

Transparency of tax regulations and costs of compliance

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“Human action is will put into operation and transformed into agency, is aiming at ends and goals, is ego’s meaningful response to stimuli and to the conditions of its environment, is a person’s conscious adjustment to the state of the universe that determines his life.”¹

“Acting man is eager to substitute a more satisfactory state of affairs for one less satisfactory.”²

Background

One could soundly argue that the aim of every human being (and especially one who is an entrepreneur) is to minimize costs and maximize benefits. Thus we can assume that the higher the net costs imposed by the tax system, the higher the incentive for non-compliance. Therefore, the costs of compliance with tax regulations should be examined, as well the benefits. It is quite difficult to quantify them; in some cases descriptive reasoning will be used.

In this paper I assume that tax legislation in Bulgaria encourages informal behavior among the business community. Since informality means non-compliance with tax laws, a way of avoiding penalties should exist. This might be either a lack of relevant deterrent sanctions in the law, or corruption of government (tax) officials to conceal violations. Since no empirical data on corrupt tax officials is available, we will explore the sources of informal (in terms of tax evasion) economic activity, which as noted above is closely related to corruption.

When analyzing the impact of tax legislation on informal behavior - and consequently corruption - we focus on several major characteristics of the tax system:

- ◆ First of all, it is very important that the system is stable and predictable. Important criteria are the number of amendments to tax laws, the number of regulations related to the taxation of certain activities, and the level of transparency of legislation (whether it is published or not).
- ◆ Second, we consider any possibility for arbitrary decisions by tax authorities (officials) as a potential source of corruption, which intensifies in proportion to the decrease in the rank of the official in charge
- ◆ Third, we will examine the economic incentives to maintain informal behavior.

Stability and predictability

The history of modern Bulgarian tax legislation began with the adoption of Decree 56 in 1989. This was an attempt to regulate emerging private sector activities, and a huge section in it dealt with corporate income taxation. Since the beginning of market reforms, and the adoption of the Commercial Code in 1991, numerous laws and Council of Ministers (CM) Decrees were introduced, to regulate the taxation of both sole proprietors and corporations.

Table 1: Stability of the legal framework 1991 - present

Law(s) (regulation)	First published State Gazette No	Amendments ³ after 1991
VAT	90/1993	9
Income tax	132/1950;118/1997	17
Decree 56 /Profit tax/Corporate Income Law	4/1989 ; 59/1996;/115/97	22
Tax Administration	59/1993	3

¹ Ludwig von Mises, Human Action, NY, Irvington-on-Hudson, 1996, p.11

² Ibid., p. 13

³ Including 1st publication in the State Gazette

Tax Procedures	61/1993	6
State Financial Control	12/1996	1
Accounting Act	4/1991	8
Total		66
Implementation rules	First published State Gazette No	Amendments after 1991.
VAT	17/1994	8
Income tax	100/1994	9
Decree 56/Profit tax	15/1989 ; 109/1996	24
State Financial Control	2/1997	2
Total		43

Table 2: Regulations related to social insurance (as of beginning of 1998)

Laws	6
CM Decrees	5
Implementation rules	3
CM ordinances and instructions	10

Several things should be mentioned:

