The Bulgarian Flat Tax

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Summary:

The flat tax has become broadly popular in Central and Eastern Europe in recent years. Many of EU newcomers adopted flat tax regime. Even at first glance, however, it is evident that there are large variations in its design, although flat tax is clearly defined in literature. The question is whether this relates to different applications of one and the same concept or to different concepts called by the same name – flat tax. Perceived as standard the coherent tax structure of the flat tax, proposed by Hall and Rabushka, we assess the current income tax system in Bulgaria. We focus on the structure of the tax system and design of the tax bases, because even they reflect to a greater extent the specificity of the flat tax. Cuts of tax rates are important; they have been not only broadly discussed, but also do not necessarily relate to the flat tax concept. Bulgaria adopted the "flat tax", this did not increase the transparency of income taxation nor did it become easier to administer. Moreover, income taxation is not simple, neutral, and non-distortive. Despite the introduction of some elements of the flat tax, one cannot say that a theoretical flat tax system is implemented in Bulgaria.

Key words: flat tax, taxation in Bulgaria, neutral taxation

JEL Classification: H24, H25, H29

Introduction

The flat tax has become broadly popular in recent years, so that *The Times* concludes: "A flat tax revolution shakes up Europe", while *The Independent* reports that "Flat tax revolution sweeps in from Eastern Europe". An IMF working paper reviews experience with the flat tax and summarizes: "The last few years have seen widespread interest - not quite a revolution, but certainly something of a craze - in the 'flat tax'." (Keen et al., 2006, p. 3).

The beginning of a discussion on the flat tax was an article on December, 10, 1981 in *The Wall Street Journal* of Robert Hall and Alvin Rabushka of the Hoover Institution at Stanford University. The next year, US Senator Dennis DeConcini provoked political debate by introducing one of the first bills. The US Tax Reform Act of 1986 adopted some elements of the flat tax concept, reducing the top rate to 28 percent and the tax brackets from more than a dozen in only two. However, it did not reform the tax bases whence it could not solve the issues of complexity. In the Democratic Party's presidential nomination in 1992 flat tax appears as a reform proposal. Four years later a Republican candidate proposed a similar idea as part of his platform (Hall and Rabushka, 2007, pp. 72-75). Nevertheless, all the efforts to implement the flat tax in the United States remain unsuccessful.

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In contrast, flat tax has been adopted in 22 countries, including 7 EU newcomers: Estonia, Lithuania, Latvia, Slovakia, Romania, Bulgaria, and the Czech Republic. However, one should not be misled that the Hall-Rabushka's proposal was implemented in these countries. Instead, wide variations of it are being used and often only the term "flat tax" is being exploited: "Their sole common feature is a single strictly positive marginal tax rate on labor income" (Keen, Ibid, p. 4). A correspondence of a particular "flat tax" with the Hall-Rabushka's concept is not a matter of formality, because the integrated flat tax is a coherent system of taxation, and only as a system it delivers simplicity of tax law and low costs of compliance, encourages savings and economic growth, and ensures decision neutrality and fairness.

A flat tax has been in effect in Bulgaria for a fifth year already. Its adoption has been accompanied by many positive expectations, such as a significant decrease of the grey economy, simplicity, attracting more foreign investments, economic growth acceleration, and lower compliance costs. In reality, the introduction of flat tax has neither led to the expected reduction of the grey economy (CSD, 2011, p. 28), nor has it simplified the tax or reduced compliance costs. Moreover, it is directly evident that there are some important differences between the flat tax and the Bulgarian income taxation.

Generally, the point is to what extent the current Bulgarian income taxation is associated with the flat tax of Hall-Rabushka? To make it clear, we shall compare the two tax systems, identify similarities and differences and analyse them. What is more, we will focus mainly on the structure of tax systems and the design of tax bases, because even they largely the specificity of the flat tax concept. Tax rate cuts are important; they have been not only broadly discussed, but also do not necessarily closely relate to the flat tax concept.

