected changes in the economic environment.

Realized change: Reduction of profit tax from 19.5% to 15% from 2005.

Realized change: Reduction of dividend tax from 15% to 7% from 2005.

Realized change: Reduction of the highest marginal rate of income tax from 29% to 24% in 2005.

2005

On November 4, 2005, IME together with 10 other non-governmental organizations and centers for analyses, published [An Open Letter for Reduction of Taxes](#), which once again received a wide media coverage and support. The number of people and organizations who signed it was constantly growing and we all should express our gratitude to them. Here are the basic theses of this letter:

“In recent years the consolidated state budget shows a significant over-fulfillment of incomes and a surplus. Between 2001 and 2004 the total over-fulfillment of budget incomes accounts to 2.7 billion levs. In 2005 we expect an over-fulfillment of 1.5-2 billion levs. In addition to that, on account of the requirements of the European Union, Bulgaria will significantly increase its excise duties and the incomes from them. On the other hand, the big share of grey economy in the country is a significant reserve for budget incomes by creating the corresponding tax stimuli for its abolishment. Last but not least, more active measures from the government towards the carrying out of a reform in

the budget sphere could increase the effectiveness and optimize the expenses.

For these reasons we believe that a significant reduction of tax and social security contributions burden on Bulgarian citizens and the companies operating on the territory of Bulgaria, is possible through a policy of reduction of marginal rates, simplification of the taxation system and reduction of excessive procedures and expenses for its functioning.”

During the elections in 2005 IME put the debate over the taxes in the pre-election competition. Three of our colleagues at IME (Georgi Angelov, Martin Dimitrov and Dimitar Chobanov) were candidates for deputies and proved to be the undoubted leaders in the pre-election campaign with their presence in the press, the electronic media, radio and television. They changed the rhetoric and the way of leading pre-election disputes.

Here is what one of the authors of the present article noted at that time: *Thanks to IME there is one common denominator in all pre-election programs – the ideas for reduction of taxes, the attention towards reforms in the other quasi-state funds – pension contributions, healthcare and education, and last but not least - the reduction of the quasi-taxes, i.e. the so called administrative and regulatory regimes.*

A result of the clear argumentation, the pro-market ideas for reforms, as well as the efforts for increasing people's welfare was the invitation from The United Democratic Forces to three economists from IME to participate in the pre-election campaign and in the parliamentary elections. One of them, Martin Dimitrov, is already in the parliament as deputy chairperson of the Budget and Finance Committee and is an observer in EP. To Mr. Dimitrov the Bulgarian society owes a significant part of the improvements of the tax environment during this year.

In November, for a third successive year the Institute for Market Economics prepared [An Alternative Budget for 2006](#), whose aim was to show that the reduction of the taxes was possible in a relatively short time. IME's budget for 2006 envisioned incomes at 35.2% of the gross domestic product, expenses – 34.8% of GDP and respectively a surplus of 0.4% of GDP.

This budget is based on the following reforms:

- Reduction of direct taxes to 10% - profit tax, income tax, social security contributions payments;
- Abolition of dividend tax;
- 8% social security contributions for individuals born after 1959 in a private pension fund;
- Reduction of state expenses through decrease in the administration, decrease in the expenses for the costs of the state administrations, reduction by half of the subsidies for activities incurring losses;
- Abolition of programs for interference with the labor market, faster privatization and transfer of capital expenses towards the private sector, smaller reserve for structural reform;
- Using the budget surplus for a pension reform.

As a result of the reduction of the total level of taxes in the alternative budget the disposable income and the economic activity would increase, more stimuli for entrepreneurship and labor, for investments, savings and accumulation of capital would be created, the economic growth and the welfare of people would increase.

Realized change: Reduction of contributions with 6% from 2006.

Realized change: Abolition of the lowest marginal rate of income tax from 2006.

2006

The debate over the reduction of the tax burden was continued by IME in 2006 as well. In three issues of the Bulletin for low taxes, multiple publications in IME's Economic Policy Review, many articles in the press and participations in the media, IME kept active the debate over the necessity of reduction of the tax burden. Again, IME's prognosis that in 2006 again there will be a large budget surplus proved to be much more correct, than the prognosis of the government for a zero budget surplus for the year.

Realized change: Reduction of profit tax from 15% to 10% in 2007.

Projected change: reduction of social security contributions in 2007.