- ◆ Though very few laws were in place to regulate taxation, that does not make the legislation clear and transparent. The reason is that most of the tax laws were adopted or changed to serve short-term problems, mainly filling the gaps of the current budget. Some of them were enacted retroactively. The logical consequence was that numerous additional regulations have had to be implemented, to interpret the imprecise laws. Usually these were the so-called “implementation rules” issued by the CM to clarify the law. They do not only clarify, however, but often supplement the very substance of the law. Moreover, controversial cases are supposed to be solved through the so-called “General Tax Administration Directorate Letters” or even “Regional Tax Offices Letters,” which are generally not published. Thus tax regulations end up being imprecise and controversial, and sometimes remain hidden from the taxpayers. Therefore it becomes difficult to obey the “rules of the game” and consequently many choose to operate “underground.”
- ◆ There are arguments that in a dynamic economic environment the tax system should also be flexible, to meet the changing conditions. A brief overview of the data above shows that major tax laws were changed 66 times during the period 1991-1998, and the respective “implementation rules,” 43 times. That is equivalent to an annual average of 8.25 and 5.38 times, respectively. Altogether, amendments (or adoption of new regulations) to tax regulations occurred 16.13 times per year. That makes 1.34 times monthly! This makes long-term decisions impossible, or at least too costly, as most of the private companies can not afford them. Corporate taxation has been regulated by three different laws! At the same time there is a strong empirical evidence that business people prefer stability and predictability. The table below exhibits the opinion of entrepreneurs according to a representative survey among 101 private firms in the end of 1997-beginning of 1998, by IME and the Agency for Socioeconomic Analyses (A.S.A.) (*financed by The Freedom House under the international project: Needs for Deregulation of Tax Systems in CEE: Bulgaria, Poland, Slovakia*):

What in your opinion is the approximate acceptable frequency of changes and improvements to tax regulations?

Answer	%
every year	12.2
every two years	14.3

every three years	12.2
every four years	5.1
every five years	56.1

In fact, the current tax system flexibility does not fit entrepreneurs' expectations. The natural response to this is to go into the informal economy, which is at least steered by the "invisible hand" of the market and where the "rules of the game" are the results of rational action and do not change every month (see table).

The costs implied by the unstable environment could hardly be evaluated. An attempt was made in 1996, when IME and ASA studied the transaction costs of 108 entrepreneurs in the big cities of Bulgaria. According to the survey, firms rank expenses as follows: "commissions paid in cash" came first in 78.8% of answers, followed by "legal fees," "consultant services," etc. Two-thirds of firm owners (or a specifically hired person) spend up to one month of their annual working time dealing with liabilities to the Government. The average time spent for this purpose is about two months. Given the fact that accountant salaries are at least equal to the average for country, which for the period 1991-1997 ranged between \$90-115 per month, we can roughly calculate that the cost of tax compliance means an annual expense of about \$200.

Who makes the decisions?

When laws are obscure and controversial, some interpretation is necessary. Unfortunately, laws are interpreted by the executive power. This encourages informal behavior, and hence corruption, in two ways: first, it makes the tax system non-transparent and unstable; and second, when decisions are made by fewer people at a lower position in the administration, it becomes easier to influence them.

Since the beginning of the reform, the CM has issued 46 ordinances and instructions to complement tax legislation. Over the period 1996-1998 only, the General Tax Directorate (GTD) with the Ministry of Finance issued 71 interpretation letters. Even after the Parliament announced at the end of 1997 that the new tax laws would be clear and would need no further interpretation, the GTD has issued 14 letters in 1998.

The range of controversial regulations resolved by tax administrations during the period is immense. They start from the content of the annual tax declarations (personal and corporate income tax), through VAT treatment of option contracts, VAT refund for long-term assets purchased before VAT registration, instructions for 1991, 1992 and 1993 annual taxation (personal and corporate income tax) and even include the method of payment and the level (!!!) of corporate tax advance installments for 1998. Moreover, the Tax Procedures Code allows the head of the regional tax office to establish tax duty at to his own discretion if accounting papers are incorrect or missing, and if no tax declaration is submitted. At the same time, the procedures for tax audits are regulated by Ordinance N4 of the Ministry of Finance, accompanied by eight Letters from the GTD and four Orders from the Finance Minister!

Table 3: Regulations by the executive power and tax offices

Other CM ordinances, instructions 1991-1998	46
Interpretation letters of Tax Directorates (1996-1998 only)	71

There are several types of problems with such practices:

- ◆ The GTD letters are intended to serve other tax officers rather than taxpayers; most of them remain unpublished. Thus the rules of the game are unclear, the taxpayer never knows what the latest "Interpretation Letter" (in fact, regulation) is about, and finally it becomes easier (and cheaper) to go "underground."

