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The Tax and Social Contribution System in Bulgaria: Formal Structure and Possible Impacts

by

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1. Introduction

Like in all countries in transition, the tax as well as the transfer system have been under serious reform pressures. The socialistic systems were not able to fulfil the necessary functions in providing a certain degree of redistribution and social security, which are inevitable for social oriented market economies. Increasing income and wage differentiation is one of the most important prerequisites for a market oriented ability to pay tax system. But in the transformation period, numerous quasi-legal or even illegal property transactions have taken place, thus leading to wealth concentrations on the one hand while as consequence of the bankruptcy of socialism, enormous poverty problems have arisen on the other.

For the political acceptance of the transformation process it is of utmost importance that an efficient and fair tax system is implemented and social security is organised by the state on a level which secures at least the physical minimum of subsistence or – if economically possible – even a social-cultural minimum.[1] Whether the state should go further in providing compulsory social insurance systems has been a hotly debated topic for decades even in the welfare and social states of the Western type.[2] Whereas the basic security systems have to be financed by general tax revenue, for a compulsory social insurance system – due to the insurance character – special earmarked social security contribution are held necessary. Both public goods and services as well as at least basic security have to be financed by total tax

[1] For details see Müller/Petersen (1995).

[2] See, e.g., Rosa (1982) and Giersch (1997).

revenue. For the acceptance and fairness of the whole system the total redistributive effect of both sides of the budget – the tax system as well as the expenditure system – are decisive.[3]

In this paper we will concentrate on the revenue side, e.g. on the taxes as well as on the social security contributions. Adam Smith had already formulated some very simple tax norms which have been transformed in modern tax theory. The equivalence as well as the ability-to-pay principle are basic yardsticks for every tax system in a democratic oriented market system, not to forget tax fairness.[4] In the historical development process equity-oriented measures have often produced an enormous complexity of the single taxes as well as of the whole tax system. Therefore, reconsidering the Smithian principles of simplicity and of minimum compliance costs for the tax payer would even press many Western European tax systems to undergo serious reform processes which often are delayed because of intense interest group influence.

Hence, a modern tax system is a simple one which consists only of a few single taxes which are easy to administer. Such a system consists of two main taxes, the income and the value added tax. Consequently in all countries of transition both taxes have been implemented, while the implementation was fostered by the fact that both also constitute the typical components of the EU member states systems. Therefore such a harmonising tax reform is the most important prerequisite to become a membership candidate. Bulgaria also tried to follow this general pattern in reforming the income tax system starting in 1992 and replacing the old socialistic turnover tax and excise duty system by the value added tax (VAT) in 1994. Especially with regard to the income tax system the demand for simplicity has not been met yet. Complex rules to define the tax base as well as a steeply progressive tax schedule have led to behavioural adaptations which are even strengthened by the effects of a high social contribution burden which is predominantly laid on the employers.[5] In the following some concise descriptions of the tax and social contribution system are given; the paper closes with a summary, in which the impacts of the system are evaluated and some political recommendations for further reforms are presented.

[3] In the theory of public economics such an approach is called budgetary incidence.

[4] For the basic definitions see the introductory text books of public finance, e.g., Petersen (1993).

[5] See Bogdanov (1998) in particular.

2. The Income and Corporation Tax

Since 1989 the income tax system stemming from the socialistic period (introduced in 1950) has been underlying several amendments which have increased overwhelmingly the complexity of the system as well as the compliance costs for the tax payers. If one takes all amendments for the tax and social contribution scheme together, 66 major changes in the law were to be observed in the period 1991 to 1998.[6] In view of such instabilities a strong mistrust in government arose because such changes even enhanced the instabilities caused by a highly erratic macroeconomic development.[7] Hence, mid- and long-term decisions were made impossible.

Like in almost every income tax system the Bulgarian one is based on the residence principle. The income tax base does not follow a synthetical definition but is pragmatically defined in enumerating the different sources of income which are due to taxation, and which are tax exempt. The income tax base mainly consists of the gross wages of employees, the income of self-employed, the profits of firms owned by individual persons (sole traders) and the rental income. Whereas for sole traders profits are estimated as difference in between turnover and the business expenses, for the other kinds of income often only standard expenses defined by law are deductible.

Exempt from the income tax base is a long list of non-permanent income sources, the pensions and child allowances. Obviously due to the totally underdeveloped banking system, interest payments are not taxable, excluding interest paid to sole traders. Additionally income tax is not due to dividends and distributed profits received by the shareholders. Dividends including all distributed profits from companies and partnerships are due to a 15% source tax rate.

