

FLAT TAX IN BULGARIA:

History

Introduction

Results

2016



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FOREWORD

For the IME publishing a book on proportional tax is not a new idea. In recent years we have had many discussions on the need to chronicle and study one of Bulgaria's most successful reforms. The continuing debates, often dominated by myths and legends, on the effects of this change, made the appearance of this type of book inevitable. The realization of the idea had to be put off, though, for the sake of *Anatomy of the Crisis* in 2015, the time for which had also grown ripe. Now the focus is exclusively on the flat tax.

The present essay collection is not aimed at claiming authorship on the 10 percent flat tax. It does include, though, texts by some of the people who were direct participants in the process of preparing, providing arguments in support of, and implementing the reform. Efforts, which, as becomes clear from the book, span over 10 years. It is this historical perspective that makes it possible to highlight the flat tax as a logical and natural result of a comprehensive change in the country's taxation and social insurance model. Introducing the flat rate was by no means accidental. On the contrary, on the eve of the change itself, the idea was seen as acceptable by most people and enjoyed solid support from both society at large and the expert community; that support eventually found its political expression. It would not be an exaggeration to say (following Georgi Ganey) that this tax reform is an example of macro-institutional change for which it took our society years to mature.

A decade has passed since the first 'pillar' of flat tax was introduced: the flat profit tax of 10% in 2007, followed by the flat 10% income tax in 2008. From today's perspective it becomes easy to separate the truth from the myths and present the results of the reform the way they are. The present edition offers both first person narratives about tax changes after 1989 along the path to the flat rate and several different views on its effect in our country: on disposable income, tax revenue, formal employment or welfare. It is these effects that allow us to call the flat tax a successful reform: one of the few in our country to have found international recognition.

We do believe this book will contribute not only to a clearer picture of economic processes in our country but also to the inevitable future discussions of the structure of the tax system in our country. We also believe ideas presented in this book will be of use to anyone looking for father knowledge on the topic.

The Institute for Market Economics wishes to thank all authors who enthusiastically participated in the making of this book. We are also grateful to the Friedrich Naumann Foundation for Freedom for supporting us and making this publication possible.

Enjoy reading it!

The IME team



FLAT TAX: CONDITIONS, PROMOTION AND INTRODUCTION

KRASEN STANCHEV

„The hardest thing in the world to understand is the income tax.“

Albert Einstein

When the foundations were laid

Hardly anyone today remembers how the idea to introduce flat tax in Bulgaria first came into being. The time advocacy for that reform actually started was 1997.

Of course, some people have quoted *Flat Taxc* (2007), Alvin Rabushka and Robert Hall's¹ famous book, which, beyond doubt, has inspired both the theorizing and the practical attempts at introducing flat tax since the concept came into being in 1981, both that and previous editions.

In the revised edition of 2007 a new chapter was added: "What does fairness of taxation mean?" There the authors provide some synonyms derived from the legal and economic tradition and literature, of 'fair' in the context of taxation, namely: legal, equitable, unbiased, impartial, non-discriminating, free of prejudice, objective and detached. What they all come to indicate is that fair taxation implies no favorizing, self-interest or commitments².

One reason Einstein expressed his bewilderment with taxes each year may have been that taxes take away forcibly or coercively a share of privately gained income. Each confiscation, albeit lawful, has a fairness problem. And from an economic perspective income is remuneration for the services people have provided to others who have shown readiness to pay for them. Therefore the more income stays with those who gained it, the more they want to work. Any other concept of the essence and origin of income, as well as of the effects of income tax on people's behavior is economically irrational. Whenever other interpretations are suggested by economists and politicians claiming awareness of the consequences, they raise suspicion of deliberate hypocrisy.³

Of course, it is possible that irrational people exist – volunteer slaves of a kind, who want to work more when more is taken away from them. But this kind of attitude to income and taxation is a matter of personal choice. At the same time, paying more taxes than legally required is not forbidden. Whoever wishes to do so, can do so. Hardly anyone would obstruct this kind of act.

¹See *Rabushka, Alvin, Robert E. Hall. Flat Tax*, Hoover Press, 2007 (Sixth Edition), available on the Internet. By the time this edition came out (and proportional tax was first imposed on corporate income in Bulgaria) the concept was actually 25 years old. The discussion provoked by this anniversary was summarized in *Rabushka, Alvin. The Flat Tax's Silver Anniversary*. We at the IME had the revised American Enterprise Institute edition of 1995. Before we were given the book we were aware of the concept from the two authors' article in the *Wall Street Journal* (10 december 1981), which Susan E. Woodward, then Chief Economist with the U.S. Securities and Exchange Commission and, for a few months in 1993, advisor to the IME, gave to us.

²*Rabushka, Alvin, Robert E. Hall. Flat Tax*, p. 39.

³For a summary of the illusions concerning flat tax in one of the more recent election campaigns see *Станчев, Красен. Фискалните илюзии в избирателната кампания. – Преглед на стопанската политика, № 627, 30 април 2013*



At the IME, we faced this fairness problem in 1997. That was a time when, amongst the variety of ideas for tax reform, ideas of lower taxation for small and medium-size businesses were revived.⁴

One of those businesses' organizations offered to commission from the Institute, for remuneration that was very good for the time, an explicit vindication of that approach to taxation, laying the emphasis on patent tax. We declined the offer. For the following, mostly theoretical, reasons.

There is no objective way to distinguish large from small enterprises economically, they are interconnected along the value chains and, regardless of company size, their motivation is to profit and develop, to grow "big".⁵ Their statistical separation is a statement of their momentary condition (in the sense of turnover, number of employees etc.), in other words, it refers to the past. While company / entrepreneur activity yields its results in the future. Their legal distinction – rather suspicious and aimed at state interference – is purely populist; it can change company incentives for work in the future, especially if belonging to different categories is fixed with different tax treatment. That creates incentives for some small businesses to stay small (if tax reductions are considerable) and not develop. The same is likely to happen to medium-sized businesses, while some of the big ones will pretend to be small or medium-sized (or will create companies of those types for purely tax purposes).

To prevent such distortions, our second reason, tax administrations would have to "take steps", watch closely the different privileged groups of companies, create additional spending for them on work with the state administration (and thus – possibilities for additional income to some of its representatives) with the perspective for tax reductions, which would be considered unfair with time, to be removed or at least modified. That is precisely what happened with the patent tax. But this is another story.⁶

What immediately followed from these arguments was that it is much fairer and more fiscally sensible to have all taxpayers equally treated by the law.

Fairness in this sense implies several things.⁷

In the first place, this is equality before the law: all taxpayers get the same treatment without prejudice and the law does not divide them into "losers" and "winners"; it generates no social conflict between the former and the latter.

In the second place, all taxpayers are equal as contributors to the state budget because they allocate to it the same percentage of their income, though they contribute different sums of money – people with higher incomes naturally contribute more, etc.

In the third place, there is no distortion of incentives. Those who produce less and make less profit have no incentives to stay in that category. That is, everybody's incentive is for more work and higher income. Of course, quite a few incentives for non-productive behavior are engendered by the system of redistribution but they are subject to different relations. Each income, before it gets redistributed in a political way by organs of the state, has to be produced. As a well-known economic aphorism from the mid-19th century says, no method has been invented to eat fish that has not been caught.

⁴In the early 90s their most outspoken proponent was Ventsislav Dimitrov.

⁵The lack of economic feasibility of this approach in developed economies was explained in detail in Ludwig von Mises' report *Big Business and Small Business* at the "Mont Pelerin" Society meeting in 1961 in Turin.

⁶In 1997 I calculated that because of the nature of my work I could get a registration as a "fortune teller" and pay an annual tax equivalent to slightly under 400 leva (in today's money). In 1998 tax regulations changed. Today fortune tellers, psychics and bioenergy therapists pay a patent tax which varies between 2000 and 5600 leva depending on workplace location.

⁷For more details, though in a different aspect, see the same topic in Georgi Stoev's text in this book.



In the fourth place, demanding from anyone to pay higher taxes and work more in order to have more income for redistribution is demanding economically irrational behavior which presupposes and is grounded in ideas about the motivation of the taxpayer that are not quite ethical.

The First Clash with Populism

In 1997 it became clear: we had practically failed to convince anyone that ours was the right approach. Lachezar Bogdanov proposed a study on whether society, especially business, would prefer proportional (i.e. flat) or progressive taxation. Depending on the results we would know what to do and what arguments to use.

Lachezar's proposal resulted in an international comparative study on the possibilities for deregulation of the tax systems of Bulgaria, Poland and Slovakia.⁸ It was only in Bulgaria that we managed to carry out (between September and December 1997) a representative survey of attitudes among businesses, with the awareness that tax relations in our country were a bit more complicated, they included relations with local government, and fewer taxes got paid (as a consequence of high inflation and economic policies between 1995 and 1997). That complexity easily transpires in the following table.

Table 1: Nominal complexity of direct taxation in Bulgaria, Poland and Slovakia in 1998

Country	Personal income	Corporate income
Bulgaria	Four rates: 20, 26, 32 and 40%	Three rates: up to 19% (municipal), 20 and 30%
Poland	Three rates from 19 to 40%	Three rates from 10 to 32%
Slovakia	Five rates from 10 to 38%	Three rates from 5 to 25%

Tradition in Poland and Slovakia, apart from relatively simpler tax rates, also had other advantages compared with Bulgaria. In Poland the gradual lowering of corporate tax already had a ten-year long history. In Slovakia the lower rate was applied in order to repatriate profit, to encourage foreign investment and the other rates were close to "flattening out".⁹

Our working hypothesis corresponded with our knowledge: that in Bulgaria business would be more likely to prefer proportional, equal for all, treatment with lower taxes. That is why our main question was whether a reform which introduced low proportional tax rates and equal treatment of all companies would be approved.

The ratio of those "against" to those "for" turned out to be 65 to 35.

The motives:

- Small businesses and medium-sized businesses should pay lower taxes;
- Big businesses should pay higher taxes;

⁸See Bak, Mieczysław, Krassen Stanchev, Juraj Rencko (eds), with Lachezar Bogdanov, Assenka Yonkova-Hristova and Docho Mihailov, Needs for Deregulation of the Tax Systems in Central and Eastern Europe. A Comparative Study: Bulgaria, Poland and Slovakia, IME, I.M.E. Occasional Papers, 1998. (The report is a bibliographic rarity, it can only be found in the libraries of IME and BMA as well as the National Library "St. Cyril and St Methodius".)

⁹For more on the history of taxation in these countries see Domaradzki, Spasimir. Tax policies in Poland, Slovakia, and Bulgaria: sitting on a ticking bomb or catching up with the West? – IREF Working Paper, No. 201603, April 2016.



- The “state” should compensate company losses from previous periods as they were caused by monetary and other policies between 1995 and 1997.

These motives clearly show the opportunistic mood in business circles in 1997. It probably coincided with the opportunistic illusion of the majority of voters that through redistribution one could live at other people’s expense.

The Campaign against Populism

Getting society convinced that introducing the flat tax in our country made sense was actually a campaign against the populism which had transpired so clearly in the 1997 survey.¹⁰

The persuasion process began by the publishing of the study in question. In my opinion it went through the following steps and achievements.

In Slovakia our counterparts were taken to task by the chief ruling parties in Meciar’s group. They decided (the idea was put forward by Jan Oravec) that they could make the parties accept the reform if they founded a Union of Taxpayers which would insist on the introduction of flat tax. That took time, about 5 years: in 2003 Slovakia introduced a 19% flat rate for personal and corporate income tax. In Poland the vice premier and minister of finance who was planning that kind of reform, Leszek Balcerowicz, resigned in June 2000. In Bulgaria we tried to follow the path of Jan Oravec but here, too, three taxpayer unions sprang up, founded by tax experts. Their purpose was to fight against the introduction of proportional tax.

It was of particular importance to calculate what the rate of the flat tax should be. In Slovakia no calculations had been made, there simply was general agreement on this issue. The 10% threshold in our country is based on calculations of the income percent which had in actual fact been paid as tax between 1998 and 2001. It was Georgi Stoev who made the calculations then; they showed the amount of tax actually paid was 12.9%. Between 2002 and 2004 that percentage remained unchanged for persons and rose slightly for corporations. Among all the reforms aimed at “flattening” (“proportionalizing”) income taxes, it was only in Russia that a scientific-empirical estimate was used to set the rate of the tax – 13%. There, the study was initiated and carried out under the leadership of the then deputy finance minister Sergei Shatalov. No studies of this kind were made in Romania, Slovakia, Macedonia or Montenegro.

In 2002 the introduction of proportional tax was supported by 15 economists while the minister of finance declared himself against; however, the prime minister supported the idea and thus a gradual lowering in corporate tax was included in the tax law changes planned for the next year.

That same year IME started publishing a bimonthly special bulletin on the issue, which was distributed in print among all MPs, ministers, deputy ministers, the main employer organizations and the more important trade unions. It was financed by a private donation (which amounted to about 3000 USD) from Georgi Vassilev, a Geneva banker of Bulgarian descent. While in 2002 15 economists had supported the introduction of proportional tax, in 2003 their number was 110; they sent a letter to the then minister of finance. Foreign direct investment (FDI) attraction was not mentioned among their arguments as the main purpose: it was said to be the increase in households’ disposable

¹⁰The study was far from being the first of its kind to find a significant presence of populist attitudes in the way people made sense of economic policy. It just showed different ones, especially in business mindsets. Social attitudes from the period prior to 1995 were generally more optimistic. See Станчев, Красен. Икономическият популизъм в България. (Оптимистичен опит от едно изследване). – Политически изследвания, № 2, 1994.



income.¹¹ All signees simply understood that the investment process depends on many other factors and taxes are not the most important one among them.

Putting in practice an idea that came from Georgi Angelov, starting in 2003 IME has annually been making a budget, alternative to the government's, which shows and proves that with low taxes (10%) budgets can be balanced without cutting social spending. The main argument in budget making is – and it could not be any different – that the so called Laffer curve works: when taxes go down people are more willing to pay them. Data on tax collection after 2001, taking into account changes in business cycles, confirmed this hypothesis. All basic political parties which took part in the parliamentary elections in mid-2005 and cleared the 4% barrier, except BSP, supported the reform that introduced the 10% proportional income tax.

The success in changing attitudes was mainly due to BSP. That party's election campaign followed the model of the Hungarian socialists of Ferenc Gyurcsány from 2003 (the main emphasis of which was raising incomes by raising salaries in the budget sector). The idea was so clearly harmful that calculating the effect both in Hungary (where it was already visible to the naked eye) and in Bulgaria was easy, in terms of budget deficit and GDP drop. Three colleagues from IME also took part in that campaign: Georgi Angelov, Martin Dimitrov and Dimitar Chobanov. Together they had more time on air in TV and radio debates than the acting members of the cabinet. Criticism of the Hungarian model also implied pointing to an alternative.

Eventually, as we know, proportional corporate tax was introduced in 2007 and the next year it was extended to personal income tax as well. The main motive of the parties in the coalition then in power was that this was a way to simplify the tax system, to collect and redistribute more taxes.

With economists the Laffer curve was – and is – a more persuasive tool. The chief motives were the growth of disposable income, the economic growth stimuli and the obvious social justice of the new tax system.

Social and Political Effects

One of the chief effects of a system with low and proportional taxes can be the prevention of ideas for tax raises and fiscal discipline. Such taxes imply a limit to government spending as a share of GDP and that creates opportunities for economic growth. The optimal size of government from this perspective would be around or under 25% of GDP.¹²

Because tax is ultimately a derivative of personal income, it offers more opportunities for social mobility as personal income, consumption and savings can be improved with gradual efforts on the part of individuals (investing in knowledge and skills that increase bargaining power in relations with those looking to hire) to improve personal income, consumption and savings.

In other words, the proportional tax system does not look upon people as classes with fixed income status. This is the chief misconception of the proponents of progressive tax: they do not see that employers compete first and foremost with each other in the demand for workforce, workers do the same with other workers and that is the driving force in the labor market – not the imaginary opposition of average statistical workers and employers Marx envisioned in the 19th century and

¹¹EU and UNCTAD statistics very clearly traced the outflow of foreign investment from the new member countries after 2008: in Hungary, Latvia and Croatia. In Bulgaria there was no outward investment – here there was a drop in the inflow of investment, but the cumulative investment capital stayed unchanged. Proportional tax may have been among the reasons. This topic, though, calls for a separate study.

¹²Mladenova, Adriana, Dimitar Chobanov. What is the Optimal Size of Government, IME, August 2009.



Piketty in the 21st century. It is from this misconception that the views on how the former can live at the expense of the latter and vice versa are derived.

Actually the problem with unemployment and low income lies in the fact that employers become unemployed for one reason or another, their own inability to withstand competition pressure being a probable one among those reasons.

Proportional tax does away with the possibility for political parties to justify their tax ideas with social phenomena such as envy, the kind of argumentation which is only good for setting off conflicts (actually one of those parties' functions) so that they could then claim to be solving them.

Furthermore, proportional tax creates a sense of fairness which helps people with lower income see themselves and their children as people with a potentially higher income and lets them teach themselves to invest in knowledge and skills that are in demand by others. For the same reason those with higher income are not left with the feeling that someone forcibly takes away something from them; they pay their taxes in a more conscientious way and if they deem it proper they help those they consider needy.

These effects are all the more powerful the lower the tax; everyone is left with more money for their own initiatives – consumption, savings or investment. Therefore it is highly probable that both the economy and social mutuality increase with flat tax systems unless prevented by some other power factor, usually a political one.

It would be absurd to suggest that the more is forcibly taken from individual income (which is the property of those who made it), the more it will be in people's interest to work and pay more taxes.

Proportional tax should actually be a purely social, even socialist idea from the economic point of view (if the implication is care and attention to the less wealthy members of society). The reasons are:

- poorer people profit from it because of the increased disposable income, the so called infiltration effect and the incentives for more work;
- all other conditions being the same, this leads to more growth in the economy and generates more jobs;
- after its introduction, more money is accumulated in the budget (with the exception of corporate tax in times of economic decline) and proponents of redistribution can spend more of other people's (taxpayers') money;
- It is fairer than progressive tax because it gives equal treatment to the various income levels and does away with the privileges of higher income levels to evade the application of tax and other laws.

The Corporate Tax Illusion

There are two important compromises in the Bulgarian proportional tax system.

The first one concerns the so called social, health "insurance", a tax on labor and personal income. It is not part of the flat tax system. Minimal insurance thresholds are a form of progressive tax. And the practice of their rates being set in administrative ways by organizations not elected by the taxpayers is in an unclear relationship with the country's constitution, to say the least. In this area there is



hardly anything that can be changed without privatizing the accounts for health and pension tax and the funds that run them.

The main criticism against proportional tax is grounded in the illusion that taxing corporations / juridical persons progressively will bring more revenue to the budget and will provide support for social justice.

In the first place, it seems highly unlikely that proportional corporate tax will bring more revenue to the budget. In the last four years the share of budget revenue from taxing juridical persons in Bulgaria has been practically equal to that in Austria and close to the levels in Denmark and Germany. From 2007 to 2014 that share was even higher.¹³

Juridical persons – companies, corporations, including international ones, are made up and consist of physical persons. A corporation's income is the income of its owners (founders, shareholders, etc.) and from that income the income of the individuals working for the corporation is formed, as well as that of its suppliers of goods and services paid by the corporation. The tax on this income is a tax on a secondary and to a considerable extent artificial person. It is created for other reasons and with intentions other than to pay taxes.

This is double taxation: once of a juridical person and then of the individuals who have founded it or work for it. It diminishes both the corporation's investments and the incomes of its individuals, as well as harming its potential to create more jobs both in the company itself and in its suppliers.¹⁴

There are two ways to finance the tax owed by a corporation: to take it from the income of owners and employees or to calculate it in prices thus making the consumers of its goods and services pay it. If that is impossible to do, i.e. if consumers cannot be forced to pay higher prices, the company downsizes investment and jobs. Often there are pension funds among company shareholders, or individual shareholders who can cause political problems for governments when their income is reduced due to increased taxes companies they invest in have to pay.

Of course, there is a third, illegal, way to finance the tax: by not paying it. As an old saying among accountants goes, "Sales are money, profit is a notion". No matter how much legislators refine the ways to calculate corporations' taxable income, profit can always prove to be a fictional figure.

All that happens within the same jurisdiction. The company can demand from the government to deploy different policies limiting the freedom of choice for its consumers or suppliers. But it can also move to an altogether different jurisdiction where taxes are lower. That even happens within the framework of the US tax system where the government operates on the principle of extraterritoriality: it collects taxes from all its registered subjects, no matter where the income was generated.

What the government ultimately achieves with this tax is create incentives for tax evasion, barter, informal economy and other forms of behavior that go against the original idea.

If corporate tax gets abolished, that does not mean governments will collect less revenue for state budgets. On the contrary, this is a tax on labor, on creative activity and earned income. As people will eventually get richer if it is abolished, more revenue will go to the budget.

¹³See the tables by country in: EUROSTAT, Taxation trends in the European Union, DG Taxation and Customs Union, 2015 Edition.

¹⁴For similar findings see: DB Research, The impact of tax systems on economic growth in Europe, An overview, 5 October, 2012.



However, the money thus saved does not disappear: it either gets reinvested or is redistributed as income between owners and employees; it finances consumption and other taxes.

In other words, companies that optimize their taxes are a substantial benefactor of social policy even though their work in this area is independent, outside the government's monopoly.

As Gregory Mankiw put it, "corporations are more similar to tax inspectors than to taxpayers: the weight of corporate tax is eventually borne by the people".¹⁵

Some Comparisons between 2016 and 2006

Taxes are part of the everyday and economic environment. It is hard to find the causal relationship between them and any other social phenomenon. It is at least possible to show, though, that deterioration in both the economy and living standards after proportional tax is introduced is either pure illusion or deliberate deception.