Mechanisms used by IME:

1. Preparing of an *Alternative budget* – three successive years
2. Articles in the weekly bulletin of IME Economic Policy Review – more than 500 articles on this topic
3. Articles in newspapers and magazines
4. Participation in the media – scores of participations of IME economists in radio and TV programs.
5. Issuing a monthly *Bulletin for law taxes “Flat tax”*– more than 100 articles focused on this topic
6. A special website dedicated to Economic Freedom
7. Annual presentation of the indexes of economic freedom of the Heritage Foundation and the Fraser Institute
8. Participation in Bulgarian and international conferences on the topic – hundreds in Bulgaria and dozens abroad
9. Translation and popularization of international researches and articles on the topic of taxation

Past and Present

The review of tax policy in Bulgaria, Poland and Slovakia in 1997 and 1998 showed the following:

1. At that time the business in Bulgaria did not accept the idea of flat and low tax, the general inclination was towards enjoying privileges on the back of the taxpayers.
2. This necessitated a relatively detailed research of grey economy and the stimuli for operating in its fumes, which we did in the year 2000 together with Harvard University and the Agency for Economic Analyses and Prognosis, and in 2003 on our own, but in the context of a comparison between Bulgaria, Romania and Serbia.
3. It proved necessary to also examine the procedures for following the tax and other laws. A leading role in these researches had Lachezar Bogdanov and Jordanka

Gancheva, as well as the authors and all our colleagues at IME.

4. In Poland a Finance Minister and very popular reformer resigned because of the refusal of the political parties to accept his tax reforms.

5. In Slovakia the business had the same attitude towards the flat tax as in Bulgaria and Mr. Mečiar’s government started nearly persecuting the people we collaborated with. One of them – Jan Oravetz – found out how to solve the problem: he established a foundation of the taxpayers, who in 2004 imposed on the politicians the introduction of a flat tax.

6. At that time in Bulgaria emerged three organizations of the tax-payers, all of them established by former employees and past and present advisors at the ministry of finance. This made the normal functioning of such organizations in Bulgaria impossible.

The context of these efforts is also changing. Their success depends more and more on the determination of Bulgaria and the citizens to stand their ground before the EU. At a session of ECOFIN on September 25th this year, under the banner of „optimal taxation” Brussels bureaucracy initiated action towards seeking „tax harmonization” between the member-states, a harmonization aimed at the high taxation levels in the EU.

For now it is not clear whether this is the exact intention of the actions, but if they are successful – which is after all hardly probable, the result will be keeping the lower levels of welfare in New Europe for a longer period of time.

At the end, we would like to thank once again everyone who openly expressed their support to the idea of reduction of the tax burden in Bulgaria. During all this time IME received support from citizens, companies, associations, non-governmental organizations and international partners in its efforts. In the future the Institute will continue encouraging the reduction of the tax burden, which remains too high in Bulgaria, especially regarding the taxation of labor. In a month IME will publish its regular alternative low taxes budget for 2007.

Political Constellations around Tax “Innovations” in New Europe³

Krassen Stanchev

Background

In 1996-1997, I had the pleasure to coordinate a think tank effort to instantiate reforms in Bulgaria, Poland and Slovakia that would lead to the adoption of flat tax⁴. Part of the effort

included asking businesses to approve or disapprove low and flat tax. In all three countries disapproval rates were higher than approval ones. In Bulgaria, the ratio was, roughly, 35:65.

I cannot comment on the reasons for this constellation in other countries but in Bulgaria two sets of beliefs contributed to this attitude: the idea that a given business, say SME, should be treated more generously by the government; and the idea that certain businesses should be compensated for losses incurred due to government policies in the first half of the 1990's.

There were two key conclusions from that effort:

1. Businesses were not likely to be the prime reform demanders, therefore, there was a need to recruit broad public support;
2. Broader reform issued needed to be addressed for having reforms (aimed at tax lowering and flatter taxes) accomplished, e.g. expenditure reforms and lowering, decomposition of the welfare state, etc.

The fate of that reform in those three countries was, roughly the following:

- In Slovakia, Jan Oravec of the Hayek Foundation established a tax payers' association and through it managed to push forward an introduction of 19-% flat tax.
- In Poland, the idea for tax reform was dropped altogether, at least until 2001, in 2001 one finance minister, Leszek Balcerowicz, resigned for not being able to persuade fellow cabinet members to implement his tax reform ideas; Poland focused on quazi-taxes instead

(implemented Economic Activities Act – in 2001, and Economic Freedom Act – enacted on May 1 2004).

- In Bulgaria, there was no political party or a politician to like the tax reform objectives; there were three tax-payers' unions, all established by employees and advisors to the treasury; so, the feasible strategy was to start a broad public education and focus reformists' efforts on welfare state, expenditures and detailed (but yet understandable) argumentation of the need for reform.