- ◆ It is difficult for the Parliament to change laws frequently. The procedure is time-consuming, and more importantly, it takes the persuasion of at least half of the MPs to make an effective amendment. On the contrary, a Ministry of Finance instruction or a GTD Letter may be quickly issued, and it takes just several (in some cases, one) men to sign it. This is a dangerous state of affairs, for two reasons: first, the tax administration can change regulations virtually every week and thus make tax legislation obscure and unpredictable; and second, the level of disclosure in Tax Directorates is quite lower than that of the Parliament - while MPs should publicly motivate their proposals, tax officials in the Ministry of Finance can do whatever they feel necessary, with no effective checks-and-balances mechanism. Hence the cost of being dishonest is lower in government administration, and thus the likelihood of corruption (basically, through promoting certain interests in regulations) is higher.

Rational grounds for informal activity

By definition, taxation is the confiscation and further redistribution of private property, rather than the volunteer purchase of goods and services provided by the state. One could argue that the more taxes are paid, the more public goods are available for consumption. Or even more, that those who pay more taxes are richer, and hence benefit more from public goods such as defense, property protection, and infrastructure (e.g., those who own three cars utilize three times more road facilities than those who own just one). Both arguments are erroneous, or at least imperfect.

- ◆ First, in all democratic societies equal access to public goods is granted. Which is to say that no one can deprive you of the right to justice or police protection if you fail to pay enough taxes. It turns out that while everybody deserves police protection, only a few really pay for it; while everybody has the right to a fair trial, only a few are obliged to pay to the judge.
- ◆ As for the second argument, it assumes that those who pay more are those who actually should pay more (or, that the richer pay more than the poorer). In other words, the statement would sound like this: if there was no tax evasion, then those who pay more (the richer) would utilize more public services, and therefore they should be willing to pay more taxes. This is a logical contradiction, a vicious circle in reasoning.

In this paper we assume that, first, there is no direct relation between the amount of inputs (taxes) and benefits (public services, goods, etc.), and second, that the individual agent has the freedom to choose between paying taxes and not paying taxes.

Hence tax evasion is a result of rational choice, determined by costs and benefits. As argued earlier, the benefit from so called “public services” might be treated as fixed for everyone. Its level depends on the level of government spending, and is not related to the tax regulations. Therefore it will not be examined further in this study.

The benefits of non-compliance might be defined as those costs that would be incurred if the entrepreneur were to operate legitimately. The cost of non-compliance is the cost of missed opportunities provided by compliance, the level of any bribes, and the penalties for non-compliance.

1. Costs of compliance

If taxes are avoided, expenses saved might be interpreted as the first, most direct benefit from such behavior. The corporate income tax rates are 28% for profits below BGL 50 million and 37% (combined with municipal tax). It is useless to assess whether they are too high or not; more comprehensive analysis of what enterprises actually have to pay is necessary. In other words, we need to evaluate how the tax base is established, how revenues are accounted and which expenses can be deducted. The major hypothesis is that tax legislation in the last eight years levied costs on business that are high enough to create rational incentives for informal activity.

Impact on capital as production factor

There are several ways of capitalizing a company: reinvestment of profit, bank loan, non-bank loan, and attraction of equity investors. What is important here is that tax-recognizable returns differ significantly from cash-flow balances. For small, and especially start-up, businesses,

matching incoming and outgoing cash flows is crucial for survival. Investing profit does not favor such correspondence. The cost of long-term assets can be deducted from the tax base up to the level of a linear five-year depreciation allowance (for certain assets the first quota might be 30% of value). Which means that even if the entrepreneur incurs a negative cash result after investing in certain assets, for tax purposes he realizes profit, and therefore is taxed. Similarly, companies are obliged to make monthly tax installments based upon a fraction of one-twelfth of the previous year's profit,⁴ even if they have no revenues at the moment. Another impediment to formal growth and enlargement is applying a legal rather than economic (cash) approach to accounting and tax reports. Implicitly this means that contracted and invoiced receipts are considered taxable revenues. In an unstable business environment and with troublesome contract-enforcement procedures, such regulation is a direct threat to enterprises' profitability, and yet another incentive to stay "in the shadows."