2006 was the year preceding Bulgaria's membership in the EU and two years after the country entered NATO. Ten years have passed since. Some comparisons between the state of affairs in early 2016 and that in 2006 can show in what ways the welfare of both the economy and that of citizens has improved. Regrettably, final statistics are mostly for 2014, but anyone can compare figures with the NSI webpage.

In 2006 real GDP per capita was 4500 euro; in 2014 it was 5500 euro. The total GDP at the beginning of the period was 22 bln euro and in 2014 it was 42 bln euro. In purchasing power parity terms, Bulgaria's GDP compared to the average EU level was 38% in 2006 and 47% in 2014, probably 49% in 2015.

Unemployment in 2006 was 9%, in 2008 it reached its lowest level for the last 20 years, 5.6%, and in the third quarter of 2015 it was again below the 2006 level (8.3%).

In 2006 the personal income tax was progressive: 20, 22, 24% of income, and tax on corporate income was 15%. The introduction of proportional tax took time: only a lowering of corporate tax to 10% was planned for 2007.

The average cash income of households in 2006 was 5863 leva; in 2014 it was 11,489 leva – i.e. it grew by 51% (despite the recession and the rise in unemployment in 2009-2010).

Average household expenses on food and soft drinks in 2006 amounted to 38.2% of income and 34.7% of total expenses: the difference in percentage implies people were living partly on credit then. In 2014 food and soft drink expenses were 30.8 and 30.4% of total income and expenses respectively (credit for current consumption almost disappeared).

Between 2013 and 2015, for reasons which were never quite clear, household expenses on electricity, heating etc. turned into a political problem. Statistics indicate that there was not much ground for political anxiety of this kind. As a share of the total household expenses, electricity and other maintenance expenses were 12.9% in 2006 and 12.6% in 2014, which contradicts the claims that they rose "drastically" and the number of energy-impoveryished people increased.

Compared to communication expenses (fixed and mobile telephones, internet, post and courier services), which, by the way, increased by over 61% in that period, it turns out that household

¹⁵ Mankiw, N. Gregory. One Way to Fix the Corporate Tax: Repeal It. – New York Times, AUG. 23, 2014



electricity expenses in 2014 and after were lower than those for the mobile phones of one or two household members.

Besides, it might be a good idea to bear in mind the fact that between 2003 and 2005 the State Energy and Water Regulatory Commission raised the price of electricity by 45%. (Let me repeat: while household incomes were lower by 51% than those in 2014.)

The liberalization of the market for electric energy was scheduled for July 1st 2007 (and the date was fixed in the contracts with the companies for electricity distribution). Because of “Belene” and “Tsankov Kamak” it was de facto put off in 2006. This liberalization is, however, happening now, in 2016. The price is the National Electric Company’s deficit and the stalled payments in the system.

Comparing cash expenses on various consumer goods and services also shows some interesting facts. For example, people spend more than twice as much on clothes and shoes now as they did in 2006, they pay 3.5 times more taxes, (especially after the introduction in 2008 of the “inhumane flat tax”, in the phrase of trade union and political figures), they pay 56% more for home furniture and equipment and 2.4 times more for leisure, recreation and education.

It is true that Bulgarians also spent twice the amount they did before on alcohol and tobacco (despite the bans and the raised excise tax). At the same time, however, nutrition habits improved during the period (if it is at all true that some foods and beverages are essentially harmful): less salt is consumed, less sugar, fats (including lard) while the quantity of consumed sparkling soft drinks has remained unchanged. There is some increase in beer consumption but some people claim it saved humanity. Statistics on diet components show that consumption of better quality meats and fruits, especially citrus fruits, has increased.

So far as food is concerned, things were a lot worse in 2006 than in 2015 or 2016. But at that time it did not occur to anybody to levy tax on foods.

For the duration of the “unseen” (in the phrasing of non-caretaker prime ministers since 2005) crisis, between 2008 and 2012 Bulgaria ranked first in the EU in car sales. In number of cars per 1000 inhabitants Bulgaria occupied the 37th place among 136 countries, before Russia and Romania.

In 2006 there were some things few people were familiar with, for example, there were almost no smartphones. A representative market study in early 2013 found that 64% of Bulgarians have smartphones and almost 70% surf the Internet on a daily basis.

During all those years Bulgarian citizens and companies not only restored the bank savings (as a share of GDP) they lost in 1996. That happened precisely in 2006. But at that time household bank deposits exceeded those of non-financial enterprises by only 5 bln leva: 14.6 bln versus 9.7 bln. As of December 2015, the total level of the bank deposits of Bulgarian citizens and companies was 73% of GDP, the share of deposits of households was 49% of GDP, twice as big as that of companies. Banking confidence was high despite the eschatological talk of politicians.

An argument against all this would be that these are average values and they do not take into account inequality among individuals and households. That is not true.

In terms of inequality, measured by Eurostat according to the Gini coefficient, Bulgaria was practically equal with Greece, Latvia, Portugal, and Romania in 2012. According to the World Bank’s calculations the dynamics of the coefficient is as follows: in 2006 and 2010 its value was 35.7 and in 2012 it was 36.0; in 2007 it went down to 28.1, the lowest value for the period; subsequent changes were the result of the 2009-2010 recession.



Anyway, two things transpire from what was said so far: that the welfare of Bulgaria's citizens is improving and that the rumors about taxes contributing to impoverishment are really either grossly exaggerated or a deliberately planted illusion.

It would be interesting to note that since 2006 the efficiency of the Bulgarian tax administration in tax collection has improved 4 times. It is measured using the ratio of the expenses on the collection of tax revenue to the revenue itself. This indicator ranks Bulgaria before Australia, Belgium, Canada, the Czech Republic, France, Germany, Hungary, Ireland, Japan, Luxembourg, the Netherlands, Poland (two times better) Portugal, Slovakia and Slovenia.¹⁶

There is more to be done: this indicator does not include excise collection. But this is more a problem of the law's implementation.

More importantly, low expenses of the tax collecting administration mean two things – that the system is simple and clear and that people perceive it as fair.

¹⁶ See OECD, Cost of collection ratios (administrative costs for tax administration/net revenue collected).



SOME HISTORICAL MOMENTS (1989 – 2002)

(First person singular speculations on tax policy)

GEORGI SARAHOSTOV

This essay does not claim to be either scientifically grounded or exhaustive. It bears the mark of subjectivism. I agreed to share thoughts and facts connected with past tax reforms because to some extent I took part in them. My role has never been decisive.

Part of my motivation lies in my concern for history. Some of the things I am sharing could have remained unnoticed or forgotten. I want nothing like that to happen, but I am not always able to provide detailed explanations why. In the most general sense, I believe that if I don't, some researcher from the future might draw some meaning from this.

Part of my motivation also lies in a certain anxiety. In my opinion politicians in our "welfare" states are sending more and more destructive messages. They keep charging people with unrealistic life expectations and pushing them towards irresponsible behavior, mostly by maintaining the illusion that states should ensure nations' welfare and have the ability to do it. All that is financed from taxes: sums sequestered from people by installing in them fear of sanctions, or even by using force. We are going into more and more dangerous waters. I have been asking myself if it is not too irresponsible to pay taxes to such states unconditionally. Worse than that – if my own efforts for the construction of an efficient and pragmatic tax system (mostly in the area of indirect taxes) were not in fact doing more harm than good. I am convinced that misgivings of this kind are meaningful and I do admit I wish more readers could be sensitized to them.

I am apprehensive of people who tell others "we should" (usually those are politicians, people from the administration or applicants for such positions). My hope lies with those who think and act following the "I choose, I bear the consequences" model (usually those are entrepreneurs, professionals, students, unemployed people who do not complain, children).

I am learning to avoid preaching. If I have failed to do so in this essay – please excuse me. I am open to comments and recommendations at gsarakostov@yahoo.com.

I break rules. It does not always show but I like doing that on principle and wholeheartedly. I am also doing it in this essay. If the thoughts, data and quotations about taxing seem boring (I can understand that) you can always jump straight to the last section entitled "Is it right that we pay taxes?"

On the connection between the period from 1989 to 2002 and the introduction of the flat tax

I don't think at the end of 2002 either I or any of my acquaintances, colleagues, clients or partners had a clear expectation that in 2008 Bulgaria would introduce a flat tax rate of 10% on personal income.

It is my belief that the decisive role for that change was played by the developing tax competition between countries in combination with the persuasiveness and persistence of economists who had been calling for the introduction of a flat rate since 2003.



My perspective on taxes has always been that of the taxpayers and the way one tax system peculiarity or another reflects on their lives. There have been some international corporations, too, among my clients, so I think we can already talk of a tax system that is, in a sense, global. A tax system change in a country other than Bulgaria can influence fiscal revenue in Bulgaria, too – or the other way around.

I have not analyzed the macroeconomical aspects of taxes – I just happen not to be a macroeconomist.

My interest has been mostly in the interaction between taxpayers and the representatives of state institutions – how it can be made easier, cheaper and free of corruption risks. And even – surprise! How it can be made more pleasing and better in terms of software design and human experience.

Going back in tax history, I would highlight the following circumstances between 1989 and 2002 which in one way or another prepared the ground for the introduction of flat tax:

- After 1989 the country gradually passed from the formal tax system characterizing a centrally planned economy to a real tax system with a separate tax administration and a gradually increasing capacity to collect revenue from private enterprises.
- In 1994 a value added tax was introduced with a single positive rate of 18%. What made that possible was the broad tax base. There was awareness that relieving some groups of taxable persons means imposing an additional burden on all the rest; also, a decisive political choice was made in favour of tax neutrality and the broadest possible tax base.
- In 1996 the approach to personal income tax changed radically. It came to resemble the approach applied in most countries: local persons are taxed for their total income and foreign ones – for their income from sources in the country. Earlier the taxing of Bulgarian persons depended on whether the income had been “imported” into the country which created potential for erosion of the tax base.
- The hyperinflation of 1997 showed in practice that progressive personal income tax in a changing environment (not necessarily inflational) inevitably requires uneasy political decisions about corrections in the scale. The idea to invent a progressive scale based on the minimum salary failed to produce a meaningful model.
- The progressive scale created yet another problem: people who had had a high paid job for only, say, two months in a certain year had to file annual tax returns to get back part of the tax deductions made by the employer according to the monthly scale. That meant more effort for both the taxpayer and the administration. There is no such problem if the tax rate is flat.
- Although between 1989 and 2002 there were times when the number and rates of the progressive personal income tax scale went up or down, the general tendency for both parameters was downwards. As of 2002, the progressive scale had four positive rates (the highest number for that period was 8), the highest one among them being 29% (the highest one for that period was 52%).

What comes next does not necessarily follow from or complement the above thoughts. It should only be considered as descriptions of different moments in the development of tax culture in the country and personal opinions connected with them.



Under the leadership

In 1989 Bulgaria had a constitution according to which “the driving force in society and the state is the Communist Party” (article 1, par. 2) and “the socialist state supports the passing of socialist society into communist society”. (Article 4, par. 2)

In January of that year the State Council approved Ukaz (Decree) № 56 for economic activity which was an attempt at reviving and regulating private economical initiative. For the first time after decades of denunciation of the “capitalist system” Bulgarians could legally acquire stocks and earn dividends though “according to rules set by the Council of Ministers” (article 34, par. 2). The Ukaz had the ambition to play the role of a commercial law, a public procurement law, tax legislation for business and what not.

The practical application of the Ukaz was not well prepared and rather unclear, at least so far as the public is concerned. Thus for example article 87 stated that “companies pay value added tax”. The authors apparently did not have a remote idea what this tax is about and that its introduction requires (with the state of technology at that time) at least two years of preparation. In reality the tax only began to be implemented on 1st April 1994.

The laws concerning state spending were not much better than those on revenue collection. Article 84 of the Ukaz said literally: “State procurement is governed by a contract including one based on a competition of tenders. It cannot involve more than 2/3 of the company’s capacity.” Possibilities for interpretation of regulations like this were huge.

There is something symbolic in the fact that a regulation, approved only months before the stepping down of Todor Zhivkov and signed by himself in person, contained the direct tax legislation for business in Bulgaria in the first years of the so-called transition. That phase ended with one of the acutest economic crises in our history – in the winter of 1996-97. Between 1989 and 1997 valuable time was lost for important institutional reform.

Ukaz 56 embodied a contradictory political and legal culture, the bearers of which seemed ready to do anything in order to keep their leading role in society and the economy, no matter in what form. People who had for many years called for struggle against “the capitalist system” expressed their ambition to lead the return of the country to it. In saying that I am not putting the blame on them, I am rather trying to express some regret that there was no well-prepared alternative. Or at least that it failed to assert itself.

Bustling with pointless work

In the summer of 1992 between the IMF and the Ministry of Finance a discussion was held on the role of tax declarations in the taxing process. This role had been limited until then. For example, article 35 B of the then acting Law on the General Income Tax went: “Taxes are determined by a tax authority and are announced to the taxpayers with individual notifications when they are determined according to declarations. In other words, receiving the declaration, the tax administration checked it for arithmetic errors and if there were none, sent taxpayers a notification on how much they owed (the sum, of course, coincided with the one they had declared themselves). It was the notification that constituted the legal basis for payment of the tax. The declaration itself did not.

The IMF experts proposed eliminating the notification sending procedure as it added no value to the taxing process while it only increased administrative expenses and delayed payments to the budget. In the event of a mathematical mistake in the declaration, they pointed out, the most sensible thing



to do was send the taxpayer a notification about it and demand correction. That would have to be done for only a small percentage of the declarations. Tax fraud (declarations with no mathematical errors, but with incorrectly declared input data) could be discovered by means of audits and checks and criminalized. The administration would have 5 years for auditing and verification.

The discussion took place in the VAT context as VAT implied monthly declarations, so administrative expenses for the “traditional” notifications would be too high in comparison with the annually declared taxes.

Much to my surprise, experienced Bulgarian lawyers with influential positions opposed the IMF proposal, regardless of the convincing arguments and worldwide practices. They seemed relentless, too. They said the tax could not be set by the taxpayer; that was the state’s business, besides, there were traditions which should not be broken. For some time this put a question mark on the support of the IMF for the introduction of VAT in Bulgaria. The issue had to be taken to the minister (another Bulgarian tradition which seems to be observed even now). For about a month there was no answer even from him. Finally, to a question which began with “Are we about to go against global practices?” the endorsement went: “We’d better not”.

When a lucrative sale leads to losses

According to one of the tax incentives for small businesses and juridical persons without state participation, approved in 1992, they should pay 30% profit tax for profits up to 1,000,000 leva (article 87, par. 4, sec.1 of Ukaz 56). For higher profits the tax went up to 40% and that rate was applied to the entire taxable profit. No one had thought of the borderline cases. By way of illustration: if the annual taxable profit of 999,999 leva increased by 2 leva (for example by a successful retail sale of 2 leva in the last working hour of the year), the increased tax would adversely affect the company many more times than that company could have profited from the additional sale. More precisely, the harm would amount to 99,998 leva. Professionally speaking, the tax burden of the additional 2 leva in profit would amount to 4,999,900%. A carelessly designed system of this kind, apart from giving the impression of a disrespectful attitude to society, certainly failed to stimulate companies to declare all their taxable profit, especially if it did not go over 1 million leva by a lot.

The idea of stimulating small businesses by a lower tax rate turned out to be impracticable and has not been applied in Bulgaria for many years now.

Fewer rates – better choices

A considerable reduction in the number of tax rates was implemented in indirect taxes in the first years of the transition.

The turnover tax inherited from the centrally planned economy applied over 40 rates while the service sector was practically outside the range of this tax. What was the rationale of this complicated system? There was no sensible rationale.

In the state economy taxes were very much a formality. If each type of production is owned by the state which determines both prices and salaries and “each citizen capable of work is obligated to be engaged in socially useful labor” (article 59, par. 1 of the 1971 constitution) government can be performed without taxes. When everything is state-owned there is nothing to divide (of course, if people are all law-abiding and can stand this situation). In a system like this even citizens wishing to



leave the state's territory needed its permission ("exit visa"), i.e. they were themselves treated as state property.

The numerous rates of the turnover tax were the result of administrative decisions. The development of free entrepreneurship, however, demanded a much more neutral tax system. It should not cause price distortions or influence the choices made daily by millions of producers and buyers. Finally, the awareness was reached that the quality of these economic choices is much more important for the economy than the idea of the politicians elected by a different type of choice on what should cost how much to the consumers. With the liberalization of prices in Bulgaria the number of rates for the turnover tax was first reduced to 3 positive ones – 2, 10 and 22%, and then, on 1 April 1994, VAT was introduced with a single rate of 18%. This pragmatic system survived until the end of 2002.

Under cover

In 2002 a change in VAT in effect introduced a lower tax rate for some tourist services concerning mainly foreign tourists in Bulgaria (changes in articles 91 d, par. 2 and 91k, par. 4 and 5, State Journal, 117 / 2002). The changes went into force on 1st January 2003.

What is interesting here is that instead of introducing a reduced tax rate of 7% and demonstrating clearly the political determination of the National Assembly for a lower tax burden on certain tourist services, the tax base, on which the positive 20% rate (which remained – now only formally – the only one) was applied, was reduced by 35%. Thus the services in question (seemingly) were subject to a 20% tax, but this was imposed on just a part of the tax base which it would have been otherwise natural to be taxed for its total value.

It has to be noted, that at that time most countries with tourist destinations competing with Bulgaria applied reduced VAT rates. Those were, however, openly announced.

I present this moment of the past without offering moral judgement. That happened, it seemed interesting; maybe it would be a good idea not to forget it.

Hyper politics

It seems interesting to remember how the monthly income tax rates changed between January and June 1997 (in non-denominated leva).

January 1997

<u>Monthly Income</u>	<u>Tax</u>
up to 3,500 leva	untaxable
from 3,500.01 to 4,000 leva	18% for the part above 3,500 leva
from 4,000.01 to 5,000 leva	90 leva + 20% for the part above 4,000 leva
from 5,000.1 to 10,000 leva	290 leva + 24% for the part above 5,000 leva
from 10,000.01 to 20,000 leva	1,490 leva + 28% for the part above 10,000 leva
from 20,000.01 to 40,000 leva	4,290 leva + 32% for the part above 20,000 leva
from 40,000.01 to 80,000 leva	10,690 leva + 38% for the part above 40,000 leva
from 80,000.01 to 240,000 leva	25,890 leva + 44% for the part above 80,000 leva
over 240,000.01 leva	96,290 leva + 50% for the part above 240,000 leva



June 1997

<u>Monthly Income</u>	<u>Tax</u>
up to 50,000 leva	untaxable
from 50,001 leva to 60,000 leva	20% for the part above 50,000 leva
from 60,001 leva to 80,000 leva	2,000 leva + 22% for the part above 60,000 leva
from 80,001 leva to 160,000 leva	6,400 leva + 24% for the part above 80,000 leva
from 160,001 leva to 320,000 leva	25,600 leva+ 28% for the part above 160,000 leva
from 320,001 leva to 640,000 leva	70,400 leva + 32% for the part above 320, 000 leva
from 640,001 leva to 1,280,000 leva	172,800 leva + 36% for the part above 640,000 leva
over 1,280,000 leva	403,200 leva + 40% for the part above 1,280,000 leva

Note: in 1999 money was denominated, 1,000 old leva were replaced by 1 new lev.

It could be added that from February to May 1997 another scale was in operation, different from the above, where the untaxable monthly income was 25,000 leva.

It is also noteworthy that in June 1997 there was one rate less in the progressive scale than there was in January of that year.

It seems apparent that those changes required both intense calculation and fast political decisions.

Is it right to pay taxes?

Somewhere in the early 21st century the title “taxpayer of the year” began to circulate in public space. At first bestowing it was initiated by regional tax authorities, and starting in 2002 it was conferred at the central level with wide media coverage. The criteria included the amount of tax paid and the absence of tax code violations. The highest prizes usually went to large trading companies.

I mean no offence to the companies and individuals who won this award. But I am trying to figure out its meaning. Is having paid the most money in taxes and having obeyed the tax rules really a reason for celebration or special distinction?

In English bearing the tax burden is often expressed with the verb *suffer* – *to suffer tax*. It is considered totally acceptable to attempt to lessen this burden, as long as the letter and spirit of the tax law is not violated.

Many times have I witnessed bewilderment in foreigners at the existence of such an award in Bulgaria. To some it seemed similar to a hospital honoring the patient who had suffered most during the year. Strategic foreign investors were confused by wishes such as “this year you were awarded as investor of the year, hopefully next year you can make it to taxpayer of the year”.

I can understand the arguments in favor of such an award, too, but I still think those against are stronger.

My speculations on the moral aspects of taxation have reminded me of a collegiate discussion from the time immediately after the Constitution was adopted in 1991. Its article 13, par. 12 states that



“the traditional religion in the Republic of Bulgaria is the Eastern Orthodox Christian denomination” (I do not mean to comment whether such an article should be in it). In the course of the discussion in question the idea arose spontaneously that we should propose to the Ministry of Finance to print on letterhead forms of the tax administration the familiar biblical postulate “Render therefore unto Caesar the things which are Caesar's; and unto God the things that are God's”. The proposal was eventually not accepted – it must have seemed too religious a manifestation for a secular institution.

Still, it would be useful to consider briefly the equivocal answer to the question “Is it right to pay taxes to Caesar?” offered in the bible. To me that answer sounds like “it depends”. It makes sense. A good citizen is not the one who uncritically fulfills every duty stipulated in a law but rather the one who feels jointly responsible for the acts of the state performed in his name, too. Otherwise we would not have been able to vindicate the amnesty announced on 8th September 1944 and freeing from responsibility the people who had violated the discriminatory tax laws exclusively imposed on the Jews in Bulgaria.