Political constellations of the eve of lowering taxes

The Baltic countries seemed to have benefited from the fact that their respective treasuries did not have sufficient resources for any sort of substantial redistributionist policy mix. In different years they pegged their currencies to Deutsche Mark or to a basket of DM and US Dollar, a policy that motivated a flexibility, liberalization of fiscal policies combined with strictly observed budget constraints and deepest than in Europe trade liberalization, as it was implemented in Estonia. And it was Estonia, again, to prompt in early 1990's with a flat tax system (at around 25% threshold on individual and corporate income). The Estonian system is now being further reformed towards lower tax rates (aimed at 20% for personal income in 2007). Lithuania and Latvia did something similar (in 1994 and 1995) but with greater differentiations between personal and corporate taxes.

Flat taxes since then were implemented in numerous countries: Georgia, Romania, Russia, Serbia (and Montenegro), Slovakia and Ukraine. Macedonia is the next in line. In some countries, like Bulgaria, the policy is still one of multiple thresholds, but the difference between is 1-2% and, thus, it is almost flat.

A closer look at the constellations at the eve of introduction of flat taxes, allow drawing a sort of a common denominator:

Most countries introduced flat taxes with the view on increasing the budget revenues, and rarely, if not never, there was a consecutive policy to reduce or restructure expenditures.

³ First presented at the 30th Summer University on New Economics in Aix-en-Provence, August 29, 2006.

⁴ See, collection of reports at: www.ime.bg (discussion).

Peculiarities of lower tax reforms of the (EU) New Member States

Interestingly enough, the new member states behaved in this respect as most of the non-member states, similar to those of former Soviet Union (FSU). Here are some comparisons:

- Often flat income tax is combined with lower rates of corporate taxation, and this is a common feature of Baltic with other EU countries, including those supposed to join EU;
- This constellation is different from that of FSU, where corporate taxation is higher than the flat rate (which is, in turn, lower than respective taxes in the Baltics, Slovakia and Romania); this is to be explained by government ownership on natural resource companies and late or delayed privatization;
- It is obvious, that apart from servicing to objective to increase revenues, the flat tax reform aimed at creating incentives to invest (FDI in particular).
- No country have ever effectively reformed the welfare state, which is evident from the rates of the social taxes; the so-called social contributions rates are 1.5-2 time higher than the personal income tax;
- On average government expenditures in the new member states remain in the last seven years considerably lower than the average share of government expenditures in the respective GDPs of the old members states; there are exceptions (e.g. Bulgaria's government expenditures in the last five years stay at around 41% of GDP) but the overall level of the new member states and Romania is 36-37% of GDP.

The impact of regulations and EU accession

The compliance cost of EU companies and individuals (i.e. the costs of operating within the laws and to deal with governments) were last studied by OECD for the entire Union in 2001. For the new members states there are different estimates, and only rarely there profound surveys on these costs in the accession countries.

The picture is roughly the following: the EU compliance costs are EURO 540 billion in 2000, 3-4% of GDP for that year. In the new member states, these costs are believe to be up to two times higher, because of juridical harmonization,

the pace of the process and due to inherited administrative inefficiency. These impacts were combining with much better visible impacts of the higher EU indirect taxes (most often duties on tobacco, gasoline and gas).

This was one of the factors to convince political establishments of the new countries to use the only available fiscal policy instrument to mitigate the costs, and they reduced the direct tax burdens. Politicians in countries that did not lower taxes, like Poland, dealt with indirect taxes, but the impacts are not yet studied.

Globalization and taxes

There is yet little empirical research but it is possible to assume that the EU governments are doomed to collect less taxes. Factors that contribute to this are the following:

- The existence of jurisdictions that maintain low taxes, low transaction costs and better rule of law;
- Electronic money;
- The use of Internet in channeling investment and savings and in retailing;
- The overall greater mobility of factors of production, particularly capital and people.

Conclusions

It is unlikely that new member states would reverse the policies of lowering direct taxes. However, the unreformed or rather semi-reformed social welfare systems (pay-as-you-go pensions, centralized healthcare) would probably work as a factor that requires constant if not upstream inflow of revenue.

With privatization, in the some of FSU countries there might be a shift in the policies, e.g. lowering of corporate tax rates in order to boost investment; it is likely that the former Yugoslav countries are moving in this direction, e.g. it is almost certain that Macedonia will have a 10-percent flat tax on personal and corporate income two to three years from now. Lower levels of indirect taxes in countries neighboring the EU would also pressure their EU neighbors to lower taxes or at least keep the existing levels.

It is difficult to predict the pace but it is obvious that the tax competition is already out there.

 * One exception is Bulgaria, in 2000 and 2001.

Bulgaria – An EU member from 1st January 2007

Adriana Mladenova

On 26th of September 2006 the final Monitoring Report of the European Commission on Bulgaria was released with the statement that Bulgaria will become a full-pledged member of the union on 1st of January 2007. For now there are no protective clauses, but the European Commission has left an open way by declaring explicitly that the strict supervision and control on the areas of concern in the country will continue. Protective clauses in the sphere of internal affairs and judiciary system can be activated later on, and part of the subsidies and money from the *Eurofunds* can be reduced or declined ex-post, if supervision shows that Bulgaria does not meet the requirements of EU concerning the transparency of the expenditure of public resources, fighting corruption, efficiency and independence of the judicial system.

