

BULGARIA

In 2008, Bulgaria introduced a 10% flat tax on personal income, replacing a progressive rate with three income brackets (ranged between 20 and 24 percent with a non-taxable threshold). This is the lowest flat tax rate in Europe, along with those in Albania and Macedonia. The considerable cut in personal income tax and the removal of the progressive scale was accompanied with the abolition of the tax-exempt minimum.

1.

The Flat Tax reached Europe for the first time in the mid-90s when Estonia, Latvia and Lithuania introduced the single rate. About fifteen years later, more than 10 European countries introduced flat tax, with positive results everywhere. The first one to take this decisive step was the former Prime Minister of Estonia, Mart Laar, who went ahead with the reform in spite of the loud accusations that the concept is absurd and completely inapplicable. Estonia's economic performance since then speaks for itself.

The introduction of the flat tax on personal income in Bulgaria followed the cut of the corporate tax by five percentage points to 10% in 2007. The favorable results of the low corporate tax had a strong influence over the government, as it was clearly shown that lower tax rates do not necessarily lead to lower revenues for the state budget.

Aside from those positive changes, the tax burden in Bulgaria remains relatively high. Social security contributions, even after the 6 percentage points cut in 2006 and the 3 percentage points cut in 2007 – are still on average 33.7%, which makes them the highest tax in Bulgaria. To compare, in Ireland – Europe's "economic tiger" – social security contributions are between 8.5% and 17.25% depending on the level of income¹. In other words, the social insurance burden in Bulgaria is between 2 and 4 times higher than that in Ireland.

Besides the lower direct taxes, the main challenge for the Bulgarian tax policy in 2008 will be the actual fiscal decentralization in the country. In response to local governments' demands for financial independence (2006), Bulgarian parliament approved fiscal decentralization of municipalities, granting them authority over collection and administration of some taxes, thus further enhancing local economic stability.

2.

Presently most of the taxes in Bulgaria are collected on a central level. The local government share in consolidated government revenue, minus social security receipts, is only 3.5% (2007), which is relatively lower than in the other European countries². To compare, in countries like Spain, Slovenia and Czech Republic the local govern-



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In 2007, corporate tax had been cut to a flat 10% bringing positive results. This paved the way for the flat tax on personal income.

social security contributions remain relatively high with an average of 33.7%, that is between 2 and 4 times higher than in Ireland

the main challenge is fiscal decentralization

Fiscal decentralization

currently, local government share of tax revenues is 3.5%

¹ "PRSI (Pay-related social insurance) Contributions Rates and User Guide 2008", Dublin City University

² "Index of Fiscal Decentralization – Methodology and Findings", Victoria Curzon Price & Jacques Garelo (2003)

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ment raises around 20% of consolidated public revenue. In Germany, Sweden, Denmark, Poland and Hungary the local governments get to raise around 30% of public revenue, while in Switzerland the local authorities (cantonal and municipal) share in consolidated government revenue is more than 60%.

Since January 1, 2008 Bulgarian municipalities are allowed to determine the rates of the local taxes (not just the local fees as earlier). This includes real estate tax, transfer tax, vehicle tax, gift tax, inheritance tax and local fees (e.g. garbage collection). However, the newly adopted law says that municipalities will have to set the rates within prescribed limits, the upper cap providing for as high as a double increase from the 2007 levels. Surprisingly, the minimum level of the local taxes is set to be equal to the current levels (2007), which exclude the possibility of establishing lower taxes due to tax competition between municipalities. On the other side, it is questionable whether the municipalities themselves have the capacity to perform wider local tax policy but this should not be an excuse for the limitations set in the law.

A further step toward fiscal decentralization is the transfer of the patent taxation (lump-sum taxation) from state to local level. The rate should be determined within a range that will have the existing minimum rate as the low and the existing maximum rate as the high. Nevertheless, the revenue from patent taxation in 2008 is expected to be BGN 40 million (€ 21 million), which represent only 0.2% of consolidated public revenue. In other words, the transfer of revenue (taxes collected) from the central government to the local authorities is still relatively low.

3.

As one of the latest in the Black Sea region, Bulgaria is after Russia, Ukraine, Georgia and Romania moving to the flat tax, introducing it on the lowest level in the World – to 10 percent. The reduction of the maximum rate of taxation from 24% to 10% will affect significantly the income of middle class households. The immediate effect will increase the available incomes as a result from the lower tax rate. The long term effect will be that the people will be encouraged to work, since this is the way to influence their choice between work and leisure. In addition, the so called excess burden is reduced – that is the difference between the expenditure for society from the existing taxes and the state revenues. In other words, the net loss of society from taxation will be reduced, which will result in more goods and services produced, which will mean higher real incomes. Another advantage of the proportional tax is the ease of administration due to reduction of part of the existing preferences. This will allow for reduction in the number of civil servants employed in the tax administration.