For most entrepreneurs this way of capitalizing their business is too expensive and, on some occasions, inapplicable.

The availability of bank financing is determined by fundamental economic factors, rather than by tax legislation. The outcome, however, is that almost no banks extend long-term (investment) loans, especially to emerging companies, and most firms can hardly rely on financing from commercial banks. A 1996 IME survey on transaction costs showed that 82% of the private entrepreneurs interviewed started their businesses with family savings or credit from friends.

Table 4: Private Sector - Dynamics of Credit Extended and Share of Gross Value Added (GVA)

Year	1993	1994	1995	1996	1997
Share of credit extended (in % of the total)	12.4	13.9	25.9	21.21	57.49
Share of GVA (in % of the total)	35.4	39.4	48	52.5	58.8

What this table exhibits is that the private sector share of GVA has been consistently higher than the share of credit it received, until 1997. The data in the table proves empirically that entrepreneurs rely on sources of funding other than bank loans.

Non-bank loans are also unattractive because interest on such loans is not recognized as an expense, and hence is taxed.

As for equity financing, there is a fundamental principle that discourages potential shareholders. Dividends on invested capital are taxed at a rate of 15%, while interest on bank deposits is tax exempt. Moreover, the government-maintained state guarantee on personal bank deposits while investments in corporate equity was affected by serious default risk during that period. The outcome was a serious incentive to save in commercial banks, as opposed to investing in shares.

Summarizing the observations above, it becomes obvious that tax regulations during the last eight years discouraged private business growth and capital accumulation, which resulted in large-scale informal activity. According to the 1996 IME/ASA Survey:

- ◆ One-fourth (24.5%) of firms turned out to have "double" accounting - one for the Government and one for internal use.
- ◆ One-fifth (20%) of foreign trade businesses openly declare that they decrease or avoid custom tariff due through intermediaries or customs officers.
- ◆ In 1993, Western tobacco industries reported that about 10% of tobacco imports to the UK are illegal.
- ◆ About 43% of the sample report a level of 70-100% of cash payments within the total payment structures of the companies.

⁴ This might be avoided through writing a letter to the tax office declaring that the current year's profit would substantially lower. However, the penalties if the profit exceeds the declared amount, are high.

About 20% of 101 private entrepreneurs (IME/ASA Survey on Tax Deregulation, 1997-1998) believe that those who are obliged to pay at the maximum personal income tax rate save avoid paying more than 50% of amounts due.

Impact on labor as production factor

Here we pay attention to two major factors: income taxes and social insurance contributions. The personal income tax rates range between 20% and 40%. Compared to other countries, they seem quite appropriate. The problem becomes obvious when the progression in the scale is examined. Just for demonstration, for 1998 the level of annual income which is taxed at the maximum rate of 40% is BGL 15,360,000, about \$700-760 a month (according to the exchange rate). Thus, even relatively small businesses are obliged to pay 40% of their income to the budget.

Formal business goes hand-in-hand with formal employment. In Bulgaria, formal employment entails obligatory social insurance contributions. A social insurance burden substantially higher than direct income tax appears to be major problem for entrepreneurs, and therefore deserves special attention. According to Bulgarian legislation the insurance contributions are proportional to the salary rate. In the most common category of labor, the contribution consists of:

- ◆ 22% of the base insurance income for pensions (about 59% of the total contribution, which is made in two parts: the first part is paid by the employer and equals either 37%, 47% or 52% of the base insurance income, according to the different labor categories. The second part is always 2% and is paid by the employee);
- ◆ 10% of the base insurance income for motherhood, illness benefits etc. (about 27% of the total contribution);
- ◆ 5% of the base insurance income for labor hazards and accidents (about 14% of the total contribution).