Bulgaria's accession to EU legitimates the economic reforms that have been undertaken (or have begun) in the name of the country's integration to the Eurozone. The EU membership has psychological, political and economic dimensions, which should be considered together (in order) to draw a complete picture of the accession process. By any means, the recent events and the tension on the political scene in Hungary and Poland, which coincided with the period of the official release of the decision for the next EU enlargement in 2007, also have impact on the attitudes of people for the functioning of the "common European family". Politicians and lawmakers in each state bear responsibility before their voters, and the EU membership cannot be used as an excuse for the lack of coordination of their economic programs with the citizens.

The economic consequences for Bulgaria of the accession to the EU are not one-sided and straightforward. The Institute of Market Economics as an independent non-governmental organization, promoting market solutions in the conducted economic policy, have stressed

continuously on the problems the problems, related to the European Union including heavy bureaucratic machine, strict regulations for certain business activities, (which distorts the market reality), numerous norms and rules, (which operate in different institutional environments and informal sets of behavior practices), etc. The IME is simultaneously welcoming the liberal ideas of the EU concerning free movement of Capital, goods and services, people, and continuing the open debate on the problematic spheres, where there is disparity between reality and the principles of economic freedom.

The EU does not mean automatic increase in the incomes of citizens, but it does assist for improvement of the functioning of many of the institutions – judicial system, protection of property rights, and control on the spending of the public resources. The establishment of an effective institutional frame is a necessary prerequisite for the economic development and flourishing of entrepreneurship. At the same time, discussions about the policies of the EU in a number of spheres should be further intensified – such as redistribution of resources through the government sector, imposition of regulations on the labor market, protectionism in the sector of agriculture, tax duties harmonization. We should not forget that the EU is before all a political unit, which means that the interests of the politically active and 'strong' often dominate when decisions concerning all members of the Community are taken.

The focus of (the) attention should not be directed only to the grants and subsidies, which we will receive as an EU member. The agenda of the commentaries on the report by EC are centered only on the possibility of reducing the amount of the structural funds or the direct payments for agricultural producers. However, this may happen only if the administration does not do its job. Additionally, even if all requirements and conditions of the European Commission are met, the application process for the structural and cohesion funds will start at the end of 2007, according to the official timetable. The absorption of resources during the first years of the operation of the financial mechanisms of EU is traditionally weak for the new EU-members (15-30%), so the possibility

of reduction of the promised money should not be dramatized. The granted money by itself is not a guarantee for improving the living standard of people, the significant point is how the funds have been allocated and exhausted. (the important thing is where it will be distributed to and how it will be spent.) And for this purpose, visible and well-established business models and entrepreneur ideas should be available on the market. There is not invented by now any central planning mechanism by which scarce resources in the economy to be effectively and fairly allocated. The market makes it most efficiently (“the invisible hand of the market”), and as a result, the interests of both consumers and suppliers coincide.

The positive effects from the EU accession for Bulgaria are the following:

- More trade within the EU, which will have by all means, a positive impact on the economy – due to specialization and competition pressure;
- Easier traveling and more opportunities for professional realization of people, gaining experience and appearance of new business opportunities on the horizon;
- More chances for people to get education and qualification abroad;
- Exchanging of ideas, know-how and best practices by attracting investors and foreign companies outsourcing their operations in Bulgaria; and
- Harmonization of procedures and rules, which facilitates doing business,

establishment of well-defined property rights and greater accountability of institutional and economic environment.

At the same time, the EU membership does not excuse Bulgaria of the necessity for launching and conducting more economic reforms; on the contrary, this need gets even stronger. It is so because being an EU member means that Bulgaria will have to compete “on an equal basis” with:

- The tax systems of the new EU members, which attract more and more investors from “old Europe” due to their low tax rates and lessening of the tax burden for the business;
- High labor productivity in Austria and Germany;
- Technological progress in Ireland and Finland;
- Level of education and qualification in Great Britain and Netherlands;
- Efficiency of the public sector and transparent rules of managing of the public resources in Denmark and Sweden.

The conclusion is that the Bulgaria’s EU membership should not be regarded from an economic point of view either as too pessimistic or too optimistic. The future economic growth of the economy and improvement in the well being of people depend on the political will for continuing of the economic reforms and applying the best, market-driven practices from the EU.

An Overview of the Policies in the Tobacco Production Sector

Metodi V. Metodiev

In the political space this week there has been talk about the real prospect for subsidizing Bulgarian tobacco producers with money from the state budget for three more years. This proposal is based on the permission given by the European Commission at the end of August.