As consequence of an incomprehensive income definition some income sources are discriminated, others privileged. With regard to spouse taxation the individual principle is applied. The taxable year is the calendar year; the employees income tax is withheld from the monthly gross wage by a pay-as-you-earn procedure. For other tax payers an assessment procedure occurs, for sole traders connected with quarterly declarations and advance payments. Since January 1, 1998 taxation occurs in monthly advance payments made by the

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6 For more details see Bogdanov (1998 pp. 6).

7 See the paper of Demopoulos/Fratzeskos (1998).

15th of the month and is based on 1/12 of the earnings in the previous year. This base is corrected (i.e. increased) with the current rate of inflation.

The regulations on the tax base and the tax schedule have been underlying several changes, the latter often caused by the inflationary environment. Due to political reasons the tax schedule has been very progressive with marginal rates which went up to 52% in 1993 (compared to 40% until 1992) with the aim to combat the increasing differentiation of the pre-tax income distribution. As empirical analysis have proven, these high scheduled tax rates have not become effective because of tax payers behavioural adaptations.[8] Such observations are in clear accordance with numerous investigations made in Western tax systems of the post-war period.[9]

The failure of the steeply progressive tax schedule was at least partially corrected in 1997 when the maximum marginal tax rate was reduced to 40% again. Since 1999 the tax schedule starts with a basic exemption of 900,000 Leva (900 DM) per annum which is clearly above the annual minimum wage of 732,000 Leva (732 DM).[10] The tax schedule applied then consists of four income brackets with increasing marginal rates from 20% in the first to 40% in the fourth bracket. The tax schedule formulas are presented in Table 1.

Table-1: Tax Schedule

Taxable Income x (in Leva)	Individual Tax Yield t
$x \leq 900{,}000$	$t = 0$
$900{,}000 < x \leq 1{,}200{,}000$	$t = 0.2\,(x - 900{,}000)$
$1{,}200{,}000 < x \leq 4{,}200{,}000$	$t = 60{,}000 + 0.26\,(x - 1{,}200{,}000)$
$4{,}200{,}000 < x \leq 15{,}600{,}000$	$t = 840{,}000 + 0.32\,(x - 4{,}200{,}000)$
$x > 15{,}600{,}000$	$t = 4{,}488{,}000 + 0.40\,(x - 15{,}600{,}000)$

Source: State Newspaper, No. 153/1998.

The course of the marginal and average tax rates are depicted in Figure 1. Marginal tax rates are stepwise increasing with growing taxable income, leading to an indirect progression within the single income brackets. The first bracket is very small so that the marginal rate steeply increases to 26%. With regard to the average rate progression the type of the tax

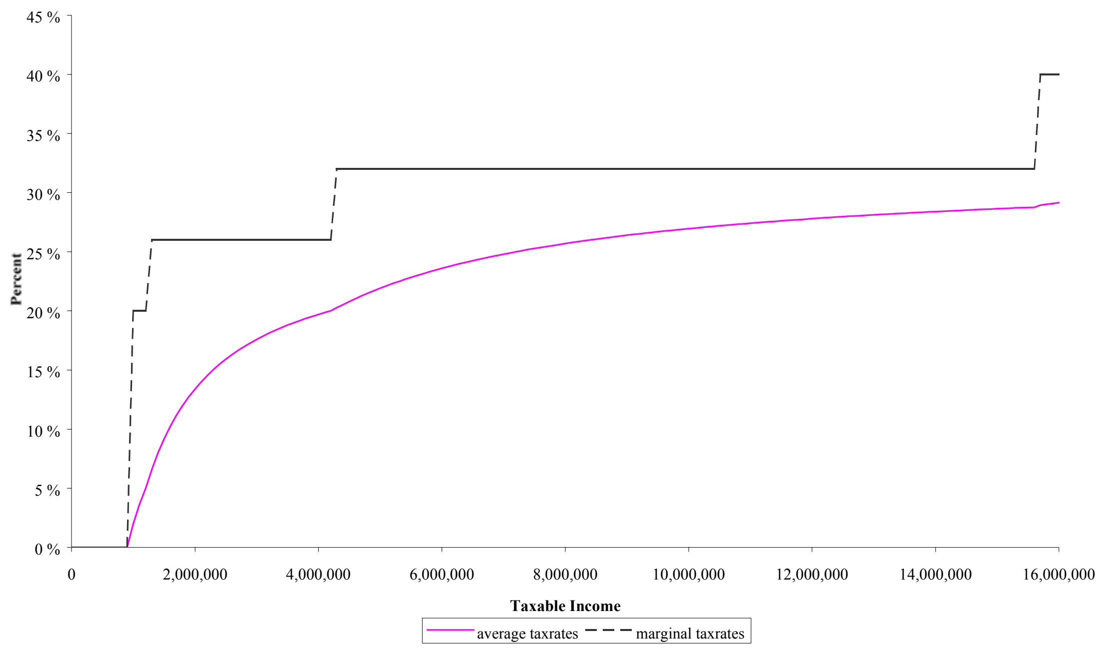
8 See, e.g., Bogetic´/Hassan (1997, pp. 24).