True tax does not include only the money we can contribute to the budget but also the sense of solidarity and empathy to what the state does on our behalf and, most of all, the open expression of an honest position about it. I believe that IT development will allow more and more people to do this in a more and more visible, organized and decent (without anonymity) manner. I believe that soon new forms of socio-political creativity will spring up, far from subsidized party offices and official state institutions. Our identity is not determined by our fingerprints or the IP address of our computers but by what we do to other people. Deeds we acknowledge with our names and faces. Deeds which now can be documented at the moment they are done. It is becoming increasingly apparent that there is a strong need for deep changes in our social life – changes which contemporary states do not seem capable of realizing.

Perhaps today speculations like these sound abstract and utopian. However, at the very end of my essay I would like to offer that all interested read or see / hear what I call a symbolic Victory Parade at the end of the cold war: the speech of the American president in front of Soviet college students in Moscow on 31 May 1988, more particularly the part in which Ronald Reagan describes the revolution as having the potential to unite rather than divide people (almost at the very beginning). It is to this revolution that we owe the fact that today the speech in question is a few clicks away from each of us and I don't even need to send a link (back in the days such accessibility sounded like science fiction).

I can understand the skeptical background which lights up as soon as we hear a politician (in this case also an actor) read a beautifully formulated speech. Skepticism is healthy. I took the liberty to draw my esteemed readers' attention to this fragment from a political speech because I believe that with those spoken words personalities like Chaplin and Pasternak would have agreed. I hope the list is much longer.



FLAT TAX AS AN APEX OF PRAGMATIC TAX REFORMS

GEORGI ANGELOV

Ramblings at the dawn of the transition

When the transition in Eastern Europe started in 1989, some countries were ready – at least to some extent – for the challenges awaiting them. In Poland, for example, economic thought had been discussing the problems of the socialist economy for a long time, which allowed Leszek Balcerowicz to prepare and apply a reformist economic program in the very first months of the transition. The situation was similar in the Czech Republic where Vaclav Klaus had been advocating a reformist course for decades and after the fall of communism managed to put it into practice. Later, a similar development took place in Estonia led by Mart Laar.

A characteristic of both the countries of Central Europe and the Baltic region was the strong societal support for reforms leading towards freedom, democracy, and market economy – especially during the first transition years. In some of the former socialist countries the reform consensus was so strong that at first reform was supported even by the departing former communist parties. Also, demands for reform had sprung up even before the demise of communism, ideas were exchanged with the West and groups more strongly bent on reform were formed among economists. Thus at the beginning of the transition in central Europe and the Baltic region a successful blending was achieved between strong support for reform and knowledgeable people with an awareness what reforms were needed and the ability to carry them through.

Things were quite different in the countries situated further away from the west, including the Balkans, and most of the former Soviet republics, especially in Asia. There was neither a strong enough social support for reform, nor were there ready reformist ideas or the right kind of people to carry out quick and radical reforms.¹⁷ Thus in countries like Bulgaria, Romania, Albania, Ukraine and many more, what began was some kind of rambling, based more on trial and error than on a clear and purposeful strategy. In the case of Bulgaria all possible mistakes were made – before the politicians took the right direction.

While in the successful countries financial and macroeconomic stabilization were achieved in the very first years, even months of reform, in Bulgaria the agony went on for almost a decade. By 1997 the country suffered from high inflation – even hyperinflation, persistent currency devaluation and capital flight, large deficits and huge debts, periodic deficiency in necessities. While the more successful countries started restructuring and privatizing state enterprises early on in the transition, in Bulgaria attempts were made to prolong the existence of the state economy – at the price of huge budget subsidies, brutal drain and the eventual bankruptcy of numerous companies.

The same thing happened in tax policy. In the early 90s the wager was on high direct taxes, including a strongly progressive income tax. Thus for example in 1993 income tax followed a scale with nine different rates – between 20 and 52% (accompanied by high social security tax). Company profits were taxed at almost 40%, plus additional payments to the municipalities which reached 10% according to the Ukaz №56. The tax system was used for unconventional purposes as well, for example through a “tax on the growth of salary funds” an attempt was made to limit the rise of salaries in order to lower inflation.

¹⁷ See for example Rumen Avramov's (self)-critical approach in “Money and Destabilization in Bulgaria 1948-1989”. (Sofia, Ciela, 2008)



Tax table for income tax, 1993

Monthly income tax

Leva before denomination

Up to 1,250 leva	untaxable
from 1,250, 01 to 2,000 leva	20% for the part above 1,250 leva
from 2,000, 01 to 6,000 leva	150 leva + 24% for the part above 2,000 leva
from 6,000.01 to 12,000 leva	1,110 leva + 28% for the part above 6,000 leva
from 12,000.01 to 20,000 leva	2,790 leva + 32% for the part above 12,000 leva
from 20,000.01 to 40,000 leva	5,350 leva + 36% for the part above 20,000 leva
from 40,000.01 to 80,000 leva	12,550 leva + 40% for the part above 40,000 leva
from 80,000.01 to 125,000 leva	28,550 leva + 44% for the part above 80,000 leva
from 125,000.01 to 225,000 leva	48,350 leva + 48% for the part above 125,000 leva
over 225,000 leva	96,350 leva + 52% for the part above 225,000 leva

Source: Income tax law (repealed), article 4. (amended: State Journal, No 23 1993; in force from 1st March 1993)

Note: in 1999 money was denominated, 1,000 old leva were replaced by 1 new lev.

Progressive taxes and rates of up to 50% of income and profit, however, neither filled the budget, nor limited social inequality or encouraged economic development. The result was exactly the opposite. It was precisely during this period of high and progressive taxes that the economy fell into permanent crisis and depression, social stratification acquired huge proportions and tax evasion turned into a national sport. The grey economy in the 90s increased dramatically to reach between 35 and 40%¹⁸ according to different estimates, mostly due to the failure in tax payment and social security contributions (including mass scale failure to issue receipts and invoices, employment without contracts, ubiquitous cash payments, taking advantage of “loopholes” and exceptions in tax legislation).

Poor economic results and the failure of many policies in the first transition years caused them to be reconsidered. After the hyperinflation a currency board was introduced, the lev became a stable convertible currency. After the plunder and technical bankruptcy of state owned companies, privatization was launched. After a tremendous piling up of debts and deficits the budget was balanced and the debt went down. After the bank crisis the bank system was reformed and privatized. After the mid-90s governments began to actively attract foreign investment.

Though hesitantly, more pragmatic tax reforms and modernization of the tax system were initiated. Increased tax collection could not be achieved without lowering the rates and simplifying the tax system, including limiting the “loopholes” in tax laws. What is more, encouragement of the private sector and attraction of investment also required reforms and lowering the rates for direct taxes as many other countries offered much better tax conditions. In 1994 VAT was introduced and the maximum rate for income tax was lowered from 52 to 50% - a symbolic first step to tax reform.

In early 1997 the rate of profit tax was 40%, income was taxed at rates between 20 and 40%, and social security contributions – at 44%. In indirect taxes VAT was 22% and excise revenue was

¹⁸See for example *Schneider, Friedrich, Robert Klinglmaier*. Shadow Economies around the World: What Do We Know? – IZA DP, No. 1043, 2004, Institute for the Study of Labor.



dominated by taxes on fuels. Thus after the initial excesses with tax rates way too high, a gradual tendency towards the lowering of direct taxes was gradually established. Pragmatism began to influence the tax system in a positive albeit limited way.

Reform acceleration after 1997

The “rambling” of the transition – and the attempts to avoid reform – brought hyperinflation, drastic devaluation in currency and savings, a bank crisis, an economic crisis, a ubiquitous grey economy, and the need for external help from the IMF. All that formed support for a more reformist economic and tax policy. In actual fact, true profound reforms in Bulgarian economy did not start until after 1997.

Having wasted almost an entire decade, Bulgaria had to compete with the much more advanced countries from Central Europe and the Baltic region. To attract foreign and encourage local investment taxes are of special importance, particularly profit tax. It was not by accident that the initial effort was concentrated on lowering profit tax – starting in 1998, each next year rates were lowered to reach a cumulative reduction of the rate by 1/3 (down to 28%) in 2001.

The other taxes were also reformed and lowered but at a much slower pace. With income tax the reduction was symbolic, by 2 percentage points, but the system was simplified, the number of tax rates going down from 7 to 4. Social security contributions were first raised because of the health reform then lowered with the pension reform, though slightly. VAT also dropped to 20%. On the whole, between 1997 and 2001 the downward tendency for direct taxes was retained and noticeably accelerated so far as profit tax was concerned. Economic reform combined with the focus on corporate tax produced a result: in 2000 foreign investment rose over 1 billion euro for the first time in history.

After 2001 the lowering of corporate taxes continued with the purpose of increasing investment and speeding up economic growth. However, that resulted in a considerable difference between corporate and individual taxation creating incentives and possibilities for tax arbitrage. For sole traders it became more advantageous to register as firms, for personal income an incentive appeared to be registered as company profit. Undeclared income and employment continued to weigh heavily on the tax system and increased the pressure for a lower income tax – thus income tax also went down significantly to reach rates between 15 and 29% in 2003. Social security contributions, however, did not change and retained their high levels of 42.7% until the end of 2005.

Flat tax as a culmination of reform

As a result of economic and tax reform Bulgaria started advancing and gradually recovering from the economic plunges of the first transition decade. However, the other former socialist countries had advanced much further in reform – so much so that they gained acceptance to membership in the European Union (in 2004) which worked as an additional stimulus for investment and economic growth. Many countries from the region had made more progress with tax reform. Bulgaria was lagging behind in the competition and needed to speed up, to do something more radical in an attempt to shorten the distance.

Improvement in the business environment was slow and difficult – as most institutional reforms are. Reform in the state sector faced strong resistance and the increased budget revenue due to economic growth provided sufficient resources and comfort for the public sector. Actually the raise



in excise tax because of European requirements could blow up even more the already blown up and inefficient state sector with negative effects on economic development.

It was in this environment that in 2003 I prepared an alternative budget intending to point out an alternative: more reform, more efficient budget spending with lower taxes of 10% and accelerated economic growth (the alternative budget turned into a regular annual initiative of the IME). In March 2004 over 100 economists, analysts, financiers and intellectuals sent an open letter to the minister of finance insisting on the introduction of a single rate of 10% for taxing income, profit and social security¹⁹ and in August a periodical bulletin was launched for low taxes entitled “Flat Tax” which published analyses and arguments in favor of the tax reform. The idea of a 10% tax sounded radical and was initially supported by a limited circle of people, but precisely because of being so radical it provoked a fierce public debate.

In the meantime the flat tax began to spread in a number of countries from the region. Countries known for their reformist spirit like Estonia and the other Baltic republics introduced it, alongside with countries which were struggling with mass scale tax evasion like Russia. The effectiveness of flat tax both for revenue collection and for the encouragement of investment, employment and the economy caused it to spread fast. Almost every year flat tax was introduced in one of the countries in the region: Romania, Slovakia, Georgia, Macedonia, Serbia, Albania, Montenegro, Hungary and so on.

As usual, Bulgaria was not among the first to introduce flat tax but the fact that the idea was widely spread started making it more attractive here, too. What is more, the introduction of flat tax in almost all neighboring countries and in the whole region carried a competitive pressure – all the more so as Bulgaria was surrounded by the lowest rates: between 9% and 16%. It had to compete with the countries from the region in attracting foreign investment and could not afford to lag too much in tax reform, moreover as it had been left behind in many other aspects.

There was one more factor that played a decisive role in tax reform – the budget balance. Despite the systematically lowered direct taxes (or maybe precisely because of that) contributions to the state budget consistently rose faster than predicted and after 2002 a growing budget surplus kept being reported. The positive budget balance created a buffer, an opportunity to speed up tax reform without risking budget deficit. That was important as until 2007 Bulgaria had an agreement with the IMF and the Fund was against abrupt tax reform, especially if it threatened a great income loss.

The gradual drop of tax rates on profit in the period after 1997 led to the interesting observation that lower rates did not cause a proportional drop in revenue. In fact, in some years an *increase* of tax revenue was reported despite the lowered tax rate (for example 2001 and 2003). That became a tendency after 2004 as revenue from corporate tax regularly surpassed budget plans. In 2005 revenue increased despite the considerably lowered (to 15%) tax rate.

At the very beginning, when the idea of a 10% flat tax was formulated, the concept that underlay it was that the tax had to be low enough to lower the burden on taxpayers and stimulate payment, while providing sufficient resources for the state budget. The rate of 10% looked precisely like that golden average, all the more so as research by my fellow economists (Lachezar Bogdanov for example) showed that avoidance to declare profit, for example by means of fake invoices, cost about 8 to 10%, in other words a 10% rate would get rid of the incentives for that tax avoidance and would increase considerably the tax base. In this way, with a low rate, the state could get the same – or higher – revenue, simultaneously encouraging investment and development.

In early 2006 neither the profit tax rate nor the income tax rate had been lowered – but not because the new government had stopped the tax reform. In fact, to some extent for ideological reasons, but

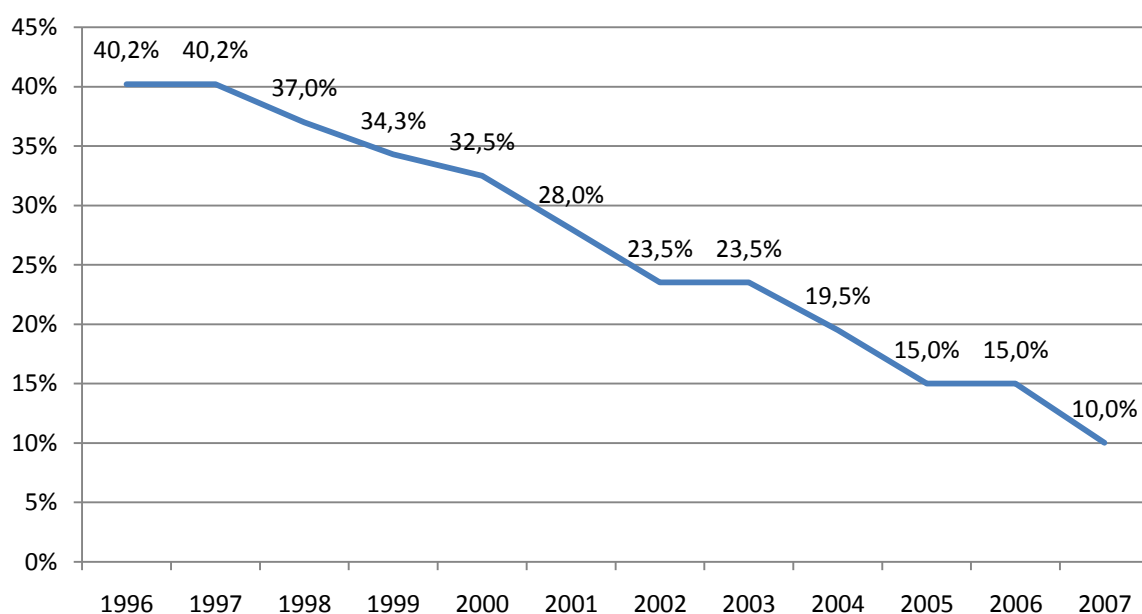
¹⁹See Open Letter to Milen Velchev, 19 March 2004, IME



mostly for pragmatic considerations, a decision was made to lower the social security burden as it was the greatest weight on the labor market. At the beginning of 2006 it was lowered considerably, by a total of 6 percentage points, from 42.7 to 36.7%. Despite that serious decrease, at the end of the year revenue from social security tax registered a minimal drop and exceeded what had been planned by 6.6%, while the surplus increased again. The lowered social security tax was supported by the EU as a way of shrinking the grey economy and by the IMF as a way to improve competitiveness and a restraint on salary growth.

However, when at the end of 2006 Parliament approved the introduction of a 10% profit tax rate, the IMF was against, being apprehensive that such tax would lower the budget surplus and encourage current account deficit.²⁰ At that stage, however, Bulgaria no longer needed external funding and the influence of the Fund was not strong enough to stop the reform. What is more, both among the economists and the parliamentarians there was a consensus on the appropriateness of the measure while the Ministry of Finance was relatively at ease due to the surplus and the observed over-performance of revenue at previous tax reductions.

Fig. 1 Profit tax by year, %



Source: State Journal, tax laws

The results surprised everyone, both the pessimists and the optimists: 2007 brought not a drop, not even a retention, but a huge growth of revenue from profit tax (by 39% compared with the previous year), and considerably surpassed Ministry of Finance forecasts (27% over-performance for that tax). The budget surplus rose despite considerable emergency spending at the end of the year. The reasons are complex: the tax rate itself which considerably limited the incentives for tax evasion, as well as the optimism at the beginning of the country's EU membership and the increase in foreign direct investment, which reached an all-time record high of 9 bln euro for one year.

²⁰ See for example The IMF vs. Oresharski. Dissent on parting. The Fund objected to the lowered corporate tax and the salary rise. Standard, 27 oct. 2006



At the end of 2007 the government once again distributed additional disbursements – the so called surplus spending. This means additionally approved uptake in the last days of the year, often for arguable and inefficient expenses, including 13th salaries in the state sector, subsidies and covered losses of state-owned companies, funding for municipalities, capital expenditure etc. That raised the issue if such additional extra-budget spending had a point and if the funds would not be better directed into reform including a general tax reduction.

As for indirect taxes, the hands of the government were tied to a considerable extent due to the existing minimum European rates for excise duty (which actually required Bulgaria's rates to be raised) and the importance of VAT as a fundamental revenue source for the budget. Last but not least, numerous studies from the period showed that direct taxes had more influence on economic activity and incentives.²¹ So it was quite natural for the focus to be redirected towards direct taxes.

After the successful lowering of corporate tax to 10%, the only possibilities left were lowering social security contributions (which had already been lowered in early 2006) or lowering income tax (which by that time had stayed without significant changes for several years in a row). A mixed variant – lowering both income tax and social security contributions – was also an option. The balance was tipped in favor of a serious income tax reform, namely the introduction of a 10% flat tax rate.

What influenced that choice was doubtlessly the successful introduction of the 10 percent profit tax rate, as well as the concern that if the difference between profit and income tax was too big, that would create arbitration, i.e. declaring personal income as profit. What is more, the fast spreading of flat rate in the region also supported acting in this direction. EU membership opened the labor market for Bulgarian citizens and the lowered tax burden was one of the mechanisms to limit migration among highly educated professionals (including doctors, IT specialists and others) who were in high demand.

Besides, social security contributions are too important for budget revenue and changing them faces strong opposition. Nevertheless, at the end of 2007 parliament surprisingly voted for both the introduction of a 10-percent rate for income tax and lower social security contributions. After a vote rerun, lowering social security contributions did not go through – more precisely, it was put off until mid-2008 and made contingent on the condition that the budget surplus was higher than planned (which it was and social security contributions did get lowered, though by only 3 percentage points).

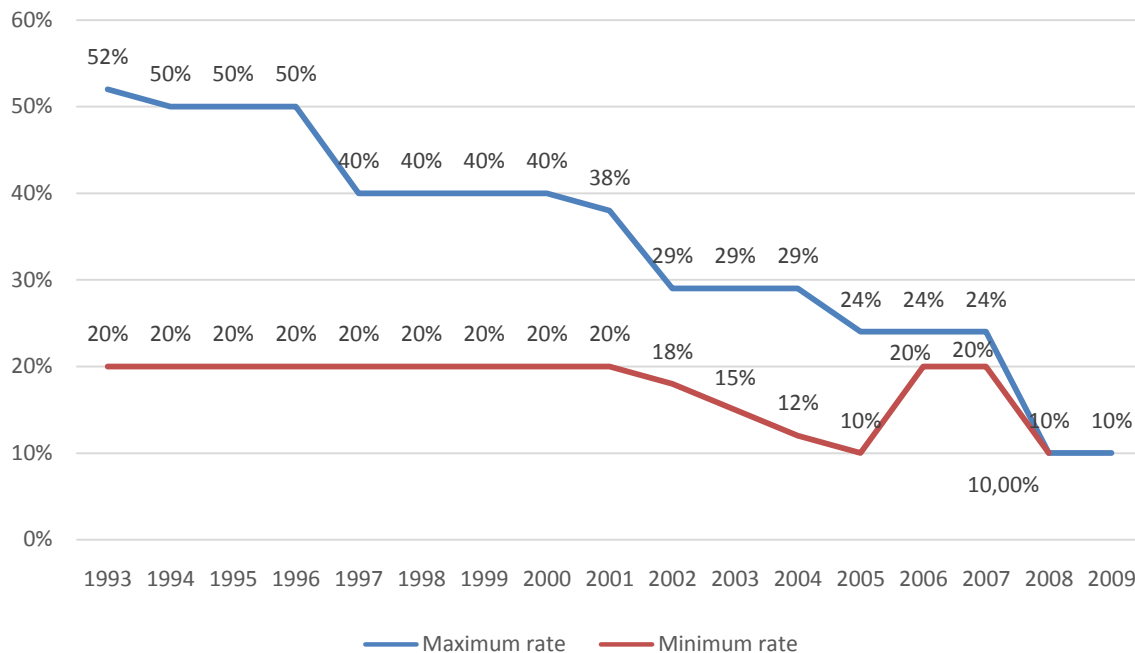
In the introduction of a 10% income tax the issue arose how to guarantee that everyone would gain from the tax reform as the significant rate reduction was combined with abolishing the untaxable minimum and for a small group of people a drop in actual income was likely to be registered. The solution was found in a package of social measures agreed upon by trade unions, employers and the government, which included raising in advance the lowest incomes in the state sector, a faster increase of the minimal salary, agreement on considerably higher minimum social insurance thresholds, higher benefit payments, lower social security contributions (plus additional expenditure at the end of the year for yet another partial surplus spending). Apart from that, in a dynamic sense, each rise in income was now taxed at only 10% and, as the lowest incomes tend to grow most rapidly, they were also fast to take advantage of the low rate. Eventually the gains from the tax reform reached all who had jobs – not accidentally, inequality figures (measured as the ratio between the incomes of the richest to those of the poorest 20%) dropped in 2008.²²

²¹See for example *Lucas, Robert E.* Macroeconomic Priorities, Presidential Address delivered at the one-hundred fifteenth Meeting of the American Economic Association, January 4, 2003, Washington, DC, *American Economic Review*, 93(1): 1-14.