We set as our task to make a general overview of the policies of the European Union and the Bulgarian state regarding tobacco production.

What is the situation in the tobacco production sector?

Tobacco production is under the protection of the Common Agricultural Policy (CAP) of the EU. In its frames the ensuring of the production and its following realization are guaranteed on the basis of the so called instruments of the CAP:

1) Direct (compensation) payments – funds are granted directly to farmers by a scheme for income support. They compensate the gradual reduction of the prices of agricultural production and are, as European practice indicates, a substantial additional income for agricultural producers.

2) Intervention – i.e. buying up of agricultural products by a special Intervention agency of the country, for a certain period (a period of intervention), at fixed (intervention) price. Thus, the realization of the production at an acceptable price is guaranteed. Intervention is a means of market interference – agricultural production is bought up in case there is a very high supply at low prices. This process is to be administered by the State Fund “Agriculture”, which will be accredited as an intervention agency. For some sectors like fruit and vegetables, interventions will be carried out by acknowledged producer organizations.

3) International trade regime – this is the special EU regime for the import and export, whose main aim is protection of agricultural production and of the market for agricultural production in the European Union. Export subsidies belong to this type of aid.

The Common Agricultural Policy introduces a single payment per farm or per hectare, with which direct payments are decoupled from production. In the case of tobacco, the reform will become effective from harvest 2006, as for the period from 2006 to 2009 inclusive, a compulsory decoupling of direct payments and production is envisioned, ranging from 40 to 60% (at the choice of the member state). From 2010 on, after the three years have elapsed, the Single Payment Scheme (SPS) will be applied, i.e. a single payment per farm will be applied.

Besides the instruments of the CAP, the tobacco production sector also enjoys the protection of the state. The mechanism through which it provides the welfare of tobacco producers is entitled “Common Organization of the market for raw tobacco”.

Its main aspects of activity are:

1) A system for determining production quotas – the Council of Ministers determines a maximum guaranteed limit for production of raw tobacco in the EU, within which individual maximum guaranteed limits are determined for each group of tobacco for three consecutive harvests. On the basis of these limits the Council allocates through production quotas the quantity for each group of tobacco, which is consigned for production to each country – producer of tobacco. The member state, on the basis of the quantity assigned to it, determines and allocates individual production quotas to the respective national producers or producer organizations.

2) A premium system – the amount of the premium is determined for each harvest by the Council and is different for the separate brand groups raw tobacco, but is the same for the brands in a certain group. Only tobacco produced within the limits of the respective quota is awarded a premium. The premium is divided into three parts: a) fixed – it is paid only to producers or their organizations, b) variable – comprises 30% to 45% of the total amount of the premium and is paid to the producer organizations, and they distribute it among its members according to the quality of their individual production and the price paid by the primary processor, c) specific – amounts to 2% and is granted to organizations for definite purposes like improvement of the management and the organization, activities related to environmental protection and others.

3) Producer groups - a) their members should be only producers of raw tobacco, b) the group should not carry out primary processing of raw tobacco, c) each producer should be a member of only one group of tobacco producers, d) they should have information about the production which has been produced and realized, information about areas, brand structure, quantities, quality classes and sales, e) pay their members the price of the production which has been sold, f) have a common quota for raw tobacco, which the members of the organization produce, no less than 1% of the total amount for the country per year and 0.3% for 16 specially appointed municipalities in the country, etc.

4) Tobacco-growing contracts – in the tobacco-growing contracts there are some explicitly specified requirements like: a) contracting parties b) minimum quality requirements for each class, with minimum 3 classes and an obligation from the producer to supply tobacco, which meets at least these minimum requirements c) an obligation from the primary processors to pay the purchase price according to the quality, etc.

5) Approving of processors, who can conclude contracts – the member states, on whose territory the primary processors are found, are obliged to approve the processors, who can conclude contracts for tobacco growing, as in the case of breaking some of the requirements, the permit of the processor could be taken away by the member state.

The necessary conclusions

Led rather by narrow party interests, than by rational economic reasons, statesmen increase the interference with a sector, which has been (for reasons unknown) declared a priority. Thus the state encourages keeping the status quo – protectionism of a highest level, logically linked to ineffectiveness and lack non-competitive production. For sustaining the vital functions of the tobacco sector enormous amounts of funds are being poured, taken of course from the taxpayers.

It is obvious that this does not stimulate the sector's development; on the contrary – it is put in isolation from the real market situation. And this hinders market competition. The state interferes in the economy by allocating resources to a sector with a low added value for economy, and last but not least, thus distorts market logic and stimuli.