When added to the personal income tax which average weight is 17-19%, a 100-leva net income for the employee requires payment of 177 levs by the employer.

Therefore, the first problem of the existing social security system in Bulgaria is due to the discrepancy between the structure of installments and the structure of expenditures. The pensions "exhaust" 87.23% of the National Social Security Institute (NSSI) revenues (or 83.28% if transfers from the central budget are taken into account). For benefits under the Labor Code (LC), Chap. III (for illness benefits and benefits for rising a child), 8.48% of NSSI revenues are spent; and some 7.26% for aid under the Birth Rate Encouragement Decree (BRED). Since pension expenditures "eat away" almost the whole accumulated fund, the 22% normative contribution rate for pensions is not sufficient, and the real rate is 34%. In other words, in the framework of the existing system the insured are not receiving the services they actually pay for. According to the NSSI, of the 3,473,526 people included in the system in 1996, 359,271 were self-employed (contribution rate of 22% or 32%). For the same period the National Statistical Institute (NSI) reports that 56.48% of all employees were employed in the public sector and 43.52% in the private sector. A huge discrepancy between social security contributions exists, however. According to NSSI data, the public sector contributed 94.2% of the NSSI's revenues (6.73% from enterprises and 17.29% from the budget sphere), while private sector contribution was only 5.8%.

According to the Labor Code (chapter III, article 149), even if an enterprise does not pay the obligatory contributions, eligible workers receive their benefits. This encourages employers to register their employees in the social security system, since the benefits due are automatically paid by the fund. This explains why only 2.5% of private employers pay any contributions at all to the Social Security Fund, and those contributions are based on the minimum wage.

This analysis leads to two major conclusions:

- inconsistency of payments and benefits discourages payment of social insurance contributions;
- there exists large-scale evasion of labor regulations, resulting in general informal behavior in order to cover costs.

Other costs implied by the tax system

Another factor that discourages formal behavior is the high level of informal (unaccountable) expenditures. Their level is partially due to an insecure and unstable business environment, and partially due to a “chain effect” or “vicious circle” in the system, caused by the informal activities of others.

The first group is predetermined by the enormous amount of permits issued by state officials. There exist special licenses for trading tobacco and alcoholic beverages. There is no distinction as to whether certain business activity is being exercised on one’s own land or real estate, all industrial-type activities (including, for instance, operation of a small cafe), require at least three permits: from the local fire department, local government architect’s office, and the local section of the Institute of Hygiene (a government office responsible for monitoring in-house pollution and public hygiene). Just the official fees for these permits are equal to court registration fees, but they are special license registrations due after the registration of the firm itself. The bigger the business, the greater the number of necessary permits, and the larger the costs to obtain them. For a sole proprietor to open a cafe or set up a small workshop the time necessary to collect these permits alone is at least four weeks. Submission of the permits at the local government office does not mean that the license will be issued at a provisional deadline, but the delay does not stop the applicant from operating the activity. The smaller the venture, the less likely the immediate issue of the license by the local government office; meanwhile, the entrepreneur operates freely. All this means that entrepreneurs should either operate illegally, or find alternative ways of getting licenses. The first option means informal operation *per se*. This creates a reason for corrupting not only tax officials, but also other licensing bodies whose rules have been neglected. The direct consequence of the second option, that of “buying” a license, is the corruption of responsible officials. The indirect effect is that the bribe turns out to be an effective but not tax-deductible cost. In order to keep profit unchanged, the entrepreneur is “forced” not to declare at least the same amount of revenues.