²²In 2007 the ratio was 7.8; it dropped to 6.8 in 2008 and again to 5.9 in 2009 and 2010. Eurostat, *Inequality of income distribution S80/S20 income quintile share ratio*.



Fig. 2. Maximum and minimum marginal rates in income tax, %



Source: State Journal, tax laws

Conclusion: the pragmatic “flat” tax

In 2007-2008 a single rate for income and profit tax of 10% (or “flat rate”) was introduced but as it is now apparent, this was only the last stage of a long-lasting tax reform which has been going on without interruption under numerous and fundamentally different governments for over a decade and a half. Each step of the reforms during that period was based on pragmatic considerations connected with lowering the share of the grey economy, raising tax collection, and encouragement of investment, economic growth and the labor market. For the same pragmatic considerations, each individual step of the reform was relatively small and usually limited to a single type of tax in order to avoid risks for tax revenue and to guarantee a positive budget balance.

Though very slow, this approach to tax reform has proved exceptionally successful and sustainable precisely because it was based on rationality and pragmatism. This pragmatic approach is worth keeping – not only in tax policy – in order to avoid fatal mistakes in the future.



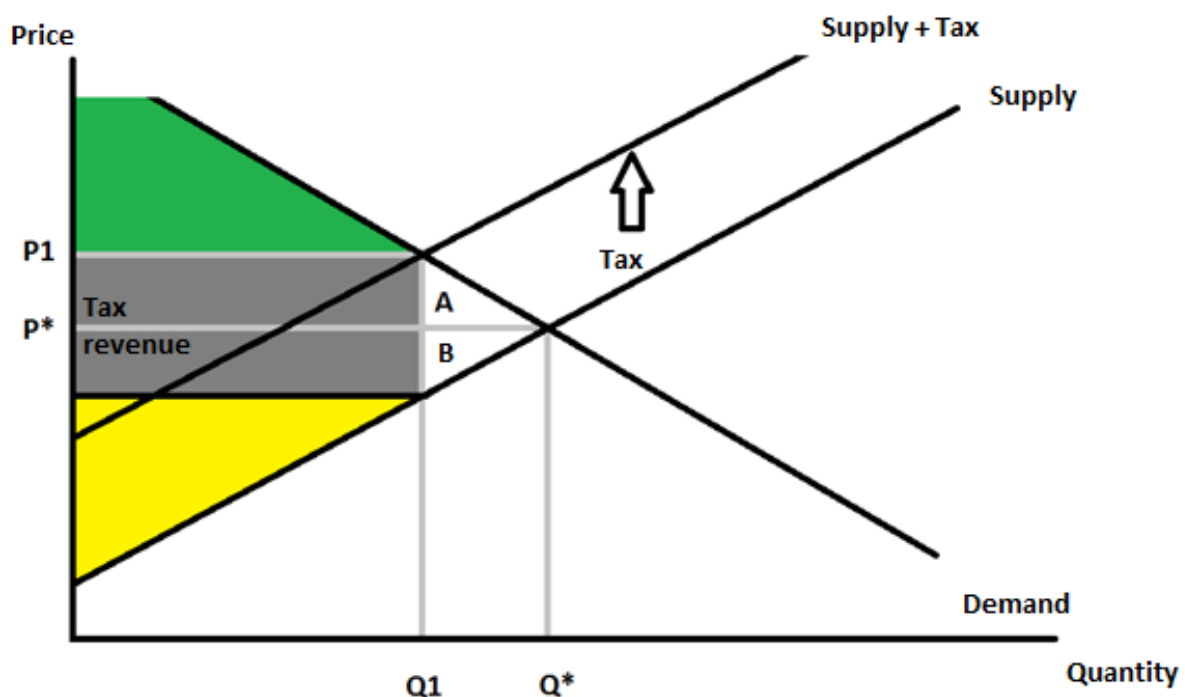
FLAT TAX AND CORPORATE TAX

KALOYAN STAIKOV

Tax policy and economic development

Setting up a well-functioning tax system faces a number of challenges, which include some caused by momentary developments; two of them, however, are fundamental. The first one is connected with the collection of tax revenue in the most efficient possible way by minimizing the adverse effects of taxation in the form of deadweight loss. In the case of corporate tax these distortions are connected both with mismatches between supply and demand and with the choice of placement and size of investments, the sources and utilization of finances and the type of the legal entity. These distortions have been subject to numerous studies over the years and can be illustrated in a very simplified way as follows:

Fig. 1. Deadweight loss of taxation is also the loss for consumers and producers as represented by the area of figures A and B



Source: IME

The second challenge is caused by the connection between personal and corporate income, more specifically by the possibility for tax evasion by declaring a different kind of income. Thus, for example, if an entrepreneur is given the chance to classify his income as corporate rather than as personal, that would allow their taxation with corporate tax rather than with social security contributions plus personal income tax and would eventually minimize tax liabilities to the budget. That is precisely one of the reasons for the lowering of rates in personal income tax in Bulgaria in 2008 to reach levels close to those of corporate tax as a tendency became noticeable for more people to declare corporate rather than personal income.



Table 1. Difference between the rates of corporate tax and personal income tax

year	Corporate tax	Highest personal income tax rate	Difference (percentage points)
1997	40.2%	40.0%	-0.2
1998	37.0%	40.0%	3.0
1999	34.3%	40.0%	5.7
2000	32.5%	40.0%	7.5
2001	28.0%	38.0%	10.0
2002	23.5%	29.0%	5.5
2003	23.5%	29.0%	5.5
2004	19.5%	29.0%	9.5
2005	15.0%	24.0%	9.0
2006	15.0%	24.0%	9.0
2007	10.0%	24.0%	14.0
2008	10.0%	10.0%	0.0

Source: corporate tax law, personal income tax law

But possibilities for income displacement are not limited to this. With the development of globalization, what matters more is not simply the migration of capital, such as moving production from a country with higher taxes and expenses to one where they are lower, but the migration of corporate profit. This is due on one hand to higher profit mobility and on the other to the fact that though tax expenditure depends on tax jurisdiction, it is a small part of total corporate expenses which depend on many more factors. An example in point is a recent decision of the European Commission²³ accusing Ireland of state aid unlawfully granted to Apple, which has a retail network in a number of European countries but declares profits in Ireland where corporate tax is among the lowest in the EU: 12.5%.

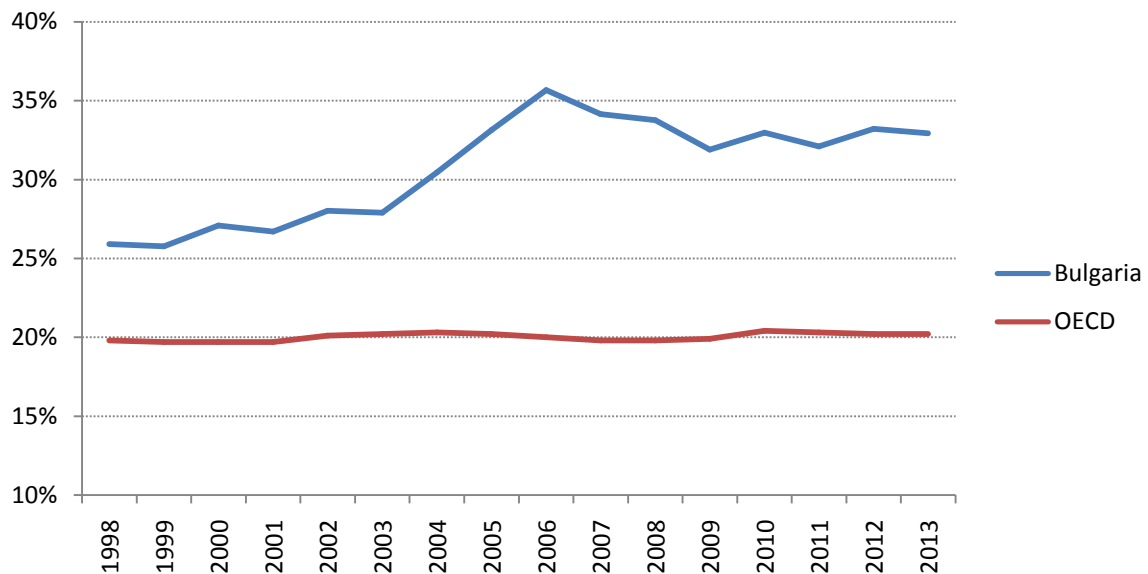
Tax policy development

Data on the development of tax policy in EU countries and other developed countries show that governments have come to depend more and more on revenue from indirect taxes and less and less on that from direct ones as can be seen from the rising VAT rates at the expense of falling corporate tax rates. Thus the VAT share in tax revenue on average for OECD countries has risen from about 12% in 1965 to over 20% in 2013. In Bulgaria this ratio has gone up considerably faster and in a shorter period of time: from nearly 26% in 1998 to over 31% in 2015. At the same time the share of corporate tax revenue in OECD countries reached 9.3% of all tax revenue in 1965 and dropped to 8.3% in 2013. In Bulgaria, again, that ratio changed faster and dropped from 10% in 1998 to slightly over 7% in 2015. Unlike the clear upward tendency of VAT as a share of tax revenue, it is hard to discern anything similar in corporate tax revenue, as seen from the graphs in fig. 2 and 3.

²³ The full text can be found on the site of the European Commission: State aid: Ireland gave illegal tax benefits to Apple worth up to EUR 13 bn, 30 August, 2016

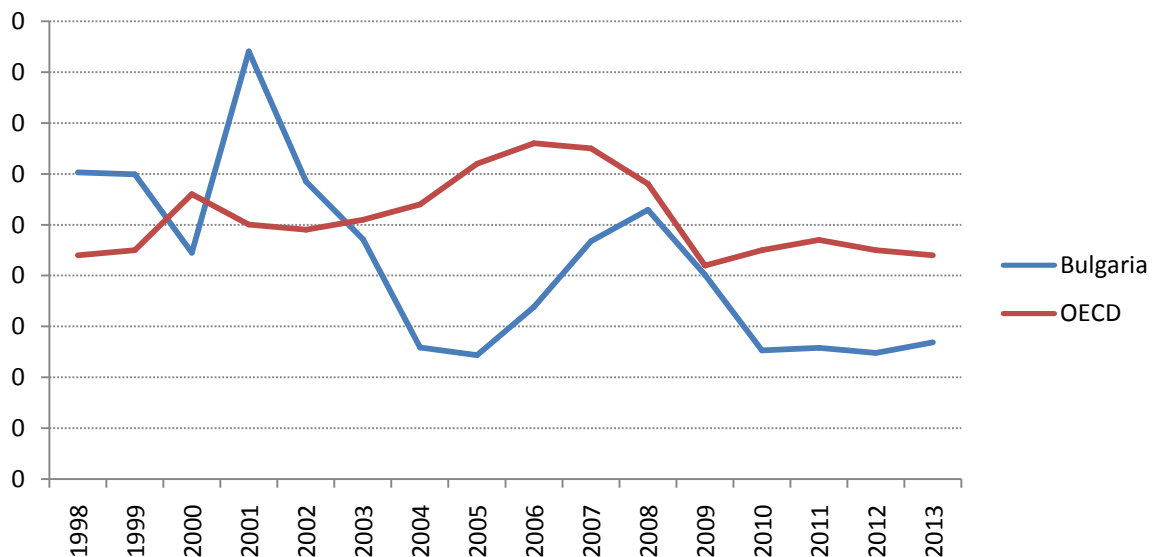


Fig. 2. VAT revenue as a share of tax revenue on average for OECD countries and Bulgaria, %



Source: OECD, Ministry of Finance, author's calculations

Fig. 3. Corporate tax revenue as a share of tax revenue on average for OECD countries and Bulgaria



Source: OECD, Ministry of Finance, author's calculations

Research supports the transfer of the tax burden towards indirect taxes

These tendencies in tax changes in developed countries and in Bulgaria are not surprising in the context of a growing number of studies of tax policy effects on economic growth in various countries. Though different evaluation methods and different information sources have been used, results from the studies point in the same direction: tax levels have serious negative effects on economic growth, even if eliminating factors such as state expenditure, business cycle development and monetary



policies. A variety of studies show that corporate tax most seriously harms economic growth, followed by personal income tax, consumption tax and property tax.

Results from a study of 21 OECD countries in the period between 1970 and 2005²⁴, which were controlled for a variety of circumstances and tendencies specific for individual countries, show that a tax burden (in the form of collected revenue from direct taxes – corporate and income tax) shifted by 1% towards consumption and property taxes would raise the level of GDP per capita by 0.25 – 1% in the long term. Other studies²⁵ go down to the level of economic sectors and even company level to analyze the influence of tax policy on the growth of investment and productivity. Their results show that both the level of corporate profit tax rates and the method for determining depreciation costs for tax purposes influence the growth of investment and productivity.

Results from those and other studies support the classical economic paradigm that incomes and welfare first need to be created and then consumed. That means that taxing factors of production – capital and labor – is a serious obstacle to the increase of welfare in the economy. Both the corporate profit tax and the tax on dividends lower investment incentives and the growth of the economy's capital base. Lower investment leads to lower productivity growth and thus to lower salaries. Taxes on labor lower the incentives for working; that is even more valid for the progressive income tax which sets higher tax rates for incomes over certain thresholds. As higher incomes are usually the result of higher degrees of education and/or skills, progressive tax plays the role of punishment which discourages investment in education and professional qualification and limits the development of human capital.

Other studies focus on episodes of fiscal consolidation (lowered budget deficit) and the effects on the economy of the policy chosen for the purpose. Alesina and Ardagna²⁶ consider a number of such episodes in OECD countries between 1970 and 2006. Results show that the probability for fiscal incentives based on lowered taxes to increase economic growth is higher compared with those based on increased public spending. What is more, consolidation of the fiscal position based on lower public spending and not raising taxes is more likely to lead to the required result of shrinking budget deficit and public debt and less likely to result in recession compared with the policy of raising taxes. These results are also confirmed by an IMF study²⁷ of 170 episodes of fiscal consolidation in 15 developed countries in the last 30 years: lowering public spending is considerably less harmful for short-term economic growth compared with raising taxes. The study shows that 1% expenditure shrinkage has no serious effect on economic growth while a 1% raise in taxes leads to a drop in GDP in 2 years. Studies by the American bank Goldman Sachs²⁸ confirm these results.

²⁴ *Arnold, Jens, Bert Brys, Christopher Heady, Åsa Johansson, Cyrille Schwellnus, and Laura Vartia.* Tax Policy for Economic Recovery and Growth. – The Economic Journal, 121 (February), 2011, pages F59-F80.

²⁵ *Arnold, Jens.* Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries. – OECD Economics Department Working Papers, 2008, No. 643; *Vartia, Laura.* How do taxes affect investment and productivity? Industry level analysis of OECD countries. – OECD Economics Department Working Papers, 2008, No. 656.

²⁶ *Alesina, Alberto and Silvia Ardagna.* Large changes in fiscal policy: taxes versus spending. – Tax Policy and the Economy, August 2010, The University of Chicago.

²⁷ International Monetary Fund. Will it hurt? Macroeconomic effects of fiscal consolidation. – World Economic Outlook: Recovery, Risk, and Rebalancing, 2010.

²⁸ *Broadbent, Ben, and Kevin Daly.* Limiting the Fall-Out from Fiscal Adjustment. – Goldman Sachs Global Economics Paper, 2010, No. 195.



Corporate tax in Bulgaria

Corporate profit in Bulgaria was taxed with a two-stage progressive rate for companies with profit up to 50 thousand leva until 2002 when a single rate was introduced. The maximum tax rate was lowered from 40.2% in 1997 to 10% in 2007, remaining unchanged only in 2003 and 2006. Regardless of the lowered rate collected revenue rose nominally in almost all years due to the increasing tax base. The higher profit declared can only be explained, on one hand, with economic growth, on the other – with the improved investment climate and the accumulation of physical capital and on yet another – with the economy becoming increasingly formal.

Of course, these effects had no simultaneous effect on the business environment and tax revenue and there were years when a lower collection was observed both compared with the prognosis and compared with the previous year. Still, there was the influence of objective factors:

- 2000 – the shrinkage of collected revenue was due to outside economic factors such as the Kosovo crisis, and the high level of tax paid in advance in 1999.
- 2002 – the lower collectability was due to high but one-off inflows in 2001 thanks to the higher profit of the Bank Consolidation Company, mainly from the privatization of Bulbank.
- 2004 – the drop in tax revenue was mostly the result of the lowered rate, which, however was accompanied by a rise in declared taxable profit.

As noted earlier, the effects of tax changes tend to have more of a long-term effect, which can be seen from the reform in corporate tax in Bulgaria. In 1999 corporate tax was 34.3% while revenue from that tax was 10% of tax revenue and 3% of GDP. In 2008 the corporate tax rate was already 10% and the revenue collected was 9.3% of all tax revenue and 2.8% of GDP. In other words, with the profit tax rate almost three and a half times lower, revenue, both as total tax revenue and as a ratio to the GDP was only lower by 7%. The Ministry of Finance gave the following estimate of the corporate tax reform's effect²⁹:

“The continuing tendency for revenue from corporate tax collection to increase is a clear indicator of the visible effect of tax policy regarding this tax during the last few years, as a result of which the incentives for investment increased, economic activity was encouraged thus raising company profits, the share of the grey economy was lowered and revenue from corporate tax in the budget increased.”

Two years later the National Revenue Agency³⁰ provided a numerical expression of the statement as well: the lowered corporate tax, plus the lower expenditure on compliance with tax legislation brought a rise in voluntary collection by 13 percentage points between 2003 and 2008.

The effect of lower taxes on investment mentioned in the Ministry of Finance's report can be seen in the following graph. The lowering of corporate tax between 2001 and 2008 happened against the backdrop of a real cumulative increase of fixed capital formation by over 2.7 times. Part of the investment increase was, surely, the result of a number of factors, such as the development of the international economy, the inflow of foreign direct investment, Bulgaria joining the European Union etc., but the tax policy carried out undoubtedly played an important positive role in shaping the business and investment environment. At the same time, the real growth of the economy was over 6% annually and in 2008 tax revenue as a ratio to GDP went over its 2000 and 2002 levels (as was already pointed out, tax revenue in 2001 was characterized by one-off effects). In other words, the reform in corporate tax supported the business environment and did not cause any loss of tax

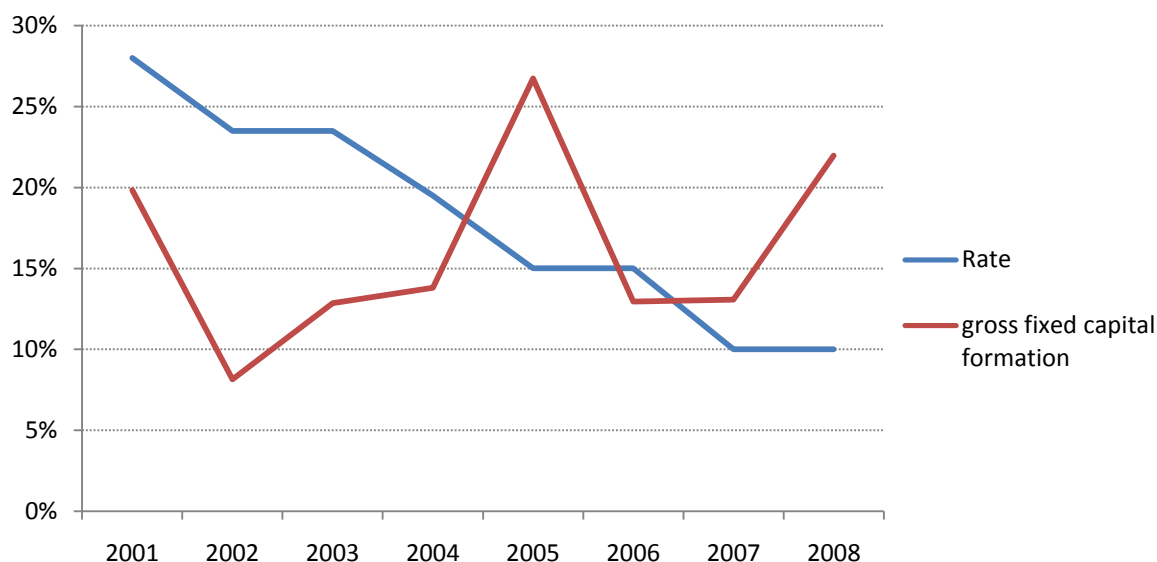
²⁹ Report on the execution of the state budget of the Republic of Bulgaria, 2007

³⁰ Annual report on the activity of the National Revenue Agency for 2009



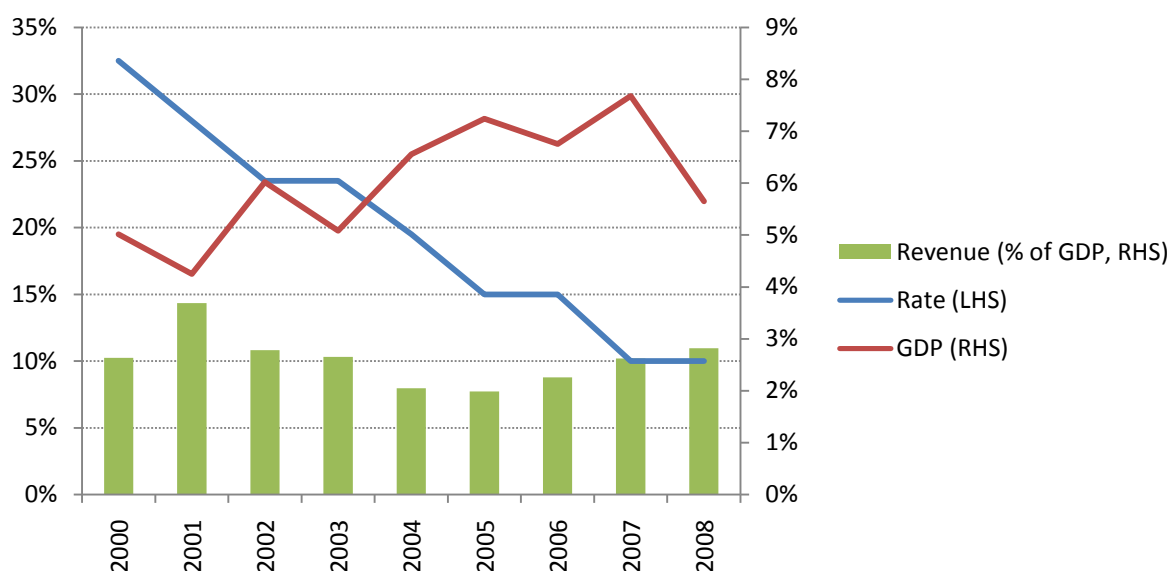
revenue as a ratio to the aggregate output, though, as noted earlier, the weight of that revenue dropped as a share of the total tax revenue.