What should be done? A few recommendations:

- 1) The right of ownership should be guaranteed through a stable, effective and transparent judiciary system.
- 2) Privatization of “Bulgartabac”

- 3) Withdrawal of the state from its inappropriate regulatory functions in the sector – i.e. minimizing the state's interference with the tobacco market, abolishing of the barriers to export and import, abolishing of all protectionist tariffs, abolishing of the production quotas.
- 4) Abolishing of subsidies, because they create a culture of dependence and are an obstacle to the effective management of farms and hinder the natural process of land consolidation.
- 5) Dedicating vigor and energy to quickly completing the establishment of an Integrated Administration and Control System (IACS), Paying agency and Land Parcel Identification System (LPIS).

As a conclusion we can say that the proper enactment of these recommendations would encourage the effectiveness, entrepreneurship, sense of innovation and competition in the sector, which, combined with the free market determinants of demand and supply, will decide its future.

The “Bulgartabac”'s Saga – the Beginning of the End, or Is It?

Veliko Dimitrov

Better 17 years late than never.

“Bulgartabac” was established in 1951 as part of the universal nationalization of 1947, and the introduction of state monopoly over the tobacco industry by the Communist Party. The status of Bulgartabac was changed only with the formation of a holding with 22 subsidiary companies in 1993⁵. (It stayed so until the changes or more exactly until 1993, when a holding was formed with 22 subsidiary companies, 70 % of which are still state-owned at present. In 1995 the subsidiaries were included in the mass privatization.)

The primary attempts for full privatization of the tobacco monopolist were made in 2002 when the National Assembly accepted a privatization

strategy, envisioning a package sale of the holding. With a huge delay, the primary attempts for full privatization of the tobacco monopolist were made in 2002 – The National Assembly accepted a privatization strategy, envisioning a package sale of the holding. Next year (2003) a public competition for the sale was announced, (but no agreement was reached).

The next mediocre attempt for full privatization was made in 2004, when again a public competition for sale was announced. The result was unconvincing with only three sales achieved out of twelve offered for tobacco processing companies, and absolutely none for the four cigarette factories.

At first glance the two unsuccessful attempts suggest that there isn't enough investment interest towards the tobacco sector in Bulgaria, and the subsidiary companies in the holding cannot be sold. However, a more profound look at the unsuccessful privatization shows that it is due rather to unwillingness of certain political clique to finish the privatization than to lack of investor's interest. This statement might be supported by the fact that each time when the

⁵ 70% of these subsidiaries are still state-owned at the present moment – October, 2006

privatization of Bulgartabac is undertaken “someone” draws the attention from the privatization deal as a whole to particular insignificant milieu within it (i.e. price not high enough, conditions not satisfying enough, etc.).

The consequences (however) are not positive. The long standing state guardianship created an industry which, as it turned out to be in the last weeks, functions quite ineffectively compared to its future European competitors. The companies did not go bankrupt because, first of all they were state-owned, and second, the government, through its direct interference in setting the prices⁶ guaranteed their sustainability during the whole period. With the following small exception: in the beginning of 2005 the cigarette market was liberalized – the prices of tobacco products could then be freely determined, by producers as well as by importers⁷. (as it was only necessary to inform the Ministry of Finance). Thus, a big step forward was made and the conditions for the normal development of the sector were created. The registration regime did not last long though– in less than three months from the decision for liberalization of the market, representatives of Bulgartabac petitioned to the Ministry of Finance for the prices of cigarettes to be again determined on administrative grounds. (Through), It was tacitly admitted that the holding is not competitive when prices are freely determined, which, as it can be expected, do not always under all circumstances guarantee fixed and pre-planned profit. The result was that the price fixing practices were (control over the prices) restored.

Ineffective production is however only part of the bigger problems of cross subsidizing of activities within the holding.

Ineffective production is however only a part of the problem, an effect stemming from what is may be the basic obstacle to better development of the holding – the cross-subsidizing of activities within it. The two relatively most profitable factories are those for cigarette production in Sofia and Blagoevgrad. Their profits, instead of being reinvested in improvement of the technical and technological parameters, advertising and achieving a more sustainable production, are poured into the tobacco-processing factories which incur losses

⁶ it determines the prices, including those of the importers

⁷ The only requirement for the importer was to inform the Ministry of Finance for the decided price.

and which continue to buy and overstock tobacco. As it is clear, there are no economic, but only political grounds for this.

And all that lasted for years. However, reality has been changed.

Excise rates on tobacco products were sharply increased at the beginning of the year, which, according to representatives of the holding will reduce the annual profit with about 50-60%. A new increase is expected from next year. Our forthcoming membership in the EU necessitated a repeated liberalization of prices, which became a fact several days ago⁸ and can be expected to be final. In other words, there can be price competition as well.