A proper comparison must include all types of income - business income, interest, dividends, wages, and so forth - and assign total income to individuals in income categories to see how those categories of individuals fare under Hall-Rabushka versus under current law. … It sounds complicated, but it is a crucial aspect of the debate … now we just want to emphasize that any fair comparison of two alternative tax systems by income category must include corporate income taxes as well as individual taxes (Hall and Rabushka, 2007, p. 61).

The Flat Tax of Hall and Rabushka

Theoretical Foundations

Individual gross income consists of two parts: labor income L, and capital (business) income K. Amount C of the income can be consumed and amount S saved. In other words, the following equitation is valid:

$$L + K = C + S,$$

which is transformed to

$$C = L + K - S. \qquad (1)$$

From (1) it is evident that consumption can be taxed in two ways: directly (via VAT) and indirectly through taxation on gross income minus savings (via integrated flat tax).

The justification for consumption taxes rests on their built-in incentives to save and invest (in closed economy investment I, equals saving, $S = I$). By exempting investment from taxation, consumption taxes encourage investment and discourage spending (Ibid., p.

63). Under the integrated flat tax of Hall and Rabushka labor income (wages, salaries, and pensions) is taxed by *individual wage tax* and capital (business) income minus investment by *business tax,* both at the same tax rate.

The business tax base

$B = K - I$

is decomposed into

$B = P - N - I,$

where P are the positive payments (e.g. revenues from sales of products, services, fix assets) and N the negative operating payments (e.g. purchases, wages and salaries, pensions) of the business. Such a tax, based on expensing of investments in real assets and not-allowing, for example, a deduction for interest on business debt and interest revenues is called R-based cash flow tax (Meade Committee, 1978).

General Features

Following not a legal sense, as other tax systems, but economic logic the integrated flat tax is utmost simple – its two tax forms fits on postcards. The differentiation of its both structures is also optimal: individual wage tax is levied only on wages, salaries and pensions, while all other personal revenues (from business) are covered by the business tax. Both impose a tax at one and the same rate. All individual income is thus taxed only and exactly once at the same rate. Flat tax is progressive because of its general personal allowance. It is based on the principles of consumption and cash flow taxation – taxes not saving/investment.

The Individual Wage Tax

Its purpose is to tax the income received by workers in the form of wages, salaries or pensions. Pensions under Hall-Rabushka are subject to a downstream taxation - pension contributions are deductible (tax free), but

Form 1	Individual Wage Tax	1998	
Your first name and initial (if joint return, also give spouse's name and initial)	Last name	Your social security number	
Present home address (number and street including apartment number or rural route)		Spouse's social security number	
City, town, or post office, state, and ZIP code		Your occupation™ Spouse's occupation™	
1 Wages and salary		1	
2 Pension and retirement benefits		2	
3 Total compensation (*line 1 plus line 2*)		3	
4 Personal allowance			
(a) ❑ $16,500 for married filing jointly		4(a)	
(b) ❑ $9,500 for single		4(b)	
(c) ❑ $14,000 for single head of household		4(c)	
5 Number of dependents, not including spouse		5	
6 Personal allowances for dependents (*line 5 multiplied by $4,500*)		6	
7 Total personal allowances (*line 4 plus line 6*)		7	
8 Taxable compensation (*line 3 less line 7, if positive; otherwise zero*)		8	
9 Tax (*19% of line 8*)		9	
10 Tax withheld by employer		10	
11 Tax due (*line 9 less line 10, if positive*)		11	
12 Refund due (*line 10 less line 9, if positive*)		12	