Fig. 4 Corporate tax (%) and real annual change in gross fixed capital formation (%)



Source: NSI, Ministry of finance, author's calculations.

Fig. 5. Corporate tax (%), real GDP growth (%) and corporate tax revenue as a share of GDP (%)



Source: NSI, Ministry of finance, author's calculations

Tax revenue during and after the economic crisis of 2009

The situation dramatically changed for tax revenue in 2009 due to the economic crisis in the country. In 2009 GDP contracted by 4.2% in real terms on an annual basis, while corporate tax revenues as a



ratio to GDP dropped by 21% compared with the previous year to reach 2.2%. In 2010 it dropped to 1.7% of GDP to stay almost unchanged until 2012. The abrupt revenue drop in 2009, the crisis year, was the result of the drop in advance payment revenue from the last quarter of 2008, as well as the annual financial result for that year, based on which a balancing corporate tax was due in 2009. The contraction of orders was most noticeable in the “Kremikovtsi” steel mill, which also strongly affected the counterparties of that firm. A similar condition was observed in the “Neochim” fertilizer producer, while “Agropolichim” (another fertilizer producer) even stopped production at the end of 2008.

In 2010 corporate tax revenue was still under the negative influence of the 2009 recession and the meager recovery of the economy in 2010. That suppressed both the balancing payments from the previous year and the advance payments for the current year. Amendments to the Corporate Tax Law aiming to partially relieve business were approved, lowering the coefficient for the calculation of due advance payments for the period from January to July 2010 from 1.1 to 1, which additionally decreased revenue.

Though in 2011 there was a slight recovery in corporate tax revenue, it was exclusively due to that from non-financial enterprises. At the same time bank profits shrank in 2010 by 21% on an annual basis as a result of depreciation losses for credits and receivables. The insurance sector also reported worse financial results, as general insurance companies reported losses.

In 2012 things changed: there was over-performance of planned revenue from financial institutions, while revenue from non-financial ones failed to reach planned levels. To a great extent that was due to the growth of the economy being slower than expected, therefore declared profits were lower in 2011 and 2012. Repealed acts by the Supreme Administrative Court contributed in part to the unsatisfactory performance but there was also lower collection of balancing tax payments.

The influence of the economic crisis on corporate tax revenue can also be seen in the National Revenue Agency (NRA)³¹ data for declared taxable profits which shrank in 2009 and 2010 and thus suppressed revenue for 2010 and 2011 respectively. Besides, there were high levels of overpaid tax which was deduced from balancing and advance tax payments in the next years. Declared profits started growing from 2012, which affected tax revenue for the following year, but as it becomes clear from the NRA report, that revenue failed to be collected in full due to the mentioned reasons.

Bulgaria’s economic growth accelerated in 2013 despite the early election in that and the next year. That should have led to higher revenue, but tax changes, mainly aimed at reduction of advance payments, lowered the collected revenue from corporate tax in comparison with the previous year. That was mostly due to the increased number of companies that were freed from the obligation to make advance payments. The reason was the raised threshold for sales revenue of those companies from 20 thousand leva (until 2012) to 30 thousand in early 2013. Companies with net income between 300,000 and 3 million leva owed quarterly advance payments, except for the last quarter which lowered annual revenue from those. Another important change was made in the taxable profit based on which advance payments were calculated. Until the end of 2012 the tax base was the declared profit for the previous year, while from the beginning of 2013 companies began to make their own forecasts about the company’s profit for the current year and advance payments they owed were calculated on that base.

In the next two years corporate tax revenue kept growing, which could be seen from the NRA report and the preliminary data for the performance of the state budget. The increased revenue from corporate tax coincided with the higher real economic growth in 2013 and both accelerated in the next two years. That increase was also accompanied by a process of recovery in investment, which,

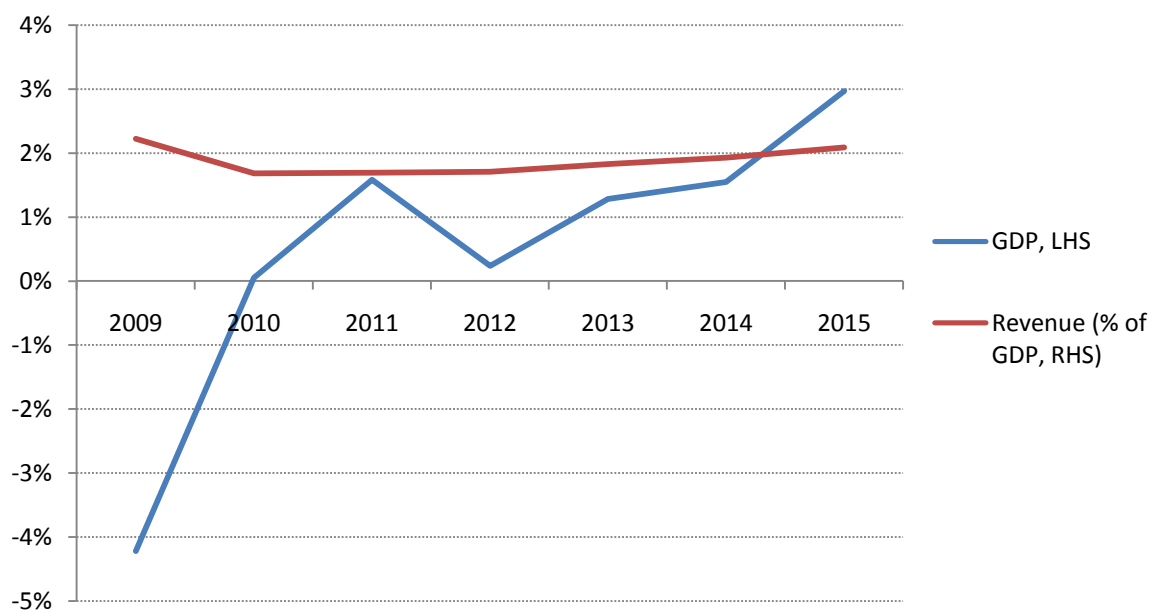
³¹ Annual reports on the activity of the National Revenue Agency for 2009, 2010 and 2011



after a cumulative real drop of about 40% between 2009 and 2011, started registering annual growths.

Corporate tax revenue as a ratio to GDP in 2015 was almost 2.1% - close to 2004 levels. At the same time one should bear in mind the fact that this result followed the economic crisis in 2009 and the slow recovery afterwards, early parliamentary elections in 2013 and 2014, a tax rate almost two times lower and a considerable growth in declared profits. Only for the period between 2010 and 2014 the declared tax profit rose by 23% while the economy's nominal growth was below 15%.

Fig. 6. Corporate tax revenue (% of GDP) and real annual growth of GDP (%)



Source: NSI, Ministry of finance, author's calculations

Summary

Tendencies in corporate tax revenue after 2009 support the evaluation by the Ministry of Finance of the positive effects from the tax policies carried out between 2003 and 2008, even though that was a period of economic crisis followed by a political one. Lowered rates for corporate tax and lowered expenses on tax compliance created positive incentives for investment, fixed capital accumulation and thus – raised productivity, economic growth and wealth in the country. The lowered rates led to no loss in tax revenue for two reasons: part of that burden was shifted towards indirect taxes and lower rates were accompanied by an increase of declared profits. The years when serious external adverse effects prevailed were an exception, such as the effects observed in 1999 – the Kosovo crisis, and after 2008 – the economic crisis in Bulgaria.

After 2009 those in power managed to keep the corporate tax rate unchanged, thereby both keeping tax policies predictable and retaining the advantages accumulated as a result of the lowered rate in previous years. If they had yielded to the temptation of a higher tax rate in their attempts to support budget revenue that would probably have had a short term positive effect on the budget, but the medium and long term effect on the economy as a whole would have been negative. In other words, during the economic crisis and the recovery that followed the government managed to keep the positive effect for the economy from the lower corporate tax rate at the price of a short-term negligible loss of budget revenue.



FLAT INCOME TAX AND TAX REVENUE

DESLAVA NIKOLOVA

One of the main concerns before the introduction of proportional income tax is potential loss of tax revenue for the state budget. These concerns are usually put forward as an argument mostly by leftist economists who support a greater role of the state in redistribution and therefore more resources at its disposal.

Where these concerns come from, actually, is not the replacement of the progressive tax scale with a flat or, more precisely, proportional tax, but from the fact that proportional tax often has a tendency towards the lower rates in the progressive scale which it comes to replace, or even to be lower than its lowest rate.

In the case of Bulgaria this was precisely the case: the new personal income tax of 10% usually referred to as flat, came to replace a progressive scale with rates of 20, 22 and 24% which was in force until 2007. In other words, the flat rate introduced in 2008 was two times lower than the previously lowest rate.

Static versus dynamic calculations of the effects of tax changes

Concerns about revenue loss usually rest on static evaluations of the effect from lowering taxes, whether income, corporate or other. Such calculations start from the assumption that the total group of taxpayers (people, companies) and thus the tax base will stay unchanged before and after the tax reform.

That assumption, however, is extremely unrealistic from the perspective of contemporary economic theory which treats economic agents (people, companies) as capable of reacting to incentives and modeling their behavior according to changes in the environment. In the context of this theory static evaluations are replaced by *dynamic* ones which take into account changes in behavior in response to changes in incentives, as well as the effects of transitions from one business cycle phase to another.

In a context of tax changes the dynamic calculation should be able to reckon with the reaction of tax subjects to changes in the tax system – raised or lowered rates, abandoning existing or introducing new taxes, introducing or eliminating preferences, complicating or simplifying the system etc. For example, if taxes are raised, other things equal (including expectations that the phase of the business cycle will remain unchanged) the dynamic estimate would rest on the assumption that this will provide more incentives for tax evasion and relocation to the informal economy. In other words, the base of those who pay taxes will contract.

Conversely, if the effective tax burden - i.e. the ratio between the sum of paid taxes and the gross income – goes down, expectations are that the base of people who pay taxes will increase.

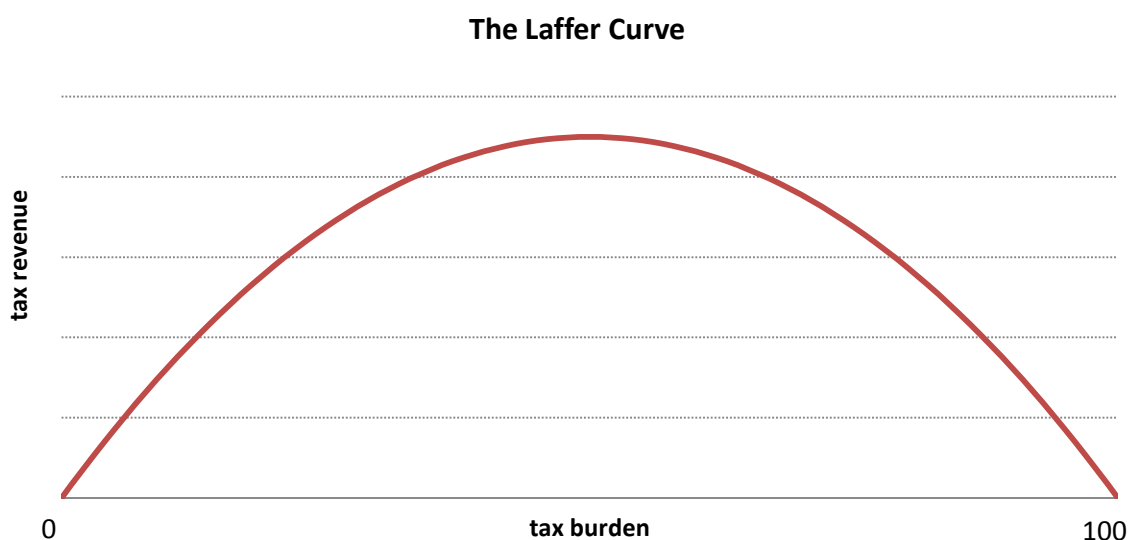
Tax revenue and Laffer

One of the best known theoretical claims about the relation between the tax burden and tax revenue is perhaps that of the American economist Arthur Laffer who created the popular “Laffer curve”. In



most general terms the curve shows that as the tax burden rises, tax revenue rises until it reaches a point where an optimal level of taxes is achieved when the revenue collected is at a maximum level. From that point on with any further increase of the tax burden revenue begins to drop as the *dynamic* effect from moving into the informal economy because of the higher taxes exceeds the effect from the higher tax revenue collected from those who stay in the formal economy. Besides, with the increased tax burden, the incentive for finding ways to avoid paying all or at least some of the taxes increases as well.

Fig. 1. The Laffer Curve



This claim is, of course purely theoretical, as the connection between tax burden and tax revenue is “purged” of any influences of the business cycle, the quasi-tax burden, the complexity and specifics of the tax system (preferences, deductions, possibilities for tax refund etc.), the sanctions for tax evasion, the effectiveness of the legal system and other factors. In other words, that dependency is valid “other things being equal” – but in economics that requirement is almost never met.

From the perspective of the Laffer curve, a drop in tax burden can lead both to increase and to decrease in tax revenue. It all depends at which point of the curve the system is positioned before the change. The catch here is that no finance minister ever knows his exact location on that curve at the moment. Nor does the minister have the slightest idea exactly how the curve itself looks, either concerning each of the taxes in the country or the entire tax burden – whether it is flatter, or steeper, symmetrical or not. In this sense even if we advocate Laffer’s concept on the elasticity of tax revenue to tax rates, each change in the tax system (in one or in more taxes) is a shot in the dark in reality from the perspective of the tax revenue it will bring. Of course, estimates are made based on the expected development of the economy but they do not include predictions on the effects of potential “greying” or “whitening” of the economy as a result of the changed incentives for taxpayers.

Proportional income tax and tax revenue: the example of Bulgaria

A shot in the dark – that is precisely what the replacement of progressive income tax with proportional tax in Bulgaria in 2008 was. The expectations of experts, observers and politicians were



scattered all over the entire spectrum of possible scenarios for tax revenue: it would increase, stay the same, drop.

It is interesting that at that time the Ministry of Finance was definitely in the optimist group. In its report accompanying the state budget bill for 2008 the Ministry shared their expectations that income tax revenue would reach a total of 1.753 bln leva for 2007 and would go up to 2.175 bln in 2008, in other words an increase of 422 mln leva was predicted for 2008.

Behind this prediction there were expectations for a rise in salaries (including from 5 to 10% in salaries of state employees from the middle of 2008) as well as an increase in the number of people in employment. The latter increase was based both on a planned expansion of the economy by 6.4% in 2008 and on the fact that the flat rate would cause the grey economy to shrink. The untaxable minimum (200 leva a month) was abolished, so were tax reductions for parents and some reductions for gifts which were also expected to bring more revenue.

Eventually, personal income tax revenue did grow in 2008 compared with 2007, but its growth did not reach the 21% predicted by the Ministry of Finance. That was partly due to the fact that revenue from that tax was higher than expected in 2007. Budget revenue from that tax rose by 9% or 163 mln in 2008 – from 1.809 bln in 2007 to 1.972 bln in 2008. The slower growth could also be attributed, at least partly, to the onset of the crisis in both Europe and Bulgaria, which caused bonuses and allowances in December to be lower than expected.

As for the income tax of salaried employees, the revenue growth in 2008 was 11% compared with 2007. Actually, this kind of income was more indicative than any other of the effects of proportional tax on personal income. The reason is that most of the other taxes on personal income have rates different from the proportional 10%. For example, income tax includes the so-called patent tax the rate of which is set by each municipality (i.e. municipal council) each year. Besides, this includes the income of professionals and author honorariums for which the law allows reducing the tax base by a certain rate of legally admissible expenses. In other words, for these people the effective tax rate is less than 10%. Last but not least, this group includes the income tax of sole traders the rate of which is 15%.

In view of all this, the income tax revenue from salaries of employed people is the type most indicative for the study of the effects the introduction of proportional tax has on the tax system. This kind of income is taxed at a single rate of 10% while most of the exceptions, possibilities for reduction of the tax base, preferences and discounts in force before have been abolished.

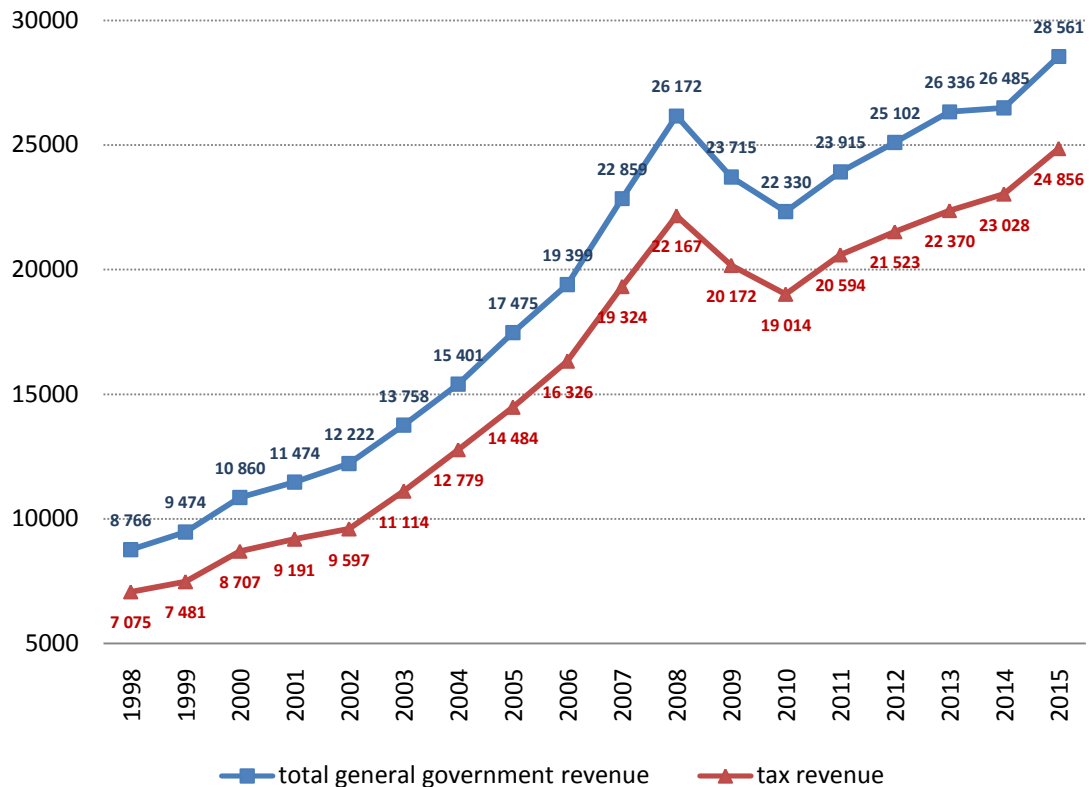
From the perspective of budget revenue from this tax, however, a variety of factors other than the scale and the rates play a role: size of salaries and bonuses, number of employed people, tax burden (social security payments are deducted from the income tax base, thus influencing it), the informal sector and tax evasion, bankruptcies and so on. In this sense it is very hard to isolate from these factors the effect of the transition from one tax system to another (in this case from progressive to proportional tax) on tax revenue.

Proportional tax as a source of steady revenue in times of crisis

Despite all provisions, the budget data for 2009, when the world economic crisis set on in Bulgaria, are indicative of the effect of the introduction of proportional income tax on tax revenue.



Fig. 2. Dynamics of budget revenue, 2000 – 2015, mln. leva



Source: Ministry of Finance

With the onset of the crisis in 2009, as expected, the consolidated budget revenue plunged. The drop in consolidated revenue was 9.4% or 2.4 bln leva, tax revenue shrinking by about 2 bln leva in 2009. The next 2010 was even worse for the budget, revenue reaching its lowest point, from which in the next few years it managed to recover.