Taking into account these changes in the situation, the holding was quick to react: it became clear that one employee in the Bulgarian cigarette factories produces a much lower amount than in the analogical factories in Western Europe and not with a lower wage. In the words of the managing director of the holding Mr. Hristo Lachev the average salary in “Blagoevgrad BT” AD for example is 1 500 levs. At first glance this might seem lower than its equivalent in the EU, but if the difference in the purchasing power parity is taken into account, which is roughly 1:3, it is probably even higher. If the effectiveness is also taken into account, than for a final production unit in Bulgaria the employee is paid manifold more than in Western Europe. In other words, the reform and the complete privatization of the holding cannot be delayed.

What is about to happen with the tobacco holding?

At the beginning of the year, at meetings of Supervisory and Management Board a decision was made for restructuring of the holding and selling the stakes in the following companies:

“Plovdiv Yurii Gagarin BT” AD (**already a fact**); (sold)

“Asenovgrad BT” AD – by a public offering of shares on the Bulgarian Stock Market - Sofia;

“Shumen BT” AD – by a public offering of shares;

⁸ On October 13, 2006 the order, which enacts it, will become effective.

“Pazardzhik BT” AD – by a public offering of shares;

“Dupnitsa BT” AD – by a publicly announced competition;

“Sandanski BT” AD – by a publicly announced competition;

“Yambol BT” AD – by a publicly announced competition;

“Smolyan BT” AD – by a publicly announced competition;

“Gotze Delchev BT” AD (not decided);

“Kardzhali BT” AD (not decided);

“Haskovo BT” AD (in liquidation);

“Vidin BT” AD (in liquidation);

“Harmanli BT” AD (not clear);

“Topolovgrad BT” AD (not clear);

“Purvomai BT” AD (not clear);

“Isperih BT” AD (not clear).

No privatization is envisioned or there is no clarity regarding the following companies from the holding:

“Blagoevgrad BT” AD (not to be privatized);

“Sofia BT” AD (not to be privatized);

“Plovdiv BT” AD (not to be privatized);

“Slantze Stara Zagora BT” AD (not to be privatized);

“Pleven BT” AD (not to be privatized);

“Dulovo BT” AD (there is a process going on and the outcome is not clear);

In quintessence, the changes are partial and no privatization is envisioned for the major tobacco companies (the tobacco plants). The restructuring of the subsidiaries is justified only for the purpose of their future selling, but for many of them it is not at stake at the near future (on the agenda). There is a great probability for the financial indicators of the holding to worsen sharply and in about a year they might be at much lower price than at present. Thus, since full privatization will be fulfilled anyway, any postponement will be a mistake. In this sense any postponing of the full privatization is a mistake, which will however probably be a fact.

The Development Pact – Few Good Ideas and Many Wishes

Dimitar Chobanov

On 26th of September of the current year, the government together with the two largest trade unions and employer organizations signed the Economic and Social Development Pact, which regulates the development in Bulgaria up till 2009. It contains the directions for conducting the economic policy until the end of the current government’s mandate considering the interests of both workers and employers. However, the character of the document predetermines the lack of particular suggestions for measures in many of the spheres it refers to, which makes it all too similar to a pre-election program. Again, there are too many promises and it is not clear whether they will be kept.

In the document there are some terms, which are rather controversial. The realization of the basic principles of the European social model, (for example) is presented as a major challenge. Discussing such a model is incorrect,

considering the great differences within the European Union, where the systems in Ireland and England are significantly different from those in Sweden and Denmark. Following the example of Ireland, which relies to a great extent on individual responsibility and economic freedom and achieves much better results concerning the increase of incomes, employment and welfare, or (following) the example of Germany, where economic growth during the last few years is considerably lower, and unemployment is higher, are two types of policy, which could not be put together under the name European social model. For this reason such texts should be clarified before adopting the final version.

The priorities set out are catch-up development, accelerated judicial reform, high quality and accessible education and healthcare, continuation of privatization, etc. They are by themselves good and should be realized. But for this purpose some criteria which allow comparison and measurement of the eventual progress are necessary. The only quantitative measurement instrument mentioned among the priorities is economic growth, which should be

about 6% per year. Probably this number corresponds to the Bulgarian socialist party's pre-election program and reflects the current rate. According to the last available data of the National Statistic Institute, the real growth of the gross domestic product for the 6 months compared to the corresponding period last year is 6.1% and probably for the whole year 2006 a value close to this will be achieved. Therefore the policy of the government will rather be oriented towards keeping this pace, than towards its acceleration.

The engagements for achieving the goals are the essential part of the text. A substantial emphasis is put on increasing the effectiveness of state administration, and also the possibility for transferring activities towards the private sector has been mentioned. Some measures included here are reducing and facilitating the regulatory regimes, e-government, tacit consent, public-private partnerships. They would have a positive impact on the work of the administration and would improve business environment. Only these ideas aren't new at all - they have been discussed for quite a long time, but their application has either been postponed or has been incomplete. Mentioning them in such a pact does not change the situation - i.e. it is clear what has to be done, but it is not clear whether there will be enough will and capacity for carrying it out.