9 See Petersen (1999).

10 Before 1998 the basic exemption has been below the annual minimum wage.

schedule is of a delayed progression where the average rates asymptotically approaches the marginal rates.[11]

Figure-1: Average and Marginal Tax Rates



Source: Own Calculations from Table 1.

For the evaluation of such a progressivity one should mention that the average annual wage within the public sector is about 1,900,000 Leva (1,900 DM) which is clearly below the physical minimum of subsistence if West European standards were to be applied. Consequently for comparatively low wages relatively high marginal rates apply. As a result the lower and middle income groups pay the bulk of the tax burden which even increases the post-tax inequality of income, because employees have much less possibilities for tax evasion and avoidance than persons who are subject to the assessed income tax. Such an inequitable taxation impairs the acceptance of the whole system. Growing discontent of the tax payers is already reflected in questionnaire studies carried out in Bulgaria. "The companies' assessment is that 70% of tax payers levied according to the maximum rate, are actually paying less than 50% of their tax due. About 90% consider that the present tax system does not encourage "fair play" in economic reality".[12] This result can mean a real threat for future developments or an enormous challenge for coming tax reformers.

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[11] For the theoretical details see, e.g., Petersen (1993, pp. 229).

[12] Insitute for Market Economics (1998, p. 32).

Most of the amendments in the tax system were directed to the corporation tax which is regulated in three different laws and, subject to special regulations which have not been published on a regular basis yet as well as tending to be imprecise and controversial. The arbitrary nature of the tax undermines not only the acceptance in view of the tax payers but also often encourages informal behaviour and corruption.[13] Up to 1996 a differentiation of tax rates for private and public companies existed, privileging the former with a lower rate (30% instead of 40%). This differentiation has additionally impaired the state owned firms which are typically non-competitive.

The aims envisioned in the Law for Corporate Income Taxes are to guarantee revenue for the State budget to decrease expenditures associated with tax collection, to minimise tax evasion and to stimulate investment. Accordingly, it attempts to provide a clearly defined and broader tax base. The Law also strives to achieve a more equal treatment in the taxation of profits and revenues received from other economic activities. A new system regulates the advance payments and modified ways are used to tax insurance companies and partial bank reserves. The Law for Corporate Income Tax was passed in 1997.[14] A year later numerous amendments were incorporated. It is important to note that through these amendments changes in 21 other laws have occurred.

All companies and partnerships - determined by the Bulgarian Commerce Law - are subject to the corporate income tax; that type of companies consists of limited liability companies, joint-stock companies, general partnerships, limited partnerships, partnerships limited by shares, and branches of a foreign company. Similar to the system of the personal income tax the residence principle is applied. Foreign legal persons with headquarters abroad are due to a source tax with a 15% tax rate. The annual profit has to be declared no later than the end of March of the following year. For tax purposes only the straight-line depreciation is allowed. The balance sheet as well as the annual report has to be certified by chartered accountants and submitted to the tax revenue service at the place of legal residence. Monthly advance payments have to be made if in the previous year a taxable profit of more than 2 mill. Leva was made. A carry forward procedure for losses is applicable, the carry back is not allowed. Also the advance payments cannot be reduced if the company runs in losses. Thus the companies' liquidity is further impaired often creating the threat of bankruptcy.

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[13] See Bogdanov (1998, p. 7).

[14] See State Newspaper, No. 115/1997.

The corporate income is taxed with two different proportional rates depending on the annual profit. Corporations with an annual profit below 50 mill. Leva (50,000 DM) are taxed with a 20% rate while corporations with higher profits are taxed with 30%. In addition a municipality corporation tax exists with a 10% rate. Because this local tax is deductible from the central corporation tax the overall effective tax rate on corporate income up to 50 mill. Leva is 28% and for corporate income above that margin 37%.[15] For the evaluation of the total burden on the companies not only the tax burden, but in addition the burden of the social security contributions has to be taken into consideration. We will come back to that problem later.