Fig. 1. Individual Wage – Tax Form

Form 2	Business Tax		1998
Business name			Employer identification number
Street address			County
City, state, and ZIP code			Principal product
1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2(a)	
	(b) Wages, salaries, and pensions	2(b)	
	(c) Purchases of capital equipment, structures, and land	2(c)	
3	Total allowable costs (*sum of lines 2(a), 2(b), 2(c)*)	3	
4	Taxable income (*line 1 less line 3*)	4	
5	Tax (*19% of line 4*)	5	
6	Carry-forward from 1997	6	
7	Interest on carry-forward (6% of *line 6*)	7	
8	Carry-forward into 1998 (*line 6 plus line 7*)	8	
9	Tax due (*line 5 less line 8, if positive*)	9	
10	Carry-forward to 1999 (*line 8 less line 5, if positive*)	10	

Fig. 2. Business Wage – Tax Form

when the retired worker receives the pension it is subject to the individual wage tax. Although the form of this tax fits on postcard, it has three important economic features: it is progressive, contains family splitting and a system for social security (financial support for dependents). All three are reached by providing each taxpayer with allowances according to his personal situation, as seen below on the tax form, which best explains the nature of the individual wage tax (Hall and Rabushka, 2007, p. 89):

The business tax is a giant, comprehensive withholding tax on all types of personal income other than wages, salaries, and pensions. The tax is assessed on all the income originating in a business but not on any income that originates in other businesses (Ibid., pp. 91-92). The tax base is calculated in a pretty simple manner and costs on purchases (of goods, services, materials, and fix assets) and on labor (wages, salaries, and pensions) is subtracted from the payments from sales of products, services and fixed assets. All financial transactions (e.g. payments on loans, dividends) are not regulated within the framework of the business tax. Losses from business can be carried forward for unlimited time period. The business tax form is even simpler then the individual tax form (ibid., p. 94):

The Bulgarian Income Tax

The Bulgarian income tax consists of two separate structures: the corporation tax and the personal income tax. They are not integrated and are based on the so-called classical system, i.e. paid dividends are subject to double taxation (10 percent corporation tax plus 5 percent personal income tax).

The Personal Income Tax

The personal income tax is a complete income tax of natural persons. Although *income* is the core of it, the *Law on Taxes on the Income of Natural Persons* does not explicitly define it. Instead, it puts the income in connection with its sources. Depending on the source the types of income are:

1. Income from employment;
2. Income from business as a sole proprietor;
3. Income from other personal businesses;
4. Income from rents;
5. Income from the transfer of rights or property;
6. Income from other sources.

Because the other sources of income are not a specified limited number, in fact, nearly everything could be considered as income. Gifts and legacies are the only two types of income excluded from the endless list of income sources.

Taxable income is the income from all sources, with exception of items defined as non-taxable. The catalogue includes more than 30 precisely defined non-taxable items, such as:

- Income from the sale of one housing real estate;
- Dividends which have been distributed in the form of new stocks or shares;
- Income from mandatory social security (including pensions);
- Income from additional (and voluntary) social security (including pensions);
- Interest on Bulgarian state, municipal and corporate bonds;
- Scholarships;
- Amounts and objects which have been received from gambling;
- Amounts for business travelling, accommodation etc.
- Income from rent or lease of agricultural land;
- Income from unmanufactured agricultural production, and so forth.

The base of taxable income (total tax base) is calculated in tree steps. First, bases of each source of income are to be computed separately. Second, they have to be totaled. Third, tax reliefs are subtracted from the total.

Against the total tax base flat tax rate of 10 percent is applied.

To narrow the total tax base the following tax reliefs are applicable:

- Persons with reduced capacity to work (invalids) can *exempt* 7.920 BGN from taxation, i.e. decrease their total tax base by this amount.
- *Exclusions* for personal social security contributions: up to 10 percent of the total tax base for personal contributions for additional voluntary pension, and up to 10 percent for additional voluntary health and life insurance.
- *Deductions* for donations (in total, up to 65 percent of the total tax base): (1) up to 5 percent – in 14 precisely defined cases; (2) up to 15 percent – in favour of culture; (3) up to 50 percent – in favor of the "Fund for Treatment of Children" Centre.
- *Deductions* for mortgage interest: interest on the first 100.000 BGN of the mortgage loan of married couples up to 35 years old, when the mortgaged residence is the only residence of the family.