On the other hand, the transferring of the administration of some of the regulatory regimes towards branch organizations can be used for setting greater barriers to entering the market by new subjects and for reducing the competition. For this reason, first of all these regimes have to be limited to the maximum possible extent, and only then should such actions be taken.

In the Pact there are many texts, which envision an increase of the state expenses, such as the suggestions for higher expenses for healthcare and education, for better technical servicing of the administration, for higher wages of budget employees. All these measures have to be more closely bound to optimization and cutting of other expenses and to more concrete reforms.

In the sphere of healthcare, no significant change is envisioned about the monopolistic position of the National Health Insurance Fund, although some mechanisms for better control over its

expenditures are suggested. In the sphere of education a more specific text about the implementation of the voucher system also is missing.

Suggestions concerning taxes and the fisc are also not stated clearly enough, and the only marginal rate which is mentioned is 18% of the Value Added Tax. For the rest of the taxes it is mentioned that reductions are envisioned, which will not be adequate implied without supplementary measures. Furthermore, the intentions of the government are related to keeping a low budget deficit, which means that there will be a substantial change in the fiscal policy. In the last years some surpluses on the consolidated budget have been realized, but it seems that the envisioned increases of expenses with keeping the relevant size of incomes will lead to such deficits. This may have a negative impact on economy by displacing the private sector, decreasing the trust of foreign investors and may have an impact on the stability of the monetary fund.

A basic moment in the Pact is the introduction of a rule for increasing the salaries in the economy, which should also give an indicative percentage for the private sector as well. This idea is an attempt for interference of the state in the free contracting between employer and employee and causes confusion about how the business organizations accepted it. Negotiating such percentage is pointless, even at branch level, because the factors, which are used, like growth of GDP, productivity of labor and expenses are different for each company, therefore such aggregation is inappropriate and there is no need for it.

On the whole, it can be said that most points of the Pact lack concreteness either in the suggested actions, or in the way of measuring their results. The envisioned additional documents will probably have the same deficiency, as it is characteristic for the numerous strategies and programs worked out by the executive power. There is uncertainty left about to what extent will this pact influence the government's policy during the next 3 years and whether only the things which might have negative effects won't be put into practice and the Pact - used as an excuse - not clear.

If you are fed up with paying taxes, you'll certainly like the idea of tax competition. It gives the opportunity to escape fiscal pressure from your own government by eventually "voting with your feet" to other jurisdictions with more favourable tax regimes. And it gives strong incentives for governments elsewhere to lower their own taxes.

Luxembourg for example is considered as a "tax heaven" in the heart of Europe, benefiting not only European but also world taxpayers.

But some governments are trying, through the European Commission, to impose tax harmonisation across Europe. For example, Brussels has issued a sanction against Luxembourg for its preferential tax regime pertaining to holding companies. Luxembourg is being called to task essentially because companies there can be exempted from income tax, which is not the case in other EU member states.

The Commission says the scheme "distorts competition and trade by altering the level playing field". Brussels also regards this as "state aid" and as "a harmful tax measure". In its view, tax systems in Europe have to be harmonized in the name of free competition.

But the argument that tax relief may pose a threat to free competition and that we need tax harmonisation is senseless.

The Commission has a very strange concept of free competition, with an absence of tax pressure defined as "state aid". It is easy to grasp how public subsidies to business - which involves confiscating resources from some parties and giving them to others - should be regarded as assistance that runs counter to free competition. But how can the fact that certain taxes are not levied be placed on the same footing?

Tax relief indicates that government is actually leaving wealth in the hands of its creators, without this constituting assistance. Does the fact that someone is not trying to trip you up mean that he is helping you walk? Similarly, it is absurd to suggest that if some companies are not paying income tax they are being "assisted" by government. And even if - by twisting the meaning of words - it is deemed that this really does amount to assistance, it would be the only "state aid" compatible with free competition because it respects property rights.

If we support this harmonisation logic, we will inevitably be led to attack other tax regimes that benefit taxpayers. In Estonia, for example, undistributed corporate profits - and not just the profits of holding companies, as in Luxembourg - are simply not taxed. When can we expect the repeal of the Estonian system, which has contributed to the economic dynamism of this East European country?

Pursuing the harmonization moves undertaken by Brussels may result in greater tax pressures on everyone. If the Commission truly wished to promote free competition, it should have suggested having tax relief of the sort provided in Luxembourg and Estonia apply all across the EU. Or it ought simply to let tax competition play out in Europe. This remains an unrivalled way of encouraging governments to reduce the tax pressure weighing down taxpayers' purchasing power and European companies' competitiveness. It is also a means of creating greater economic prosperity.

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