2. The cost of non-compliance

Here we would explore the opportunities forgone because of operating “in the shadows,” and the level of penalties.⁵ Hardly any opportunities that compliance with tax regulations provides could be found. As mentioned in the previous sections, bank credit has never played a crucial role in private-sector capitalization, and bank requirements of decent accounting papers would not touch most entrepreneurs. The prestige that could be gained seems not to be of crucial importance, whatever the reasons. As argued before, there is no direct correspondence between taxes paid and public services provided by the government. Children are not expelled from schools because their parents have failed to pay their taxes; no one is denied access to a hospital because he/she failed to pay social contributions, roads are not closed to tax criminals. Which means nothing else but a rational incentive to avoid paying taxes as much as possible.

The penalties are basically of two types. First, fines for late or missing payments or deceitful reporting. These range between DM 500 and DM 1,500 for personal and corporate income taxes, and up to DM 5,000 for VAT Law violations. This explains the relatively high collection rate of VAT. As for direct taxes, some figures are worth mentioning: according to NSI data (sample of 4,152 private enterprises with up to 50 employees), the average annual profit reported in the small business sector in 1997 (companies with up to 50 employees represent 96.9% of all firms registered) was about \$5,300.⁶ A simple calculation shows that a decent taxpayer should have paid \$1,484 in profit tax, or \$1,513 in income tax (for sole proprietors). The maximum fine is \$857, which is quite lower than the amount of tax due. At the same time, a kind of black market of false invoices has developed, and the price oscillates around 10% of the par value of the invoice.

⁵ The risk of penalties will be further evaluated in the next section

⁶ Exchange rate used: 1750 BGL/USD

The second segment of the penalty is the interest on arrears, which as set in the Law on Interest on Taxes and Other State Receipts. Its level was determined as follows: the annual Base Interest Rate (BIR) divided by 360, plus 0.1% per day. Under the current macroeconomic situation, this means 3.5%⁷ per month, which is a comparatively high level compared to the market ones. However, up until 1997 the penal supplement was only 0.05% a day. At the same time, the BIR was substantially higher. For 1995,⁸ calculations show a monthly penal rate of 6.8% and a nominal lending rate of 4.9%. For 1996,⁹ results show a monthly penal rate of 19% and a nominal lending rate of 10.1%. Considering the risk and potential benefits of not paying taxes at all, this a good price for lending from the government

3. Some thoughts on tax administration

Here we would just like to outline several factors that facilitate informal practices and provide stimuli for the tax administration to commit misconduct in its duties

Tax officials are poorly paid, compared to the taxes they have to collect. The Special Encouragement Fund operates inefficiently and very few of those who directly prevent tax crimes receive respective remuneration;

A possible benefit of decent behavior could be future promotion in administration or opportunities for a better job in private business. In fact, those who “cooperate” with tax evaders usually go into the private enterprise after leaving the tax administration. A broadly-offered service (advertised even in the press) is “tax officials who do annual tax reports.”

The fear of penalties is negligible. Bribing is penalized by up to six years imprisonment. However, in order to be detected, the crime should be reported. In cases of mutual benefit neither the entrepreneur nor the tax official would alert the police. The only cases of successful bribe detection have been when either the bribe was too high, or the official failed to perform the “service.”

As a common rule tax audits of certain papers for a period is performed only once. The Accounting Act states that “tax and financial control documents should be kept until they are audited by tax officials.” What this means is that it is legally allowed to destroy papers once a tax audit has been performed. As a result, almost no possibility of subsequent control exists. For the period between August 1, 1997 and September 1, 1998, only 13 out of 9,481 tax officials were laid off after internal control audits.¹⁰

Conclusion

Even a brief analysis of the existing tax regulations proves that there are substantial incentives to engage in informal activity. The costs of compliance with tax legislation are several times higher than the costs of non-compliance. At the same time, the “rules of the game” are unstable and non-transparent, thus imposing additional costs on private business. And finally, no incentives are provided to the tax administration to fulfill its duties.

The result is a rational escape from formal behavior.

⁷ BIR of 6% is assumed

⁸ Annual BIR = 61%

⁹ Annual BIR = 193%

¹⁰ Source: Ministry of Finance