There exist some tax incentives in the form of exemptions to foster the privatisation process. Until 2001 a company is exempt from the corporation tax for the first three years if this company was founded within the privatisation process and the state or communities hold less than 33% of its capital. A reduced rate (half of the normal rate) is applied for the following two years if the company has invested in fixed assets, paid all other taxes and contributions as well as duly performed all obligations announced in the privatisation agreement. Similar privileges are guaranteed to firms with foreign direct investment.

On land and buildings there exists a specific property tax. The rates are different depending on the owner. State-owned buildings rented for residential purposes are taxed with a 0.2% rate on the "tax value" of the building, all other buildings are taxed with a 0.7% rate. Over a number of years, the "tax value" has been usually much less than the market price. After the re-valuation of tax values for a number of buildings, the development of market prices has shown that in large cities and in certain regions of the country "the pyramid" is upside down. This has had a negative impact on the real estate markets. Additionally, an inheritance and gift tax exist in which the rates are dependent on relationship as well as the volume of the inherited wealth. The rates are progressive; the tax schedule has a basic exemption of 15,000,000 Leva (15,000 DM) with marginal rates starting with 0,1% and rising to 10% for a inherited wealth above 1,000,000,000 Leva (1,000,000 DM). For property transfers a specific transfer tax of 2% is levied.

In Table 2 the public revenues are confronted with the GDP figures. The total revenue to GDP is about 37.6% in 1997. This revenue ratio is close to the state share in the GDP because public deficits have played a minor role. The tax ratio is 29.7%, while the difference between

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[15] See Bogdanov (1998, p. 8). By the 1999 tax reforms the highest marginal tax rate of the corporate income tax was reduced from 37% to 34.4%.

both ratios is represented by revenue from contributions, fees and other income sources especially of the municipalities. The income tax revenue is in between 13.5 and 14.8% of total tax revenue; the ratio for the corporation income tax has been increased from 12.7% in 1995 to 21.7% in 1997.[16]

Table 2: Tax Revenue and Tax Structure

	1995	1996	1997
GDP in Million Leva	880322,0	1748701,0	17103433,0
total revenue in Million Leva	328328,9	579925,6	6423653,3
- tax revenue in Million Leva	261868,6	472601,7	5036688,4
- direct taxes in Million Leva	143346,4	274059,9	3183543,6
corporate income tax in Million Leva	33137,4	74199,2	1094625,0
personal income tax in Million Leva	36469,0	70137,8	679933,1
social security contributions in Million Leva	73740,0	129722,9	1408985,5
- indirect taxes in Million Leva	103947,3	181477,6	1774519,1
VAT in Million Leva	59283,3	116932,7	1048816,5
excise duties in Million Leva	23239,0	26391,4	362126,7
customs duties and fees in Million Leva	21425,0	38153,5	363575,9
- other taxes in Million Leva	14574,9	17064,2	78625,7
total revenue to GDP	0.373	0.332	0.376
tax revenue to GDP	0.297	0.270	0.294
direct taxes to tax revenue	0.547	0.580	0.632
corporate income tax to tax revenue	0.127	0.157	0.217
personal income tax to tax revenue	0.139	0.148	0.135
social security contributions to tax revenue	0.282	0.274	0.280
indirect taxes to tax revenue	0.397	0.384	0.352
VAT to tax revenue	0.226	0.247	0.208
excise duties to tax revenue	0.089	0.056	0.072
customs duties and fees to tax revenue	0.082	0.081	0.072
other taxes to tax revenue	0.056	0.036	0.016

Source: National Statistical Insitute (1996, 1997, 1998), own calculations.

Therefore, clearly more than one third of total tax revenue consists of personal and corporate income tax, whereas the corporation tax is the most important revenue source in Bulgaria.[17] The other taxes like the above mentioned property and inheritance taxes have shown a clearly decreasing trend and an obviously minor relevance for the revenue development.

[16] The data for the years before 1995 are not comparable.

[17] In many Western tax systems the wage tax as part of the income tax is the most important revenue source. Because the average wage is comparably low in Bulgaria the wage tax does not yet play a dominant role.

3. The Value Added Tax and other Indirect Taxes

As already mentioned the VAT has been introduced in 1994 abolishing the socialistic system of indirect taxation. This reform was connected with a harmonisation of the excise duties which have besides the aim of revenue creation other aims of influencing certain aspects of tax payers' behaviour. The system itself is comparatively simple while the application by the tax administration is much more complex. The VAT reform followed the Sixth VAT Directive of the EU to secure the application procedure.