In 2009 all main taxes registered a sharp drop, the biggest “culprits” from the perspective of the correction in total revenue being VAT and social security contributions which, in total, dropped by 1.580 bln leva. In other words, about 2/3 of the total loss of tax revenue in 2009 was due to these types of tax. Corporate tax and excise duties also brought considerably less revenue.

In this situation the personal income tax revenue was the only key tax which proved “immune” to the crisis and which registered some growth in revenue, albeit small. Income tax generated revenue of 1.965 bln leva in 2009, an increase of 55 mln leva from the previous year, or about 2.9%.

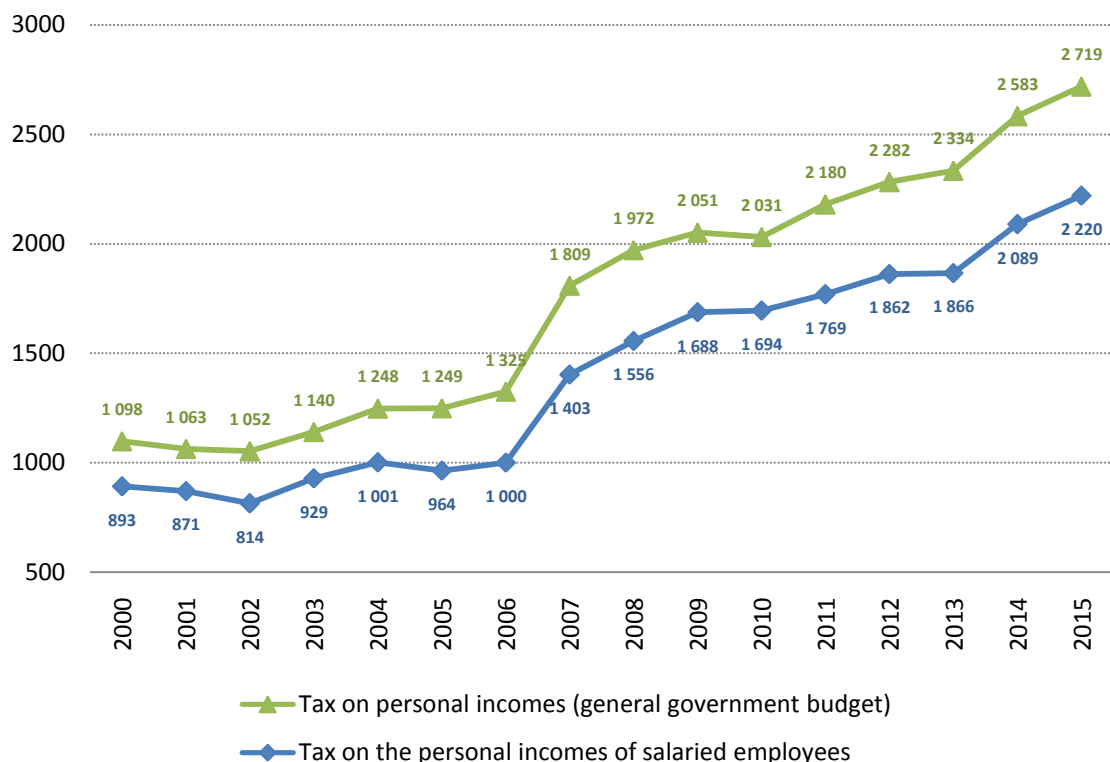
What is more interesting, however, is that the only income tax which brought more budget revenue in the crisis year, 2009, was precisely the income tax on salaried employees. Revenue from that tax was higher in 2009 by 131 mln leva or 8.4% compared with 2008 and managed to compensate the loss of revenue from other income taxes – patent tax, the taxes on sole traders, professionals and foreign nationals.

Besides, in 2009 the crisis could already be felt on the labor market, too. That is, increased revenue from income tax on salaried employers was registered even though the taxpayer base was quickly diminishing. In 2009 the number of employed persons among the population aged 15+ dropped by



107,100 people and the number of those in salaried employment – by 62,219 people, or nearly 3% compared with 2008. It was the employed whose income was taxed at a proportional rate of 10%; in that sense they are indicative of the main group of taxpayers so far as this tax is concerned.

Fig.3. Revenue from income taxes, mln. leva



Source: Ministry of Finance

Even in the year that was hardest both on the budget and on the labor market – 2010 – revenue from the income tax on salaried employees went on growing, though not very much (by 6.6 mln leva). At the same time the labor market lost another 178,000 jobs judging by the data on the number of employed people in the economy. The drop in the number of employees with labour contracts, in turn, was 162,062 people, or over 2.5 times faster than the losing of jobs in the previous year when the country was officially in recession.

Having in mind this data it is possible to claim with a pretty high dose of certainty that in the case of Bulgaria the flat income tax played the role of an unexpected budget stabilizer. This fact should not be confused with the so called automatic stabilizers in the budget which aim at exactly the opposite – to tone down business cycle effects on the economy without demanding special measures from the government.

In the case with proportional tax, however, we can see something very interesting. From the perspective of the budget and its tax revenue, the introduction of a flat rate for income tax in fact played the part of an anti-cycle tool of fiscal policy (or a kind of budget stabilizer) as it offset to some extent the revenue loss for the budget from other taxes on labor, profit and consumption.



The reasons for this positive impact of flat income tax on the budget can be found mostly in the shrinking of the grey economy, more specifically, in the smaller number of informal employment relationships. That is, on one hand, the taxpayer base in the formal economy probably grew, and on the other, the size of officially declared salaries increased. That explanation was supported by the simultaneous increase in revenue from income tax on salaried employees and the sharp decline in the number of employed people in 2009 and 2010. Though the total change in employment was negative, it could be speculated that it would have been much greater without “bringing to light” part of the (previously) grey taxpayers.

Fig. 4. Employment in the economy (number of people, thousand)

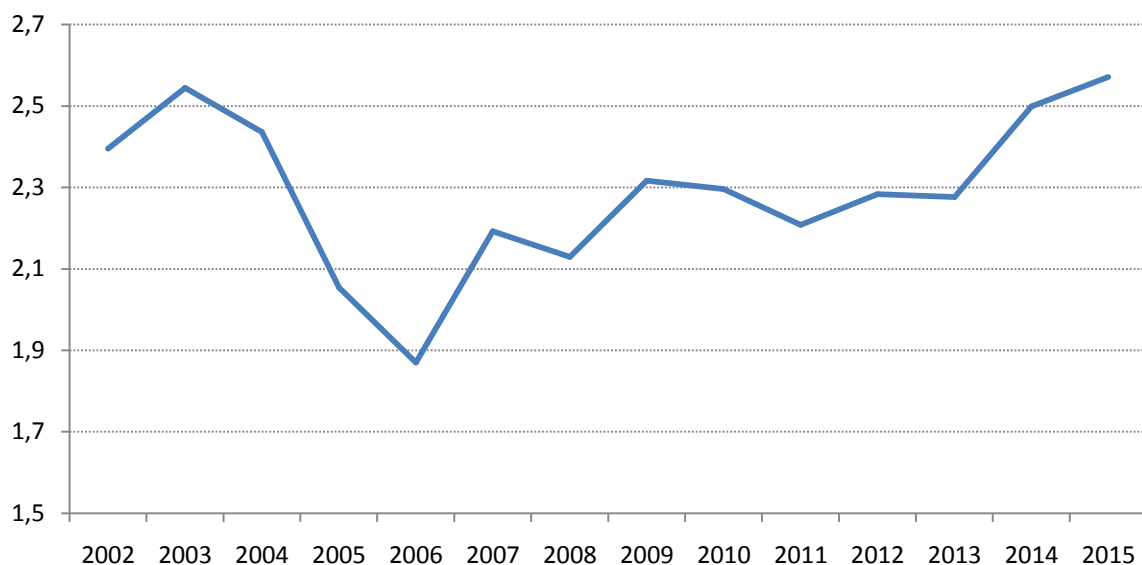


Source: National Statistical Institute

This effect can also be clearly seen if the ratio between revenue from salaried workers’ income tax and GDP is considered. During the two hardest years for the budget, 2009 and 2010, that ratio increased slightly, from 2.1% of GDP in 2008 to 2.3%, which was due both to the drop in GDP and the demonstrated immunity of tax revenue from that tax to the economic shock. On the whole, however, that ratio has shown little fluctuation (in the range of 2-2.5% of GDP) in the last 14 years, which shows the relative sustainability of that revenue for the budget. At least so far as the crisis years were concerned, proportional tax probably contributed to that stability.



Fig. 5. Revenue from salaried workers' income tax (% of GDP)



Source: Ministry of Finance, National Statistical Institute

Some conclusions

Though it is difficult to set apart the effect of the introduction of flat rate on tax revenue from all other accompanying factors that budget implementation depends on, it is a fact that the most optimistic expectations have been justified. The new proportional income tax collected more revenue in the first year of its introduction, the increase reaching 11% on an annual basis for the income tax on salaried workers.

The period after the crisis set in was even more indicative. Against the background of a rapidly shrinking employment and a plunge in revenue from all key taxes (VAT, excise, and corporate tax) and social security payments, the income tax proved to be the single significant revenue source for the budget which kept generating *more* revenue. The income tax on salaried workers, which makes up the main part of the tax base of proportional tax, brought more revenue to the budget both in 2009, and in 2010, the particularly hard year for the fisc. Besides, in 2009 that tax even managed to compensate the drop in revenue from other income taxes (patent tax, income tax on freelancers, sole traders etc.) and the budget eventually collected more revenue from income taxes. All that was happening against the background of over 62,000 salaried jobs gone in 2009 and 162,000 jobs more gone in 2010.

In that sense it would be no exaggeration to say that the new proportional income tax played the role of an anti-cycle budget tool or a kind of budget stabilizer in 2009 and 2010, the hardest years for the budget. There can only be one explanation for this: the tax base had widened. That was both a consequence of abolishing the untaxable minimum and other preferences after the introduction of a flat rate and an indirect indicator for the shrinking grey economy in salaried employment. That dynamic effect was present in Arthur Laffer's concept of the elasticity of tax revenue towards change in the tax burden. Bulgaria's recent experience with probably the biggest reform in its modern economic history is just a good example illustrating the work of that concept in practice.



FLAT TAX AND THE BURDEN ON LABOR

PETAR GANEV

The introduction of flat income tax in Bulgaria should inevitably be considered in the wider context of taxes on labor because taxes and social security contributions deducted from salaries in practice work together: as a burden on labor, and are thus under each other's influence whenever estimates of various economic effects are to be made. Suffice it to note that income tax is paid after the deduction of the employee's social security payments, which means that income is directly influenced by factors such as the size of social security contributions, their distribution between employee and employer and incentives in the social security system to declare total income.

This text will consider the development in Bulgaria of taxes on labor, focusing on the time immediately preceding the introduction of the flat rate, looking at the tax burden for the average employee and its effect on the disposable income of employees with the lowest salaries; it will look at the revenue dynamics through the lens of social security revenue and finally comment on the dynamic effects with regard to the grey economy and salary growth.

The tax and social security burden in historical perspective

We will consider the tax and social security burden on labor by comparing all deductions from the gross salary: employer contributions, employee contributions and employee income tax and juxtaposing them with labor costs. This is the methodologically correct way to calculate the tax burden on labor because what we are interested in here are the total labor costs of the employer. The NSI has a similar approach in calculating the structural indicators "tax burden on labor costs" and "gross salaries". Because of the different rates and the fact that there was an untaxable minimum before 2008, the comparison will be made for exemplary salary levels – mostly for the average salary case.

Setting up a stable model of social security insurance in Bulgaria took place in 2000 and 2001. In 2000 the different funds in the National Social Security Institute (NSSI) were created, setting apart the health insurance contribution, while in 2001 (after one step of pension contribution reduction) the deductions for social security contributions from the gross salary were stabilized. In practice, between 2001 and 2005 social security contributions were unchanged, the only changes being step-by-step redirection of pension contributions from NSSI to private pension funds (2 percentage points in 2002 and 1 percentage point more in 2004) and the gradual transfer of contributions from the employer to the employee. During the same period the structure of income tax remained unchanged (4 steps with an untaxable minimum), the rates gradually going down, while the untaxable minimum rhythmically rose. The tax and social security burden on labor costs calculated for the average employee shrank very slightly and stayed almost unchanged between 2001 and 2005 at about 40%.

Lowering income tax rates, however, brought about a lower income tax burden on labor, which reduced revenue: income tax revenue to GDP gradually shrank from 3.4% in 2001 to 2.7% in 2005. In absolute terms, income tax revenue was relatively stable at about 1.1-1.2 bln leva. Generally speaking, this was a period of symbolic shrinking in the gross tax burden, therefore with no clearly visible dynamic effects on revenue from a somewhat reduced income tax.

Another key moment was 2006, as pension contributions were reduced more seriously and the untaxable minimum was significantly raised, which automatically brought down the tax burden – to about 36-37% of the gross labor costs. In 2006 the untaxable minimum was raised by 38% to reach

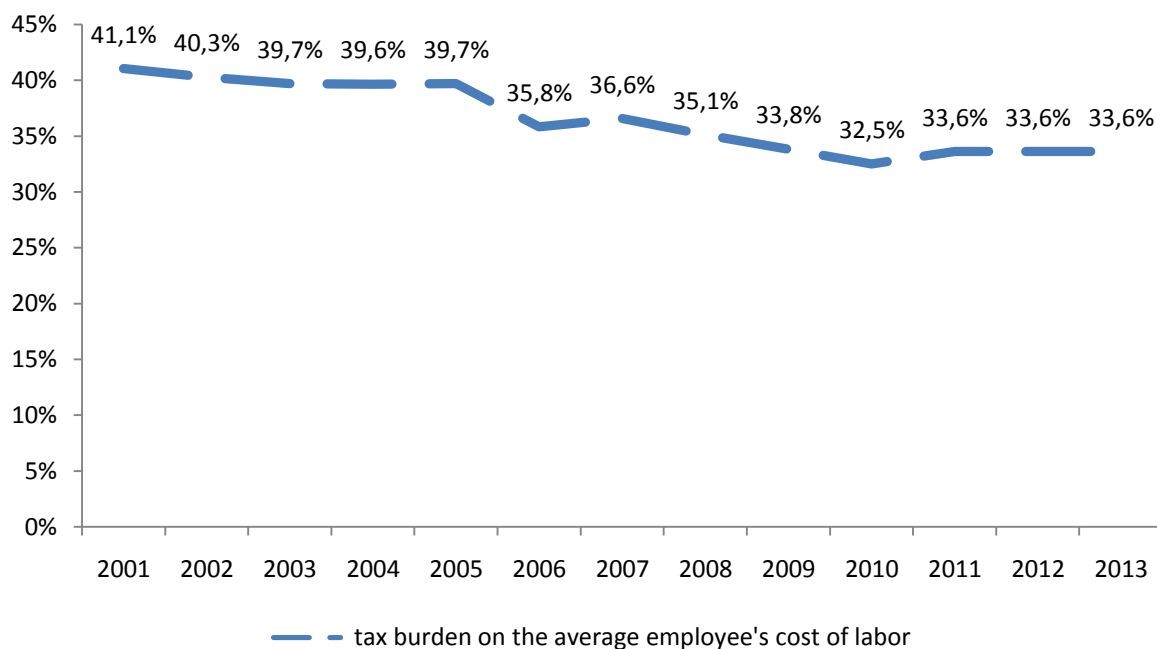


50% of the average salary in the country: that was practically 13% above the minimum salary in 2006. What it meant was that everyone who got paid up to 50% of the average salary paid no income tax. It was precisely during that period of strongest social progressiveness (with the highest threshold for people who did not pay) that income tax revenue reached its lowest: 2.5% of GDP in 2006. That is understandable: the base was at its most narrow and revenue was lower, respectively.

The next important period came in 2008-2009 when the last significant changes in the tax and social security burden were made. The introduction of flat tax in 2008 caused a profound change in taxation. The variety of rates was abandoned and so was the untaxable minimum, which broadened the base to its maximum. At the same time social security contributions were reduced, too – mostly unemployment contributions. In 2009 a new reduction in social security contributions (pension insurance) followed, which eventually led to the tax and social security burden in 2008 and 2009 going down by 3 more percentage points to about 33-34% of the total labor costs.

In the period that followed, the burden on labor remained relatively stable and no changes in income tax were made. In 2010 there was a slight drop in social security contributions, which was compensated a year later: in 2011 the burden on labor was set at 33.6%. In other words, about one third of labor costs went to taxes and social security. Between 2011 and 2015, revenue from income tax gradually rose to reach its typical levels of slightly over 3% of GDP (2.7 bln leva or 3.2% of GDP in 2015). Practically speaking, compared with 2001-2002, the burden on labor costs was reduced by about 6-7 percentage points.

Fig. 1. Tax burden on the average employee's costs of labor (%)



Source: NSI, IME

Immediate effect of flat tax on disposable income

If we consider an employee who gets the national average salary, the introduction of flat tax does not lead to a significantly lower tax burden – the reason is that during the years before the introduction of flat tax half the income of that person had not been subject to income tax. The



abolished untaxable minimum in this case was compensated by the lowered tax rates: the burden of income tax on the gross salary remained within 8-9%. At the same time, however, there were serious dynamic effects both on tax and social security revenue and on salaries, the average salary rising by a record 27% while the economy had a nominal growth of 14% in 2008. Or, differently put, the disposable income of the average employee rose considerably.

An important point in the flat tax discussion is its effect on the disposable income of those with the lowest salaries, i.e. close to the minimal salary. Abolishing the untaxable minimum (which had been dramatically raised in 2006 and 2007) as flat tax was introduced widened the tax base: employees with the lowest salaries (50% of the average salary) started paying income tax – in 2006 and 2007 their tax was 0 leva. With the introduction of flat tax, however, alongside the dynamic effects on salaries, income compensating measures were also taken (for example raising the minimal salary by 22% in 2008) with the idea that flat tax should cause losses to no employees. The NSI data on the development of the gross salary of employees who got 50% of the average show that in 2008, despite the abolished untaxable minimum, the gross salary of the lowest paid employees had risen by over 13% which was ahead of inflation for that year. That means beyond any doubt that all employees gained from the introduction of flat tax, and the disposable income (and its purchasing power) of all, including the lowest-paid employees, went up.

Social security revenue and flat tax

Trying to answer the question whether the lower tax and social security burden has had a positive influence on revenue, let us focus on the revenue from 1 percentage point of pension contribution.³² The reason for this approach is found in the fact that tax revenue depends on the social security burden as social security contributions are paid before income tax, in other words, the pure effects become visible through revenue from social security contributions. Nor are such contributions influenced by the presence of an untaxable minimum, which makes the historical overview clearer. When there is such a minimum, it is practically impossible to calculate revenue per unit income tax as everyone pays a different tax. This is not the case with social security contributions, which are the same for all employees except those above the maximum insurable earnings; such employees are, however, a lot fewer than those who fall into the untaxable minimum range for income tax, and cannot influence the big picture that much. The revenue breakdown of the Pension Insurance Fund at the NSSI in particular allows us to make a correct comparison with the same type of contributions.

In an attempt to highlight the dynamic effects on revenue from taxes and social security contributions, focusing on the budget of the Pension Insurance Fund, we should find out how much revenue a percentage point of social security contribution brings. If there are any positive dynamic effects and the grey economy shrinks, every percentage point of contribution ought to bring more (and ahead of the economy's nominal growth) revenue. To do this with the highest possible precision we should use a break-down of the revenue in the Pension Insurance Fund, in other words, we should look for the relation between individual contributions (of an employee or employer for the respective labor category) and the revenue from this type of contribution. In this case we take employers' contributions for the so-called third labor category individuals and the respective revenue from those contributions: this is the largest and most common labor category which makes it quite suitable for our purposes³³

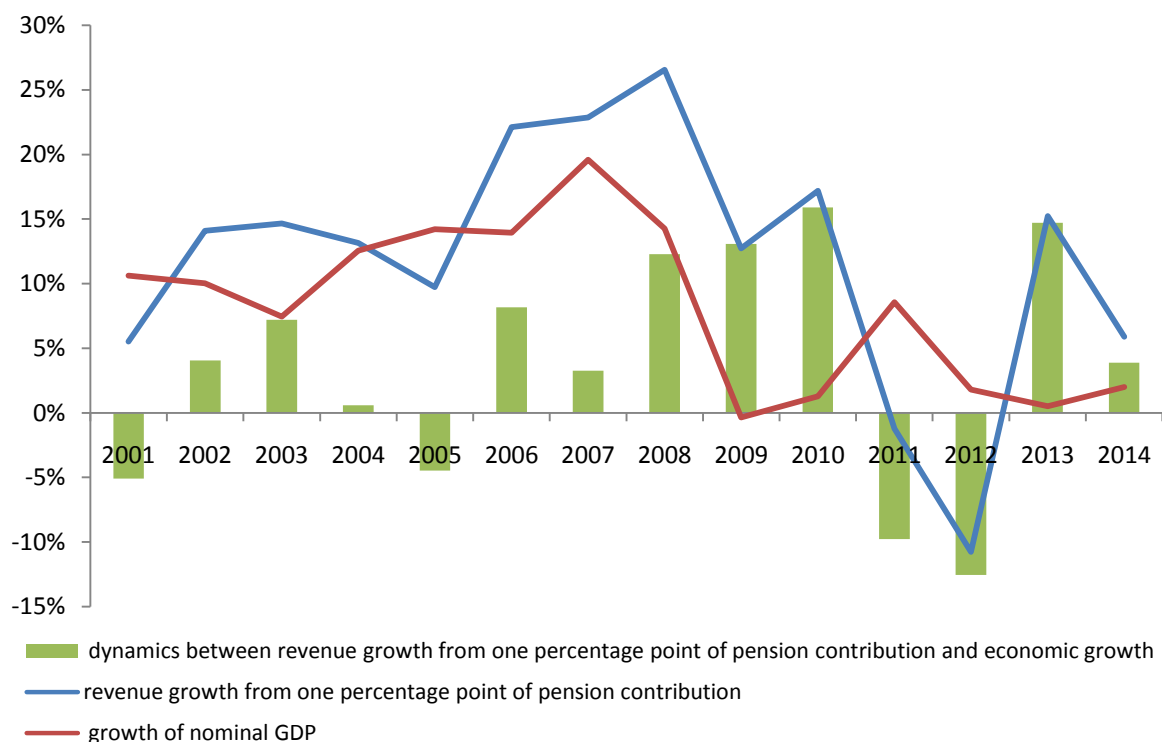
³² See more in Ганев, Петър. „Договорот между поколенията или скритият пенсионен дълг на държавата“, ИПИ, 2012.