One group of taxpayers will bare initially the costs of introducing the proportional tax. These are the people with gross monthly income of up to BGN 450 (€ 230). They will lose income due to the removal of the untaxed minimum (tax-exempt minimum), which for them means an increase in the effective tax rate. In the public sector a compensation is proposed, but this compensation does not apply to the private sector. Most affected will be respectively the people with low productivity, young employees, which are at the beginning of their career, as well as those who are paid per working hour. According to the official data provided by the National Statistical

since January 1st 2008 municipalities determine their own rates on real estate, transfer, vehicle, gift and inheritance taxes

this freedom is not total: the 2007 rates serves as minimum rates

...but, are municipality ready to take on those responsibility?

patent taxation will soon be transfer to municipality

Personal Income Tax

Bulgaria is joining the other Black Sea countries in adopting a flat tax, 10% being the lowest in the world.

This is expected to boost the economy and increase households' purchasing power

in the short run, however, low productivity workers will be negatively affected by the removal of the tax exemption for low salaries

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Institute the average wages in several sectors are below the BGN 450 limit. An important fact in this case is that this data may be different from the actual situation due to the existence of informal economy. This applies to a very large extent to the construction industry, where the salaries are much higher than reported. In other words, the claims that over 1 million employees will receive lower net income are too far fetched, since a large portion of these people are better paid, but do not declare the full amount of their incomes.

Besides, the growth of the incomes in the private sector for 2007 is over 20% and this high rate will probably remain similar for 2008. Factors leading to this effect are the continued growth of the money supply and the inflation, as well as the increased productivity of labor. For that reason, part of people which at present receive low incomes will go over the limit of BGN 450 and will not be affected by the flat tax.

4.

From the beginning of 2007 the corporate tax rate was reduced from 15% to 10%. Surprisingly for the state authorities, the revenues from corporate taxes in 2007 are equal to BGN 1.68 billion (€ 859 million) or 140% compared to 2006. These favorable results are due to the positive effects of the lower taxes – companies coming out from the gray economy, more foreign investments and economic growth. The dynamic effects will continue to work in the following years, since lower taxes mean more incentives to work and invest for the entrepreneurs.

For the entire year (2007) the economy registered an unbelievable 33% growth in direct foreign investments, reaching the highest level since statistical records have existed in the country.

In 2008, the Government reduced the dividend tax by 2 percentage points. Presently, the tax rate for dividend income and income from sale of shares is 5% for individuals.

5.

Even with the introduction of the low flat tax in 2008, the labour taxation in Bulgaria remains too high, as the social security contributions are still above 30% (paid by both the employer and the employee). There were several deductions in the social security contributions in recent years, with the 6 percentage points cut in 2006 and the 3 percentage points cut in 2007. Further deductions are strongly argued in Bulgaria, even if it was explicitly written in the Budget Report 2008, that there will be no deductions in the social contributions in the short-run.

The total amount of revenues from the social security and health insurance payments during 2007 were BGN 4.89 billion (€ 2.50 billion). The government again underestimated the revenues, by expecting the reduced social security rates to cost to the treasury BGN 118 million (€ 60 million). However, during the last quarter of the year (the 3 percentage points cut took place on October 1st 2007) the revenues from social security payments were BGN 51 million (€ 26 million) more compared to the previous quarter.

one should keep in mind that salaries are often higher than reported and that private sector salaries have been growing 20% in 2007 and the same is expected for 2008

Corporate Tax

the 2007 cut in corporate income tax (from 15 to 10%) has led to a 40% increases in tax revenues.

in 2007, foreign direct investment increased by 33%, a historical level

dividends and capital gains are taxed at 5%

Social security contribution

Despite the 2006 and 2007 cuts, labor taxation remains high

no further cut scheduled for 2008

the tax cuts did not bring the expected loss in revenues, quite the contrary

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Nevertheless, the main problem of the current labour taxation in Bulgaria is that the high social security contributions discourage people from paying them at all, or force wage-earners to declare minimal required by law incomes.

6.

Taxes on consumption include VAT and excise duties on special goods such as cigarettes and alcohol beverages. Bulgaria has to harmonize its tax regime with that of the European Union via the introduction of the minimum excise duties of the European Community on tobacco, alcoholic beverages, and fuels. Started in 2002, the harmonization process is scheduled to be completed by the end of 2013. In 2008 excise duties on tobacco and some fuels will increase, while on alcohol there will be no price adjustments. In addition, the excise duty on coffee and coffee extracts will be abolished in 2008.

Despite the deductions in the social security contributions, personal income tax and corporate tax, the increase of the excise duties and the widening of the tax base due to “lighting up” of a part of the informal economy will ensure even greater revenues from indirect taxation than expected. As far as the excises are a part of the taxable base for VAT, the additional excises lead to additional revenues from VAT. As a whole, indirect taxes are the largest and most rapidly growing component of tax revenues, accounting for around half of the consolidated public revenue or in other words 20% of GDP in 2007.