The prerequisite for the VAT procedure – especially to gain from VAT refunds – is the registration of the tax payer unit. Aside from a lot of complex details, any person (legal or natural) who has had a taxable turnover of more than 75 mill. Leva (75,000 DM) over the preceding twelve months must register for VAT purposes in the local tax offices. The obliged persons then have to complete monthly or quarterly tax forms and to make advance payments dependent on the taxable turnover. In case of a refund the tax payer continues paying the difference (filling in the tax forms, etc). If after six months these differences persist (or appear) to its disadvantage, then the local tax office pays back the incurred tax credit within a forty-five day period. In periods of instabilities such a long lasting lag might again create serious liquidity problems for companies in trouble thus often worsening their conditions for survival.

The definition of the tax base also follows the EU standards; namely domestic transactions defined by the product or service price (excluding the VAT) charged to the customer and all other taxes and fees connected with the transaction including excise duties. For buildings special provisions are applied. For imports the tax base includes the customs value and duties as well as fees and excise duties. In the case of exports for repair, only the value added created outside the country is taxed. For transactions in between related people as well as benefits-in-kind special rules apply. Following the Sixth VAT Directive of the EU, Bulgaria has adopted the definition of the place of supply of goods and services.

The list of tax exempt transactions includes financial and insurance services, renting of land and housing, transfer of land, social services (education, health service), legal advice, sales on tickets for cultural purposes, services of non-profit organisations, betting and gambling, etc. This catalogue is again in accordance with international standards. Additionally, for the first five years following the implementation of the VAT basic consumption commodities are also VAT exempt when they are sold for the purpose of individual consumption. This provision as well as the exclusion of rents corresponds to a zero tax rate and especially reduces the tax burden for the lower income groups, thus also diminishing the regressive effect which is usually involved in indirect taxation.[18] This transitionary provisions terminated on March 31, 1999.

Apart from the tax-exempt transactions since January 1, 1999 there is one single tax rate of 20% (before 22%) which is proportional to the value added. The abolishment of the former tax exemption of basic needs strongly increases the tax base and – apart from possibly increasing illicit market transactions – the VAT revenue, too. Here one has to mention again that this tax burden is especially levied with high average tax rates in relation to income on the lower income groups. Consequently, the situation for the poorest part of the population is clearly worsened if no other compensations (in pensions and other social benefits) are taken into consideration.

As mentioned before, the VAT yield on inputs is not refundable for non-registered businesses. This business however is still of great importance because the double bookkeeping methods are often too complex for the insufficiently educated management involved. Non-registration is also connected with increasing informal activities which again feed the shadow economy.[19] If services are imported the standard VAT rates apply and the yield has to be paid by the recipient if he is registered for VAT and the services relate to activities which do not lead to the right to claim the VAT on services as input VAT (tax credit). In all other cases no reverse charge applies to imported services. Exports are zero rated.

The VAT is also a very import revenue source (see Table 2). The VAT revenue has been in between 20.8% (1997) and 24.7% (1996) of total tax revenue. Consequently the VAT is – behind the corporation tax - the second important single tax of the Bulgarian tax system. The slow down of the revenue in 1997 was caused in particular by the economic crisis of the previous year.

Excise and custom duties are also a typical component of indirect taxation. In Bulgaria specific excise duties are charged on goods and services especially on the so-called demerit goods which might be harmful for the population's health or the environment.[20] The new excise duty law was introduced together with the VAT law on April 1, 1994. As mentioned

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[18] For details regarding the regressive effects of VAT systems see Nagel/Müller (1992) and Nagel/Neneman (1995).

[19] For problems concerning the informal economy see Petersen (1982).

[20] For details on public and merit goods see Petersen/Müller (1999, pp. 132).

above, such indirect taxes often lead to a considerable high tax revenue while their steering capacity is heavily dependent on the demand elasticities. Especially in case of drugs, demand is often totally inelastic; consequently the steering effects are neglectable. Such excise duties are laid on alcoholic beverages (beer, wine, hard drinks etc.) and tobacco products as well as on coffee and tea, and does also exist for luxury commodities (fur products, cars, jewellery, perfume, cosmetics) and gambling activities. Petrol and diesel fuel as well as TV electronics are also taxed. Their tax bases are defined partly in quantitative units or in monetary units. The duty rates vary from 10% up to 110%. Excise duties also apply to imported goods. If goods and services are exported, no excise duties apply. The excise duties also play an important role for the total tax revenue and their ratios have been in between 5.6% (in 1996) and 8.9% (in 1995). After the deep economic crises in 1996 the tax ratio increased again to 7.2% in 1997.