³³ The same procedure can be carried out with the contributions of employees or self-employed people. The data at our disposal on the revenue in the “**pension insurance**” fund make the calculation most precise when we use the employers' contributions.



The graph in fig. 2 shows a juxtaposition of revenue growth from one percentage point of employer pension contribution and economy growth. In response to the argument that revenue growth from social security contributions was entirely caused by high inflation and economic growth in those years, the graph also presents GDP nominal growth: it encompasses both the inflation processes and the real changes in the economy. The difference between the two lines is precisely the dynamic effect, i.e. the higher financial result for the NSSI achieved by a percentage point of social security contribution. It is apparent that revenue from social security contributions had a distinctly forerunning growth in two periods: in 2006 and especially in 2008 – 2010, the years of most serious tax and social security contribution changes and a shrinking burden on labor.

Fig. 2. Dynamic effects on social security contributions (1)



Source: NSSI, NSI, IME

Between 2001 and 2005 the growth of revenue from one percentage point of contribution, except for some fluctuations, followed the nominal changes in the economy. During that period social security contributions stayed almost unchanged and it was normal that there were no significant discrepancies. The change set on in 2006 when the contributions to the Pension Insurance Fund were lowered and the tax and social security burden shrank by 3 to 4 percentage points (calculated for the average employee). There was an immediate effect: revenue from one percentage point of contribution increased sharply to forerun the economy's nominal growth. In 2007 and 2008 the effect of the changes already started to spread, which led to an even greater increase in revenue from one percentage point. As a sum total, in 2008 one percentage point of social security contribution brought almost two times more revenue than it did in 2005.

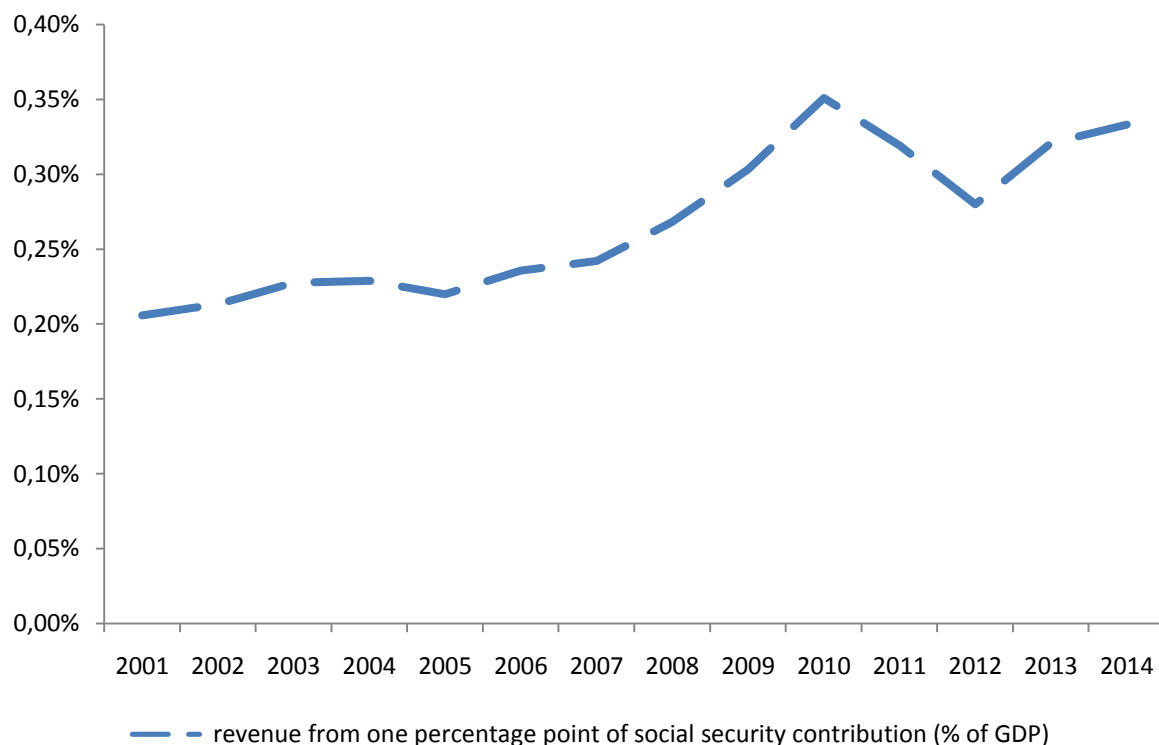
That tendency was also noticeable in 2009 and 2010 when there was another drop in contributions. In 2009 the economy was shrinking nominally, but there was a serious growth in revenue from one percentage point of contribution. In 2010, revenue from one percentage point of contribution was



already 2.5 times higher than it was in 2005, over half the effect being caused by inflation processes and the lower tax and social security burden. Interestingly, 2011 and 2012 were the only years when there was no growth in revenue from one percentage point of contribution, 2011 being the only year of growth in social security contributions (+1.8 p.p.), despite the slight nominal growth in the economy.

There is also another way to present this picture: revenue from one percentage point of employer contribution for an employee in the so-called third labor category as a ratio to the country's GDP. This is practically the same data, though shown in a more easily comprehensible way. The picture is similar: a growth in revenue between 2008 and 2010 and a drop in 2011 and 2012. Here is how using the Pension Insurance Fund's budget one can derive the positive economic results of the lower tax and social security contribution burden.

Fig. 3. Dynamic effects on revenue from social security contributions (2)



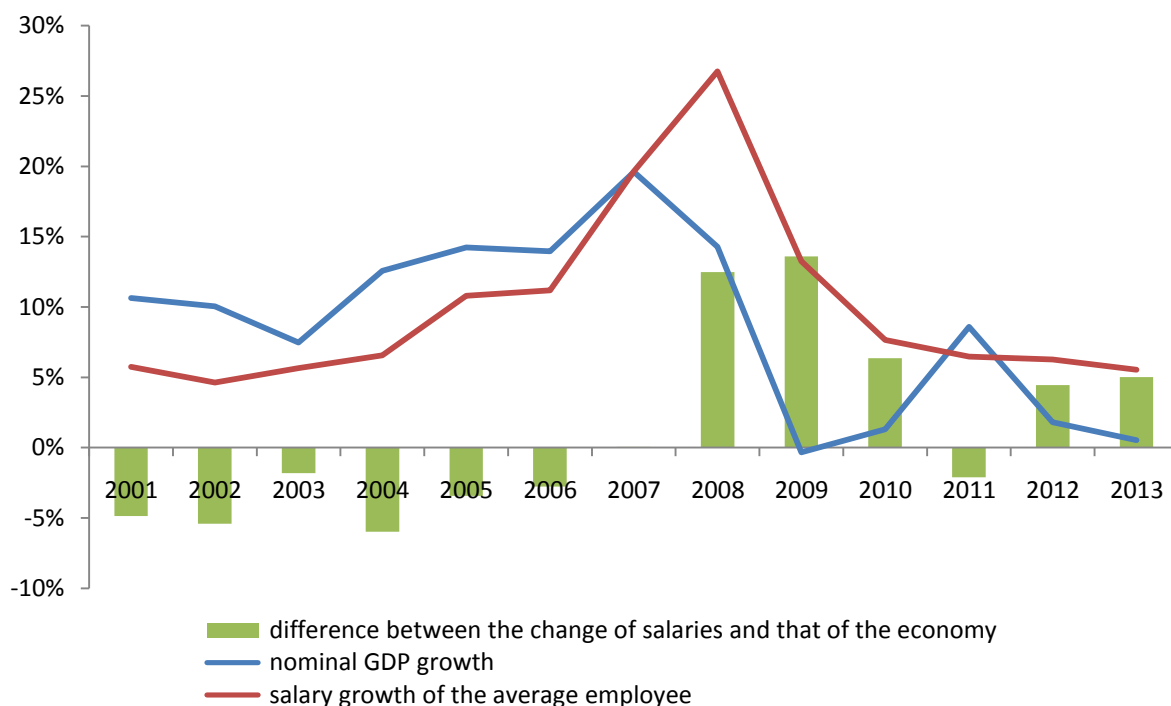
Sources: NSSI, NSI, IME

Gray economy shrinkage and salary growth

The effect on income, in this case – salaries, is an important aspect of the flat tax debate. We have already seen the immediate effects on disposable income, including that of employees with the lowest salaries, so now we can look more closely at the dynamic effects on salaries. The development of the average salary lagged behind the growth pace of the economy between 2001 and 2006. That was a period in which administrative measures were also taken, such as the introduction of an income threshold for social security contributions, which produced no clear result regarding the lagging of salaries. In 2006 and 2007 there was a change, with the growth in salaries lagging behind the economy's nominal growth. In 2008, the year when flat tax was introduced, salaries distinctly ran ahead of the economy's nominal growth which stayed solid in 2009 and 2010 as well.



Fig. 4. Dynamic effects on salaries



Source: NSI, IME

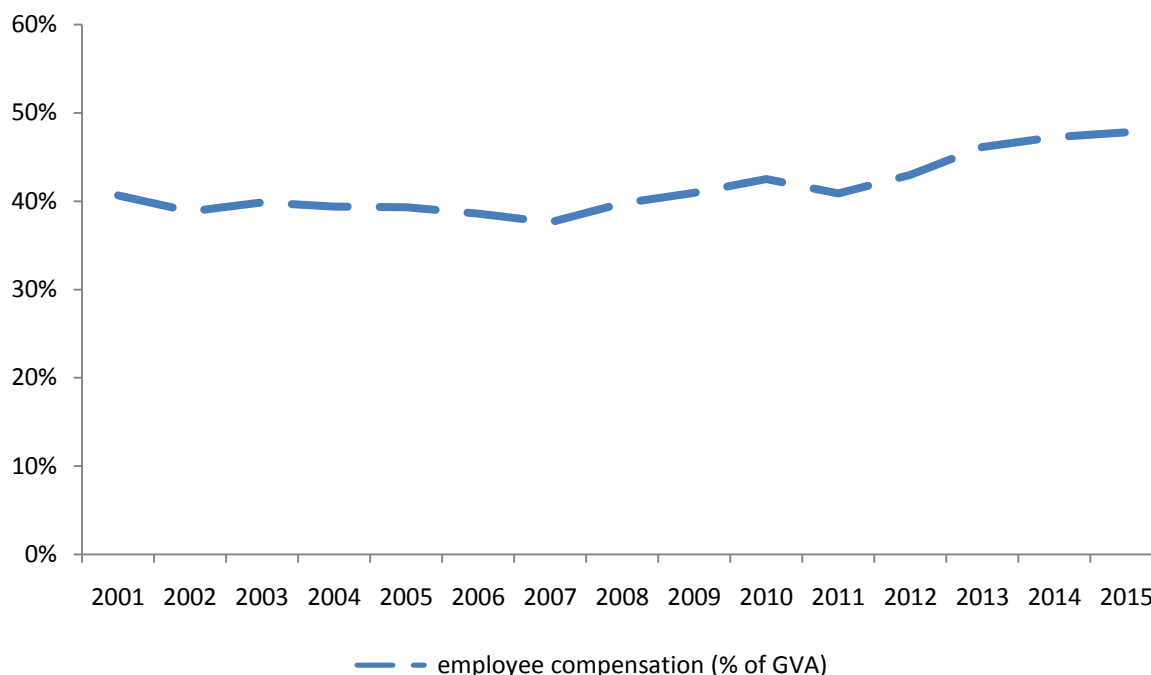
Salary changes are among the most compelling indicators of the dynamic effects of tax and social security policy. A key role is also played by employment, but the lower tax and social security burden rather “brings to light” more of the employees who fail to disclose their real salaries than employees who fail to declare their income at all. It is apparent that in the period immediately after the lowering of social security contributions in 2006 and that around the introduction of flat tax in 2008, and then the time when social security contributions were lowered again in 2009 and 2010 – in other words between 2007 and 2010, the observed salary growth was unusually higher than the economy’s nominal growth.

The explanation lies both in the lower tax and social security contributions burden and in the abolition of the untaxable minimum in income tax, which used to incentivise people to declare lower sums or actually fail to pay income tax. These incentives disappeared in 2008 and caused payments to be brought to light. This can also be seen in GDP statistics based on the income method.³⁴ The “employee compensation” component presented as a share of the gross value added (GVA) in the economy experienced a forerunning growth after the introduction of flat tax in 2008 and particularly after the labor market recovery after 2012.

³⁴ For more see PetarGanev, „Какдасравнявамерудовитедоходи и БВП в различни страни“, (ИПИ, 2016).



Fig. 5. Employee compensation as a share of GVA (%)



Source: NSI, IME

It is clear that the argument for the antisocial flat tax fails to hold its ground against the facts thus presented. The growth of salaries and the increasing importance of the “compensation of employees” component in the economy are indicative that after the introduction of flat tax in 2008 there have been positive effects for employees, all the more visible after the labor market’s recovery from the crisis – i.e. after 2012.

Conclusions

Several important conclusions can be made from the overview of the tax and social security burden development and the evaluation of its effects on disposable income, revenue and salaries. In the first place, the introduction of flat tax is part of an overall process of shrinking in the tax and social security burden in the country and it should be considered precisely from this perspective in order to be evaluated correctly. The immediate effect from the introduction of flat tax and the abolition of the untaxable minimum is an increase in disposable income for employees – including those with the lowest salaries. The wider base and the low rate led to positive dynamic effects in revenue, raising the efficiency of the tax and social security system: that can clearly be seen in the serious revenue growth per unit of social security contribution. Tax revenue from income tax also rose after the introduction of flat tax and reached its traditional levels of over 3% of the country’s GDP.

The dynamic effects on salaries are also evident: it was after 2008 that a model was established in Bulgaria according to which salaries grew at a rate higher than the economy’s nominal growth. This can be seen in the growing share of “employee compensation” in the gross value added, which has already come closer to average European levels. The latter is also a clear indicator of the social element of flat tax which treats all taxpayers equally, provides incentives for bringing income to light and, due to its low rate, allows more disposable income to be kept by employees.



THE FAIRNESS OF FLAT TAX

GEORGI STOEV

With the introduction of flat tax in 2007 and 2008 several differences were eliminated. In the first place, the rates of profit tax for small and big business were equalized. From the perspective of accounting the rates of profit tax were equalized but from the economic perspective income from entrepreneurial activity was harmonized with income from shareholding in business. In the second place, the variety of rates of progressive tax on labor income was replaced by a single proportional rate of 10%. As part of this change the so called untaxable minimal income was abolished, in other words income tax policy came to cover all groups of society. In the third place, the tax on labour income was equalized with the tax on corporate profit (we are talking of profit entirely in the context of accounting here). An extra 5 percent of dividend tax is still paid at the source when profit is distributed among company partners and shareholders, but if profit is reinvested, the burden on corporate profit is 10%.

That reform of the tax system brought harmony to income tax treatment, which was radically different from treatment before 2007 and still is radically different, compared with other taxes, for example the complicated social security contribution schemes. The harmony in tax-related treatment, however, has rarely been used as an argument in favor of flat tax. Most flat tax proponents relied more on arguments about the small size of the tax and the resulting incentives for economic activity. The opponents of flat tax, however, on their part put forward arguments based on an egalitarian or utilitarian concept of justice in income distribution, which implies some “community usefulness” of equality (or of less inequality) in income. That prevented the debate from finding a common ground.

For the purposes of the political dialogue on the topic, what one should do is reduce the comparison of alternative tax approaches to measurable and comparable effects. In this respect there is still a gap between proponents and opponents of flat tax when talking of tax treatment fairness. Let us consider briefly the way this debate on the moral aspect of flat tax looks today.

At this point, classical liberal proponents (including myself) base their arguments on the social justice that originates in property rights within a society. In that sense the fairest tax is 0%. Our arguments “for” or “against” flat tax are actually arguments “for” and “against” the effective tax burden. Our opponents, however, build their arguments on redistributive fairness, which is grounded on the assumption that people are somewhat intolerant for inequality of income. In other words, any progressive tax which leads to expectations of less inequality will be preferable to proportional tax.

To fill this gap, here I propose an approach uncharacteristic for me. I will offer a utilitarian perspective on various alternatives and I will try to prove to flat tax opponents that progressive taxation is not the alternative they wish for. I will assume just like my colleagues in trade unions and many of the economists in the main parties in Bulgaria that society has its target function. I will seek to optimize it for various assumptions. I ignore the possible opposition of a purely egalitarian character, i.e. a societal target function which can only be optimized with respect to equality of income (thus an income of 0 leva/month for everyone will bring the same societal wealth as a 10,000 leva/month income for everyone).

First, however, briefly on exactly who is paying the tax. It may sound self-evident, as we are talking of income tax, i.e. the burden is on whoever generates the income. That is probably true when talking of income from entrepreneurial activity (profit in the economic, not in the accounting sense). To get



900 leva of disposable income after a transaction I will have to contribute to the budget 100 leva in income tax.

But when we are talking about income from paid employment, things are different. The laws of supply and demand are as just valid on the labor market as on every other kind of market. Raising taxes on paid employment cannot but have the same effects as those from tax on any deal – a higher price for the buyer party (the employer), a drop in benefit – in this case gross income – for the seller party (the employee), shrinking in the equilibrium quantity of labor hired. There are also a number of “invisible effects”, known in theory as *deadweight loss*.

Taxes on labor are part of the employer’s optimization task. When there is a relatively high elasticity in the workforce supply, the tax burden will have to fall on the employer’s profit. In most cases the burden is borne by all agents in the economy – employees, employers and their clients. In an extreme case, if the supply of labor was infinitely inelastic, the tax burden would be borne exclusively by the employee (the employee’s salary would decrease if taxes were raised while the employer’s profit would stay unchanged and so would the employment level). But in all other scenarios, which are much more widespread in reality, the negative effects would spread to all participants in the economy: they would cause gross salaries, profits, investment and employment to shrink.

That is why harmony in taxation should be treated as bringing some fairness into the tax system. Without clear information (and such info is impossible to generate) on who is the ultimate bearer of the income tax burden, the proportional approach with its equal spread over all receivers on all kinds of income seems the most intuitive one.

Now let us consider utilitarian fairness, which, in my opinion, still holds ground in the mindsets of today’s generations of politicians, trade unionists, and, of course, probably in the society at large. It rests on the assumption that society is a target function, part of the optimization of which is done by modeling the levels of average incomes and the distribution of income among people. Finally, though inequality of incomes is a less easily quantifiable characteristic of society, still a guess can be made that there are several already widely accepted metric indicators. In the analysis below I will make use of some of the most popular inequality indicators also used in the arguments of the opponents of proportional tax.

According to the Jakobsson – Fellman theorem³⁵ one of the main starting points in a branch of economic science now popular as *welfare economics* – if the population’s incomes are taxed with a progressive tax, inequality will undoubtedly be lessened. Indeed, if social engineers were to design such a model of progressive taxation in which the progression spreads over the entire society, quantitative indicators will show less inequality. If, however, as it is much more likely to happen in reality, different groups get different tax treatment (though each treatment is in itself progressive) social engineers will have to provide several important conditions to ensure their success, less inequality. I will come back to considering these conditions in detail further on. Suffice it to say for now, that if there are different progressions for different groups, there is a real danger that the desired lessening of inequality will not be achieved.

So what happens to the average income in various tax schemes? Different tax schemes create different incentives for economic activity and we can expect change in average income. But proposals for tax changes are usually made with the assumption that the average income stays the same in alternative scenarios. The assumption is that the government will manage to get the target revenue from taxes without changing the average gross income and the average disposable income

³⁵ Jakobsson, U. On the measurement of the degree of progression. –Journal of Public Economics, 5, 1976, pp. 161–168; Fellman, J. The effect of transformations on Lorenz curves. –Econometrica, 44, 1976, pp. 823–824.



(the only change is in the distribution of the tax burden and the respective distribution of disposable income).

The following example presents a scheme for income tax imposed on a fictional society of 6 individuals. The society is divided into two groups according to a feature which determines different tax treatment – for the sake of the example let us assume that this feature is age and divide the society into “agricultural workers” and “industrial workers”. The group of agricultural workers is taxed progressively. A different progressive tax system is used on the group of industrial workers. Table 1 presents income distribution before and after taxes in the two subgroups.

Table 1. Distribution of income before and after taxes in the two subgroups of society

Size of income or tax	Agricultural workers			Industrial workers		
Income before taxes	300	400	500	600	700	800
Tax rate	33%	50%	60%	0%	14%	25%
Tax size	100	200	300	0	100	200
Income after taxes	200	200	200	600	600	600

The applied tax system leads to perfect equalization of income in each subgroup of society. Still, the degree of equality has lessened after taxing. That is what measurement with the Gini coefficient and the Relative Atkinson Index³⁶ shows. The result for the “sum of differences” indicator (denoted by S in tables 2 and 3), is also indicative, though not so formal, as it goes up.