7.

The recent data show that the budget surplus for 2007 is BGN 2.11 billion (€ 1.18 billion) or 3.75% of the GDP, although the planned surplus at the beginning of the year was only 0.8 per cent of GDP. Just in December, however, the government spent more than BGN 4 billion (€ 2.04 billion), which by itself is incompatible with the idea of maintaining a restrictive fiscal policy. The inflow of funds in the economy means increased money supply, which has an inflationary effect and changes the relative prices in the economy and thus, sends wrong signals to the market. Far more sensible would be a policy that takes less income out of the private sector through taxes and social security contributions so that the taxpayers are let to decide by themselves how to spend their money, and so that the government does not have to implement “urgent” large-scale projects at their expense at the end of the year.

With the introduction of the flat tax in 2008, a single rate of 10% was achieved for all direct taxes (personal and corporate). The reduction of the tax rates has a positive effect on the revenue part of the budget in 2007. However, more important are the indirect effects, which lead to more economic growth as a result of the increase in the more productive formal sector rather than the non-formal, enhanced flow of investments and reduced distortions on the market.

Taxes on Consumption

VAT and excise duties are subject to EU harmonization. This translated in higher excise duties in 2007

indirect taxes are the largest and most rapidly growing component of tax revenues

Conclusions

in 2007 the state budget surplus represented 3.75% of GDP

unfortunately, the state rushed into spending all that surplus and even more

the 10% flat tax should have many positive effects on the economy in 2008

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According to one of the latest empirical studies of the effect of corporate taxes on investments and business development in the economies³ (with a co-author Simeon Djankov, chief economist at the World Bank) an increase of the corporate profit tax by 10 percentage points leads to a two percentage points reduction of investment as a percentage of GDP and to an increase in the gray sector of the economy. It is therefore reasonable to expect that the reduction of corporate taxes has a positive effect on investment and the level of economic activity.

The data about Bulgaria indicate how these macro-economic relations work in real and prove the claim that the tax revenues grow faster at lower levels of tax rates. The reduction of taxes will show its effects in the future in other areas of the economy, not only in the fiscal sector, since it has long term effects such as increased potential of the economy to produce goods and services and to create added value.

IME & Tax Cuts

In 2003 the Institute for Market Economics published the basic outlines of an alternative policy that would have accelerated the rate of economic growth and would have improved the welfare of Bulgarian citizens. Tax cuts and lower social security contributions played a major part in the proposed policy and for this reason IME prepared an alternative budget, which envisioned a reduction of the income tax and the profit tax to 10% and of the security contributions to 16.7%.

In March 2004, more than 100 economists, analysts, researchers, finance experts and intellectuals sent through IME an open letter to the Minister of Finance Milen Velchev and the Prime Minister Simeon Saxe-Coburg-Gotha, declaring the position that a reform, related to tax reduction is necessary to be undertaken. The proposal was even bolder and more radical – a 10% income tax rate, a 10% profit tax rate and 10% social security contributions. That same year the Institute for Market Economics started publishing a monthly bulletin for low tax, propagating these concepts.

The first goal was reached in early 2007, when profit tax was pegged at 10 percent. Labour taxation, however, remained high and served as the proverbial stick in the wheels of economy. Presently, the second goal is also reached, and personal income will be taxed at the same rate for all, namely at 10 percent.

recent studies show that a 10% increase in corporate tax leads to 2% reduction of the share of investment in the GDP as well as an expansion of the grey economy

the experience of Bulgaria shows how the reverse is equally true and how it works in practice

the Institute for Market Economics in Sofia was instrumental in bringing those reforms



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³ “The Effect of Corporate Taxes on Investment and entrepreneurship”, Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, Andrei Shleifer

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STATISTICAL ANNEX

YEAR	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
rate	40.2	37	34.3	32.5	28	23.5	23.5	19.5	15	15	10	10

YEAR	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
rates	20	20	20	20	20	18	15	12	10	20	20	10
	22	26	26	26	26	24	22	22	20	22	22	
	24	32	32	32	32	28	26	26	22	24	24	
	28	40	40	40	38	29	29	29	24			
	32											
	36											
	40											

%	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
pension	39	39	35.7	32	29	29	29	29	29	23	23	22
Illness maternity				3	3	3	3	3	3	3.5	3.5	3.5
labor accidents- profes- sional illness				0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Unem- ployment	5	4.5	4	4	4	4	4	4	3.5	3	3	1
Health			6	6	6	6	6	6	6	6	6	6
									0.5	0.5	0.5	0.5
Total	44	43.5	45.7	45.7	42.7	42.7	42.7	42.7	42.7	36.7	36.7	36.7

Note: * The rate for Labor Accidents and Professional Illness is average – there are several rates depending

Corporate tax
1997-2008

Personal income tax
1997-2008

Social security contributions
1997-2008