The custom duties increase the indirect tax burden even more. In Bulgaria sole traders and legal persons importing goods are liable to custom duties. The custom base is the combined value of the commodities' cost, freight, insurance and costs connected with the import. Two different levels of custom rates apply: for countries with preferential duty status and countries with most favoured nation status. Since 1994 a third set of custom rates was introduced for members of the EU and EFTA as well as for the Czech and Slovak Republics and Slovenia. A clearance fee of 1% applies for goods values of below 700 US$. A temporary import fee is from time to time introduced by the Bulgarian Government which is 4% of the customs value and is also included in the VAT base. The sole task of this custom is to raise revenue due to severe budgetary problems. Table 2 also shows the development of the custom duties which again contribute considerably to the total tax revenue.

As we already mentioned above, a second wave of reforms in the tax system has occurred in 1999. It includes the new Value Added Tax Law, a number of principle changes in the Law on excise duties and corporate income taxes, as well as some minor changes in other tax legislation. Although the VAT and the corporation income tax rates have slightly come down, still small and medium-size enterprises have not really benefited from the reform measures. However, the Law on Excise Duties is expected to increase the State budget revenues.

If one compares the direct tax revenue (personal and corporate income tax excluding social security contributions) ratio of 35.2% in 1997 with the indirect tax ratio, which is also 35.2% in 1997, direct taxes and in indirect taxes are balanced while in the years before the indirect tax revenue has subtantially been higher (39.7% indirect taxes and 26.6.% direct taxes in

1995 and 38.4% indirect taxes and 30.5% direct taxes in 1996). The consumption taxes have been more strongly affected by the recession than the corporate income tax.

4. The Social Security Contributions

As in many countries in transition, Bulgaria had to also overcome the social security regime of the socialistic type, since new problems of unemployment and mass poverty arose.[21] While today the average wage is still very close to or even below the physical minimum of subsistence, a rational political decision would have been just to introduce a basic security scheme which then should be tax financed out of the general budget. Further insurance of higher provisional standards for health as well as old age purposes would in such a scheme be laid in the individual responsibility of the single citizen or the families, organised by intra-family transfers or a private insurance system (health and life insurances). But like in most of the other transformation countries, the compulsory social insurance model chosen was invented by the Bismarckian system in Germany more than hundred years ago.[22]

The Bismarckian social insurance schemes' main problem is that even the basic needs are insured, and for those compulsory insurance contributions are paid, which are also provided contribution free by the social aid system. Connected with that problem is the fact that the contributions are laid on the wage sum thus increasing the wage extra costs. This problem however, does not depend on who the contributions are paid by, i.e. employees or employers. For economic reasoning as well as efficiency, the only decisive fact is that the social security contributions raise the total wage costs for companies, independent of who formally or informally pays. Who really bears the contribution burden is only dependent on the labour market situation, e.g., the market power of the workers (or the trade unions) or the companies (their associations in case of group negotiations). The market power determines to whom the final burden is shifted. Independently from that result the fact remains that high labour costs partially caused by high social security contributions strengthen the competitiveness of the factor capital and induce rationalisation investments connected with job destruction.

Such simple economic arguments are totally neglected in economic and social policy. The result is that like in many other countries in transition extremely high social security

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[21] See the article of Bakardjiewa/Sowada (1998).

[22] For details see Petersen (1997 and 1999).

contributions are to be observed, which are for instance, in Poland[23] partially even higher than in Bulgaria.

As the Bakardiewa/Sowada article in this volume shows, social insurance contributions exist in Bulgaria for unemployment insurance as well as the pension insurance. The former are the same for all groups of employees and levied with a proportional rate on the gross wages of 5% until the end of 1997, exclusively paid by the employers. The employer contribution rate has been reduced to 3.6% in 1998 and in addition an employee contribution rate of 0.9% has been introduced. The contributions are deducted like the income tax at the source (pay-as-you-earn). Contributions are made by the employer and transferred to the account of the Public Social Security System in the Bulgarian National Bank. The transfers are made each month at the time when the salary payments for the second half of the month are made.

The pensions are paid by the newly implemented Social Insurance Funds on a pay-as-you-go basis.[24] The expenditures are financed by contributions which have different rates for different kinds of employees. Three categories of employees (more or less privileged) were already formed in socialist times. In the 3rd and "normal" category the employers pay a contribution of 37%, while the employees have to bear 2%; in the second category an employers' rate of 47% (employees again 2%) and in the third category an employers' rate of 52% (for the employees 2% respectively) is levied. Partially the differentiation depends on different risk situation but this explanation is more than questionable. For employees only insured against accidents and professional sickness the employers contribution rate is 10%.