It has to be noted that inequality increases despite the lower average disposable income of the population. The main income characteristics of the society before and after taxes are presented in table 2.

Table 2. Main income characteristics of society before and after taxes

Indicators for income and inequality	Before taxes	After taxes
Total income	3300	2400
Average income	550	400
S	3500	3600
Gini	0,18	0,25
Relative Atkinson Index	0,05	0,13

Note: The Atkinson Index has been calculated for $\epsilon = 1$.

$$S = \frac{1}{2} \sum_{i=1}^n \sum_{j=1}^n |x_i - x_j|$$

³⁶ Atkinson, A. B. On the measurement of inequality. *Journal of Economic Theory*, 2 (3), 1970, pp. 244–263.



Lambert (1993)³⁷ considers the case of progressive taxation but in different progressive schemes for different subgroups of society. He defines three conditions for the Jakobsson – Fellman theorem to be valid:

1. Each member of one subgroup is richer than any other member of the other subgroup;
2. All members of the richer subgroup are taxed at a higher effective tax rate than the members of the other subgroup;
3. The tax leads to no changes in relative positions (ranks) in society.

In this progressive tax example two of the conditions are fulfilled but one remains unfulfilled: the condition for a higher tax rate on the richer subgroup is broken.

Now let us consider the case where proportional tax for the entire population leads to the same budget revenue: 900 units. Thus, the tax imposed by the government will be 9/33 of each society member's income. The Gini coefficient does not change as a result of proportional changes in income. The same is true of Atkinson's index. Table 3 shows a comparison of income distribution after proportional tax and after different progressive tax schemes for the different subgroups.

Table 3. Income distribution after proportional tax and after different schemes of progressive tax

Income indicators and inequality	Proportional tax	Progressive schemes
Total income after taxes	2400	2400
Average income	400	400
S	2545	3600
Gini	0,18	0,25
Relative Atkinson Index	0,05	0,13

To complete the analysis of taxation fairness in the utilitarian tradition we need to compare the two states of the society from the perspective of general welfare. We are used to seeing this comparison made by specialists in "redistribution economy" by means of a social welfare function (SWF), which they usually base on average income and inequality indicators. Let us assume that these inequality measures are the Gini coefficients or Atkinson's indices. The intuitive way to define the function of social welfare (of course, far from being the only possible one) is by assuming that the general welfare increases as the average income increases and that the general welfare decreases as the inequality indicator increases.

$$W = f(\mu, I)$$

$$W_{\mu} \geq 0$$

$$W_I \leq 0$$

³⁷ Lambert, P. J. The Distribution and Redistribution of Income: A Mathematical Analysis. Manchester University Press, 1993.



where W denotes the general welfare, μ is the average income, I is an inequality indicator, W_μ is the first derivative of SWF regarding the average income, W_I is the first derivative of SWE with respect to inequality.

For a convincing comparison of the two states in Table 3 it is unnecessary to complicate SWF any more. In these assumptions it is clear that higher values of social welfare are achieved with proportional tax. Average income is equal in both alternative states of society but the inequality indicators have lower values after proportional tax.

The only possible opposition to this argument in favor of proportional tax (compared with alternative progressive schemes) can be based on an assumption of social welfare being indifferent to general equality an existing strong connection between social welfare and equality inside the individual subgroups. The proponents of such a position will need to go a long way to explain why they are struggling for equality, though only within the groups, while still taking serious differences between the different social groups to be socially acceptable.

We have proved that even for the relatively simple example of a society with only six members modeling the tax burden on the grounds of redistributive social justice is an exceptionally challenging exercise. It won't be too far-reaching to say that in political realities traditionally dominated by various organized groups combined with unadulterated populism this kind of social engineering looks as an impossible task. The recommendation to flat tax opponents who provide arguments based on social justice is to accept proportional tax as the best possible environment for the development of social engineering ideas. They will have ample opportunities for increasing social welfare to focus their efforts on, which they can save as a result of harmonious flat tax.



THE INTRODUCTION OF PROPORTIONAL TAX IN BULGARIA AS MACROINSTITUTIONAL CHANGE

GEORGI GANEV

From the perspective of macroeconomic theory Bulgaria is a curious case, so far as the country's history in the last twenty or so years contains some rather unusual developments. Far from an exhaustive list, they include the coincidence between the real appreciation of the lev and a considerable rise in competitiveness of Bulgarian manufacturers (measured as a share of Bulgaria's export in the global export); breaking world records in capital inflow, the respective current account deficit and the subsequent record fast correction of this deficit; following a fiscal policy of small deficit or surplus for a decade; a strong decrease in external indebtedness in the public sector accompanied by a strong increase in the private one.

All these processes deserve careful analytical consideration. But apart from them, two unusual and non-traditional institutional changes happened in the regulations framework where the macroeconomic processes take place. One was the introduction of a currency board; the other was the introduction of flat tax.³⁸

Each of these changes in itself placed Bulgaria among a relatively small group of countries but the combination of the two makes it simply unique. Even that fact alone makes it an exceptionally interesting object of study, even testing, of a number of postulates, considered established, in contemporary macroeconomic theory. As a first step towards such a research program the very process of achieving change in institutions³⁹ of macroeconomic importance should be analyzed. For the sake of brevity they will be referred to as macro institutions, and the change in them as macroinstitutional change.

The object of the present analysis is the second of these macroinstitutional changes, the introduction of flat tax. This change has three basic components. The first component is the introduction of a single proportional rate of income tax (in other words, everyone owes the same proportion of their taxable income as tax), to replace the progressive scale of rates existing up to that moment. The second one is a considerably lowered rate from levels above 20% for income above the untaxable minimum to 10%. The third one is the abolition of the untaxable minimum. It is namely these three things as a package that comprise the macroinstitutional change itself.

The analysis of the introduction of flat tax in Bulgaria here is based on the only analytical frame for changes of this kind existing at this point, namely the Douglas North frame. Its main elements will be presented in the first part of the text. In the second part they will be used to present the introduction of flat tax in Bulgaria from that specific point of view. In the third part the particularities set off in applying the used analytical frame in the case of Bulgaria will be considered from the point of view of its sustainability in the case of today's Bulgarian society.

³⁸Of course, other institutional changes of a macroeconomical nature also happened in Bulgaria during that period, for example privatization, a second pillar of pension provision and acceptance of the four basic freedoms of movement. But they were characteristic of many other countries and are not specific to Bulgaria.

³⁹The concept "institutions" in this text is understood in the context where representatives of New Institutional Economics use it: namely, as a set of rules ordering human interactions. See below for an explicit definition.



Analytical frame of institutional change after Douglas North

North's analytical frame for institutional change contains four dynamically interconnected components.⁴⁰ The first one is the system of beliefs and convictions of society on how reality works and what causal relations exist in it. This component is called "theory" in short.

There are two things human society does based on its theory of the world. First, it creates a framework of limitations on behavior it considers desirable which are aimed at achieving order, predictability and efficiency of human interaction. Second, individual economic actors in society form their perceptions of both what happens around them and expectations for the future, plus, what is of particular importance, of different possible paybacks for different actions they perform. The sum of those two things constitutes the second component in the analytical frame of institutional change and is denoted by North's term "scaffold".

Having formed their expectations and estimates of the different paybacks for different possible courses of action, the economic actors make their decisions and act. Depending on whether we are talking about the action of individuals or some collective act, this component of North's analytical frame can be called "acting" or "politics".

Finally, people's acts affect the real world. It develops in a way determined by the decisions and performance of economic actors and would be different if their decisions and actions were different. This component of the analytical frame of institutional change is denoted as "reality". Reality is the total result of people's actions based on the scaffold which is determined by the theory. On its part, however, reality influences people's convictions and faiths. The way it develops can cause them to be reconsidered, and therefore lead to society as a whole achieving a new theory or new explanatory frame of the way the world works.

Institutions are limitations on behavior, created by people, which determine human interaction.⁴¹ Institutional change itself is the result of human action. For it to happen a sufficient number of people have to decide that a change in the system of limitations on behavior will lead to desirable consequences. Within the frame of North's model of institutional change that happens either when a sufficient number of people reconsider their convictions of how the world works or reconsider their perceptions regarding the expected paybacks from different structures of their interrelations.

In practice, in institutional change, as in any social process, there are groups of people –those who are the bearers of change and those in whose interest it is that it does not happen. The relative power of these two groups within the framework of society in a specific state of affairs determines if the institutional change itself will be performed and what particular shape it will take.

Finally, presenting the institutional frame necessary for our analysis requires emphasizing the importance of dividing institutions into two basic types: formal and informal.⁴² The difference between them is in the way human behavior is sanctioned for being undesirable according to the limitation introduced with the respective institution. In the case of formal institutions, sanction is based on (the threat of) coercion and use of force by the state. With informal institutions sanction is of a different nature: through people's attitude, in the case of religion-based institutions – through the threat of other worldly punishment. As a result of this division it is also taken for granted that

⁴⁰The most concise presentation of this frame can be found in North, Douglass C. *Understanding the Process of Economic Change*. Princeton University Press, 2005, pp. 2–3.

⁴¹North, Douglass C. *Institutions, Institutional Change, and Economic Performance*. Cambridge University Press, 1990, p. 3.

⁴²*Ibid.*, p. 4.



creating and changing formal institutions is done through the mechanisms of the state, while creating and changing informal ones happens in the complex, organic and spontaneous process of communication between people in the conditions of their coexistence.

The case of introducing flat tax in Bulgaria

Flat tax, understood as a package of introducing a single income tax rate for individuals, a considerable lowering of this rate compared with previous levels, and abolition of the untaxable minimum came into force in Bulgaria in 2008. Legislative acceptance of the changes took place in mid-2007. A brief overview of the news coverage at the time of the event leaves the reader with the impression that this serious change in the tax system happened relatively quickly and unexpectedly. But an impression like that would be misleading. The change actually happened gradually and could be labelled one of the most carefully considered and estimated macroinstitutional changes in Bulgaria in the last quarter of a century.

It is another well-known macroinstitutional change in Bulgaria that can be labelled fast, even quick as lightning: the introduction of a currency board in 1997. Then, only eight months passed between first presenting to Bulgarian society at large the very idea of a currency board in early November 1996 and the mechanism actually coming into effect in early July 1997. That included all societal debates on the topic, the parties taking their decisions to accept that idea or not, the working out of a quite bulky package of legislative propositions, their acceptance and the institutional reconstruction of the Bulgarian National Bank and its interrelations with the banks.

In stark contrast, the proposition to introduce flat tax in Bulgaria had been around for over 10 years before the change actually took place. The debate around this proposition, especially among economists, became particularly active after 2003 as a result of two initiatives of the IME: the publication of a bulletin called “Flat tax” and the annual announcement of an “Alternative budget”. Even the first formal legislative proposal to change the tax system and introduce flat rate for income tax was made by Member of Parliament Martin Dimitrov in the autumn of 2006, a whole year before the legislative proposal which was eventually accepted and 15 months before the change came into force.

The contrast between the blitz introduction of a currency board and the long maturation of the idea of flat tax also points to another peculiarity of flat tax as macroinstitutional change in Bulgaria. The energy in introducing the currency board apparently came from the huge financial and economic crisis in Bulgaria at the time. Crises create a particularly fertile ground for essential institutional changes. The reason lies in the fact that it is during times of crisis that people are most inclined to reconsider their theories of the world, their beliefs about causal relations in reality and on the grounds of this rethinking they tend to agree to try arrangements of human interrelations and interactions different from what they have been familiar with until then.

The flat tax, however, was not adopted in times of crisis, quite on the contrary. It was adopted at the very end of one of the most successful economic decades in the country’s history, characterized by high real growth, a huge drop in unemployment, unprecedented political stability and stable public finances. Usually, when things are going so well – or at least without crises, societies are not prone to reconsider their institutional frames in major ways.

In order to understand better the adoption by Bulgarian society of a significant macroinstitutional change in a relatively successful decade, it seems necessary to consider this decade as well as the configuration of social and political interests in greater detail. There are four of these basic details.



In the first place, this decade was not merely free of crisis and economically successful; it was also a decade of permanent institutional change. It coincided with the period of Bulgaria applying and then gradually getting integrated in NATO, and, more importantly, in the EU. For Bulgarian society the institutional frame was anyway in a process of permanent change and reforms were being carried out in all segments of state regulation. As the social legitimacy of the purpose of these changes – NATO and EU membership – was high, Bulgarian society was prone to accept new ideas rather than reject them a priori with the argument that things are going well anyway and no change is needed. On the contrary, it was highly logical to suppose that institutional changes themselves were part of and reason for relative success. In North's terms this means the theory was not ossified but was open to novelty.

In the second place, the tax system was changing all the time anyway. At the highest level it got more and more transformed from a philosophy of financing the public sector mainly with direct taxes, which made the high and therefore progressive rates politically inevitable, to a philosophy of financing mostly with indirect taxes which made it possible for the direct ones to be lowered considerably. One level further down, there was not a year in that decade without at least one of the three pillars of direct taxation (personal income tax, corporate tax and social security contributions) undergoing some changes. In the case of social security contributions, changes since the beginning of the century included the pension reform and the public health reform, followed by incessant changes in rates. In the case of corporate tax and personal income tax, a tendency for rates to go down was started at the end of the 20th century. At the lowest level, personal income tax, the tendency was not only for rates to go down for a decade, but also for their progressive character to shrink: differences between the higher and the lower rate levels of the tax kept growing smaller all the time.

Eventually, by 2005 it had already become clear that a personal income tax with an untaxable minimum at the bottom and, further up with a progressive scale of marginal rates: 10, 20, 22, and 24% of income over the respective thresholds was practically and experientially indistinguishable from a flat rate with an untaxable minimum and a rate of 23.5%.⁴³

In the third place, by 2007 it was already obvious that flat tax was spreading all over the world. Only among the countries Bulgarians are in the habit of comparing themselves to, after the pioneers from the Baltics, in the years just before the tax was formally proposed in Bulgaria, it was adopted in Russia,⁴⁴ Romania, Slovakia, Ukraine, Serbia, Macedonia, Georgia...⁴⁵ the feeling that an established international trend was followed also contributed to the idea's theoretical acceptance.

These three gradual developments should fully suffice to explain why in theory the idea to introduce flat tax as a single rate for all taxpayers proved to be quite acceptable in Bulgaria.

The fourth gradual development shows yet another important aspect in the adoption of flat tax, namely the acceptance of a rate of 10%, much lower than previous ones. This was the development of personal income tax itself, as well as that of corporate tax, in the same decade.⁴⁶ The main objection to lowering the rates has always been that it will lead to a considerable drop in revenue and thus to a lower capability of modern Bulgaria to be a welfare state. But one decade of rates going down – in the case of the highest personal income tax rate from over 40% to 24% and in the

⁴³ See Ганев, Георги. Плоският и прогресивните данъци – толкова ли са различни? – Плосък данък, март 2005, № 8, с. 6, табл. 1.

⁴⁴ It would be hard to prove, but the introduction of flat tax in Russia was most probably key to understanding the attitude to the ideas of flat tax in Bulgaria of some Bulgaria political parties.

⁴⁵ Later flat tax was repealed in some of these countries; however, at the moment when it was proposed and adopted in Bulgaria they had flat tax.

⁴⁶ See Petar Ganev's text in the present collection.



case of corporate tax from 40% to 10%, showed no drop or a minimal drop in revenue at most. What is more, in the very year of the debates on flat tax the corporate tax lowered to 10% was registering a considerable increase in collection. Here it is not so important whether the lowered rate caused the increased collection or in that particular year collection was increased because of external circumstances. What matters more is the empirical observation that the dramatically lowered rate did not cause a plunge in revenue. That empirical observation was the foundation of Bulgarian society's acquiescence to the proposal of the same rate for personal income tax. In other words, the actual experience of Bulgarian society between 1997 and 2007 clearly showed that the theory about lowered tax rates inevitably causing a drop in tax revenue was wrong and so it became subject to revision.

Finally, the fifth development shaped the last component of the flat rate package in Bulgaria: the abolition of the untaxable minimum. That was the price for overcoming the only true opposition of the proposed macroinstitutional change in Bulgarian society: the minister of finance. In totally legitimate defense of the interest of this public position, loaded, among other things, with the commitment to secure the health of public finance, the then minister of finance demanded guarantees that revenue would not be jeopardized not only at the time the change was carried out, which was characterized by a number of momentary circumstances favorable to the treasury, but in the case of future deteriorating circumstances. The abolition of the untaxable minimum, accompanied by a package of social measures to compensate low-income groups⁴⁷ which guaranteed that there would be no significant plunge in revenue even in an economic crisis proved to be the necessary and sufficient compromise for the proposal to be seconded. As the subsequent dynamics of revenue from flat tax during the world financial and economic crisis⁴⁸ clearly showed, the otherwise completely sensible misgivings of the minister proved to be excessive and it was precisely flat tax that caused no drop in revenue.

To sum up, within a single decade, some gradual developments in and around Bulgaria caused in Bulgarian society a strong willingness to accept the theory that the introduction of flat tax could prove useful for its welfare. Combined with people's perception of what opportunities for economic action they would have with flat tax, as well as the apparent incentives that tax provided for bringing economic activity to light, these developments explain the relative consensus with which that tax was accepted. In the framework of the analytical model, the development of reality led to the theory being reconsidered, which, in combination with people's perceptions of possible paybacks from different arrangements of social relations brought institutional change, and thus – a change in the scaffold.

Is the introduction of flat tax in Bulgaria sustainable?

The short answer to this question is "yes". Flat tax is now a status quo which has seen no change in almost ten years. In fact, the overall institutional frame of taxation itself is stable and changes in it, such as the introduction of tax on interest from bank deposits, have been mostly trivial. It is not merely the structure that has remained unchanged, the basic rates of direct and indirect taxes have either undergone slight changes or none at all.

Tax revenue collection varies depending on political or economic circumstances, but these fluctuations only show differences between different parties in power and between periods of crisis and growth, not potential problems in the institutional structure of taxes. Depending on the business

⁴⁷ See Georgi Angelov's text in the present collection.

⁴⁸ See Desislava Nikolova's text in the present collection.



cycle and the attitude of the politicians in power this tax structure can generate revenue of both over 30% and under 25% of GDP.

At the same time, though several states have given up flat tax and reverted to progressive tax⁴⁹, this change cannot be seen as an apparent tendency. Their example, respectively, can hardly be used to convince Bulgarians that change is necessary and would be useful.

Last but not least, flat tax in Bulgaria matches the informal institutions of Bulgarians, particularly their tendency to get around the law and make the best of the opportunities any complicated legislation inevitably offers. Unlike truly progressive taxes⁵⁰, which, due to the relentless logic of the political process include complex and numerous exceptions, conditions, and possibilities left to the tax collectors' discretion, flat tax is simple, clear and without exceptions. In combination with the low rate, its simplicity considerably reduces both the opportunities and the stimuli for evasion. Whatever gray economic activity there is in Bulgaria, it has long stopped being caused by attempts to save tax on behalf of individuals.

This aspect of flat tax is important from the perspective of how people perceive its "fairness". On one hand, there is the argument that "fairness" requires richer people to pay a higher proportion of their incomes in tax. But reality in Bulgaria often means that with progressive taxes the rich take advantage of a huge number of loopholes and procedures to avoid paying any tax at all and in reality the entire burden falls upon the people of average income between the untaxable minimum and the higher rates. While everyone can see that everyone pays the flat tax. In this sense, as lived reality, not as legislative wishful thinking, flat tax can be said to be at least less "unfair". It is this way of looking at it that adds sustainability to this tax regime in the concrete case of Bulgaria.

Thus at the moment the flat tax regime is under no threat from either an income crisis, or low revenue collection, or the combination of formal and informal institutions in Bulgarian society. The only possible source of calls for change in this regime are certain ideologies, according to which it is unfair and economically unfeasible compared with other arrangements of tax relations. But for the moment these ideologies seem to be unable to persuade Bulgarians to accept the idea of change. In ten years, the proposal to change the flat tax regime and go back to progressive tax was formally only made once and though it was seconded by the leading party in the ruling coalition, it was rejected by a significant majority. With today's state of affairs of economic and social processes in Bulgaria, the flat tax regime seems sustainable. But, as is well known from Bulgarian history, conjuncture is capable of fast change.

Conclusion

The introduction of flat tax in Bulgaria is an interesting case of macroinstitutional change. What seems curious about it is that the change is taking place not because of some kind of crisis, but at the end of a relatively very successful period of economic development and political stability: an environment in which serious macroinstitutional changes are not a frequent phenomenon.

The main characteristic of this change is the slow acceptance, taking place in a dynamic internal and external institutional context, on the part of Bulgarian society and therefore of Bulgarian political powers, that such a change would be desirable and useful for a sufficiently large majority of

⁴⁹In close proximity to Bulgaria they include Slovakia and the Czech Republic.

⁵⁰What is meant here by true progressive tax is a tax with a difference between the different rates of at least tens of percentage points, for example 20, 40, 60% for incomes above the respective thresholds. As was already mentioned, "progressive" taxes with a difference between rates of a few percentage points are practically and experientially indistinguishable from flat tax.



Bulgarians. The main characteristics of the context were the state of permanent reform on the road to NATO and the EU, the reduction of direct tax rates that had been going on for a decade, the consecutive adoption of flat tax in countries close to Bulgaria, and not without importance, the lack of any real societal or political opposition to the idea.

Because of the relative success of flat tax from the perspective of ensuring revenue, as well as the fact that it matches certain informal institutions in Bulgarian society at the moment, the flat tax regime in Bulgaria seems stable for the time being. Something serious and unexpected with respect to the present state of affairs would have to happen to enable its change.



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