The total amount of social security contributions rates (employers and employees rates added) is then between 43.5% and 58.5% of the gross wage sum. Such a burden of payroll taxation undoubtedly must have enormous distorting effects which also can often be observed in Western countries where such burdens are substantially lower. If one then adds the average tax rate of the income tax, average burdens of more than 70% are reached. Considering the marginal burden percentages being clearly above 80% it can be said that every additional work incentive in the official labour markets is just killed.

Questionnaire studies as well as investigations of the illicit or informal labour markets have proven that in Bulgaria the shadow economy is booming.[25] Such tax and contribution burden has produced the practice that most private firms officially engage their workers only for the

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[23] See the article of Golinowska (1999).

[24] For more details see Bakardjiewa/Sowada (1998).

[25] See, e.g., Lackó (1999).

minimum wage to avoid the high social security burdens and the wage tax. Unofficially the employees are often additionally paid below the table. This process is even fostered by the fact that due to the Labour Code eligible workers receive their pension payments even when the companies did not pay the contributions. Such regulations encourage the employers to register their employees in the social security system since the benefits are automatically paid by the fund. It also explains that only 2.5% of the private companies pay any contributions to the Social Security Funds while the contributions are limited to the minimum wage.[26]

The Bulgarian National Statistical Institute treats the social security contributions like any other taxes, whereas in Western states with institutionally a more or less independent social insurance they are defined as revenue source sui generis. Because the expenditure of the social insurance is taken as public (or state) expenditure, the social security contributions have been also treated as direct taxes. This is particularly adequate when the social insurance is more basic needs oriented and the insurance principle does not play a dominating role. If then the collecting procedure corresponds to the wage tax (pay-as-you-earn) even the behavioural consequences might be quite similar. This is especially true for the evasion of the wage tax and the social security contributions just mentioned. Table 2 also presents the revenue of the social security contributions from 1995 to 1997. They have yielded in between 27.4 and 28.2% of the total tax revenue and are also a very important revenue source.

5. Summary and Political Recommendations

The Bulgarian tax and transfer system has been under substantial reform pressures during the last decade. The deep economic crisis and the hyper-inflations of 1996 and 1997[27] have made the implementation of transition reforms connected with a guaranteed minimum subsistence level even harder. Because the winners of the transformation process have not shared their benefits in an appropriate way with the losers, the acceptance of the transformation to a market system is impaired. Hence, fairness in the tax and social security systems is the most decisive prerogative for large parts of the population to support the ongoing transition process.

Almost all changes into the direction of the standard Western European systems have been made including such issues which have already led to serious problems in Western countries.

[26] For more details see Bogdanov (1998, p. 9).

[27] For details see the article of Demopoulos/Frantzeskos (1998).

In those countries massive reforms of the tax, welfare, and social state are also necessary to secure an efficient economic performance for the future.[28] Therefore the further Bulgarian reform process should much more be oriented to really innovative ideas which are connected with simple and efficient income and corporation tax systems (in an integrated form), broad tax bases also in case of the VAT and modern methods of fiscal administration. The transfer system should be basic needs oriented and higher standards for health purposes and future provisions for old-age should be organised by a voluntary private insurance system which would comprise individual preferences as well as primary responsibility for citizen and tax payers.

What does such a general message mean in detail? In some of the most successful transformation states modern integrated tax and transfer systems are already discussed or on the political way to be implemented. Of utmost importance is an efficient income tax regime which fosters private investment. Capital formation is the dominating prerequisite to create jobs and to overcome unemployment and mass poverty. Hence, an effective income tax scheme in that sense would be in particular an interest adjusted income tax system connected with an effective corporation tax, as for instance has been proposed by Rose et. al. (1997, 1998) and was implemented in Croatia recently. The system is economically efficient, creates almost no disincentives and produces a dynamic tax revenue. This expenditure oriented tax base connected with moderate marginal rates could be even further developed in the direction of a two-rate or even flat-rate system as currently discussed in Poland.[29] And of great importance is the demand that the tax and transfer system should not permanently be altered because such a policy destroys all preconditions for reliable private cost/benefit analyses. Numerous changes and amendments to the existing legislation increase the information costs and the economic insecurities for enterprises as well as households. Hence, such erratic changes might even be taken as indicators for doubts connected with the basic philosophy of market reform. In an efficient market system taxation should be taken as part of the political framework (like the constitution) which has to be stable to produce trust into the political institutions.[30] All the arbitrary features of the current system have to be avoided.

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[28] See, e.g., Petersen (1999).

[29] The Polish example is of specific importance because Poland has had a quite similar tax structure as is shown in Table 1. The income brackets for the personal income tax in 1999 have been reduced to three steps (19%, 30% and 40%). In 2001 a two-bracket system will be introduced (18% and 28%, respectively); the corporate income tax rate will be reduced from 34% in 1999 by two percentage point steps to 22% in 2003. For more details see Doliniak (1999, p. 11 and 13).

[30] In the sense of the German "Ordnungspolitik"; for details see Petersen/Müller (1999).

In public opinion and in the practical policy such schemes are often evaluated as not equitable enough because of a weak progressivity and redistributional capacity. But in view of the existing, very complex income tax systems connected with disincentives and enormous behavioural adjustments leading to tax evasion and avoidance, even those systems are theoretically but not factually redistributive, because the scheduled marginal tax rates do not become effective due to numerous tax concessions and loopholes as consequence of a permanently eroding tax base. First estimations with basic needs oriented transfer schemes and simple, partly flat-rate income tax schedules have proven that such schemes are more redistributive and less costly with regard to compliance as well as opportunity costs than many existing systems.[31]

For the Bulgarian case such a reform strategy would mean at first abolishing the current progressive rate structure and broadening the income tax base especially by introducing simple income/expenditure bookkeeping methods for self-employed and other groups of tax payers. Such simple methods would also promote the VAT because more of the small and medium enterprises would register for the VAT. In addition the tax administration has to be better educated and to perform much better with regard to tax refunds in both income and corporation tax as well as the VAT. Beyond that and to avoid further pressures on companies in liquidity problems the method of loss carry back should be implemented because such a method means an immediate help for firms in trouble, thus avoiding further destruction of jobs.

Broadening of both tax bases should be connected with a clear decrease of tax rates to profit at least in the mid to long term perspective from positive Laffer curve effects. A broad based income tax system should not have a marginal rate above 25% and the same is true for the corporation tax. Such an equal rate is also important because then income stemming from different sources is taxed equally – a basic fairness rule which even promotes the acceptance of such a system. The current one rate VAT system should be replaced by a two rate system with a much lower rate for basic commodities and services for education (less than 10%). Such a two rate system, supported by some VAT exempt expenditure like rents due to social reasons would avoid the very regressive effects of the current system and also contribute to the acceptance. Acceptance creates a larger tax base so that the revenue might very likely be higher than under the current system.

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[31] For more details see Brunner/Petersen (1990), Hüther (1990), Petersen/Hüther/Müller (1992).

Improvements in income tax and VAT revenue would allow for transfers to be paid, which are currently much too low to guarantee a socio-economic minimum of subsistence. The abolishment of the current social insurance system by a basic security scheme paid by general tax revenue would reduce the enormous tax and social contribution burdens which are currently laid on the factor labour. This incredible burden on the payroll has only created incentives to shift activities into the informal economy. Recent empirical investigations have shown that in Bulgaria over the last few years the amount of informal economic activities has been substantially increased. The share of the unofficial economy in GDP has risen from 22.8% in 1989 to about 36.2% in 1995.[32] And in view of the above cited questionnaire studies it seems to be very likely that since then the informal economy has been growing. The informal economy is like a valve for the official market sector. If the official goods, services and especially labour markets are overburdened by taxes, contributions and other public fees, then the way into the shadow economy will often represent one of the last resorts.

Political complaints do not help, because the individuals are always faster in behavioural adaptations than administrations, and in a democratic setting for effective control measures only very limited possibilities exist which have been overwhelmingly ineffective in practice. The only possible escape is a fair tax and transfer scheme with moderate marginal and average rates. Especially in transformation countries such schemes often do not meet the demands of the majority of the population, because they have lived, at least in their own judgement, for decades under a system of almost complete security without any primary responsibility. Freedom of choice, but also the risks have been substantially increased. The chances taken only by a minority create the differentiation already mentioned in the income and wealth distribution. But these inequalities are a prerequisite for a successfully performing market system, because inequalities foster the process of capital formation.[33] Capital formation leads to capitalists who again take more risks in further investment and create new jobs. Since the fall of the iron curtain all countries are confronted with the process of globalisation which has as most important consequence the free movement of capital and persons. But capital is much more mobile so that today we are confronted with a world wide competition for the capitalists. Those countries attracting most of them will be the winners – such information should be spread to the public to overcome the old illusions of socialism.

[32] For more details see Lackó (1999, Table 2).

[33] For details on the value system underlying such open societies see Petersen/Müller (1999).

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