Parallel to the mainstream taxation of natural persons presented above income from dividends or liquidation shares are taxed separately at 5 percent (through compensated taxation). Such tax of 10 percent is also due on the amounts paid for: life insurance, voluntary health insurance, and additional voluntary pension, at their reverse receipt when the insured event has not occurred.

The Corporation Tax

Similar to natural persons, legal entities (e.g. corporations) are also subject to taxation. The tax on companies' pre-tax income (profit) is called in Bulgaria corporation tax. It is regulated by the *Law on Corporate Income Taxation*. The base for corporation tax is the so called tax profit, which is obtained by adjusting the accounting profit (loss) before tax. The tax rate is 10 percent.

Although corporation tax seems to be so far utmost simple, in fact, it is not due to the fact the adjustment of income (loss) to tax profit (tax loss) is very complex. At that, the total revenues and expenses of income statement are recalculated according to tax law. In practice, for tax purposes a separate (tax) financial accounting has to be applied to prevent profit manipulations, which are not in violation of the accounting law.

Basically, the adjustment is done by adding and subtracting items to and from total revenues and expenses. Technically, these items are classified in four groups: (1) tax permanent differences, (2) tax temporary differences, (3) amounts involved in determining the tax profit, and (4) depreciations.

Tax permanent differences are those revenues (expenses) which are not recognized by tax law. When these are expenses, they increase the accounting profit (before tax). Conversely, it has to be decreased by not recognized revenues. Such items are, for example, expenses not connected with the business, expenses for fines, confiscations, donations (except for those specified in law), expenses on dividends from other companies, and so forth.

Tax temporary differences arise when certain revenues or expenses are recognized for tax purposes but not in the year of their reporting. Again, accounting profit has to be increased by such expenses - occurrence of a tax temporary difference. When conditions for recognition are fulfilled, these expenses decrease the subsequent net income of company's financial statement - reverse manifestation of tax temporary difference. The situation with revenues is the opposite - they are the first out of financial statement, and when conditions for recognition occur, these revenues are added to them. Revenues and expenses causing tax temporary differences are diverse. Mentioned may be only some of them, such as differences from subsequent evaluations of assets and liabilities – they are not recognized in the year of reporting but at their write-off; expenditures for provisions for obligations – are recognized at the pay-off of obligations by the provision; expenditures for unused leaves - are recognized in the year of payment, etc.

Amounts involved in determining the tax profit are used under the adjustment to clear the effects, for instance, of investments in securities on the income (profit) before tax. Gains of such financial investments are subtracted and losses added to the income before tax. Thus, tax profit consists mainly of operating revenues.

Depreciations are the "classical" instrument for manipulation of profits, hence the primary attention of tax legislation to them. The motives behind profit manipulation may not only be related to tax evasion, but also may pursue shifting the tax payments forward in time leading to lower net present value of them. To prevent this straight-line tax depreciation allowances are introduced. Technically, accounting depreciations are not recognized and have to be added back to net profit, and then tax depreciations have to be subtracted.

Categories	Assets	Depreciation rates (percent)
I	solid-structured buildings, including investment property, equipment, power transmission devices, communication lines	4
II	Machinery, production equipment, apparatuses	30
III	means of transportation, with the exception of motor vehicles; pavement of roads and runways	10
IV	Computers, peripheral devices for computers, software and the right to software use, mobile phones	50
V	motor vehicles	25
VI	those tax fixed tangible and intangible assets the term of use of which is limited under contractual relationships or a legal obligation	100/years of the legal limitation. The annual rate may not exceed 33 1/3.
VII	all other depreciable assets	15

Fixed tangible and intangible assets worth over BGN 500 are depreciable, which depreciation base is their historical value. These assets are divided into seven categories and each is determined maximum straight-line depreciation rate as follows:

Companies can carry forward for up to five years the tax loss, deducting it from subsequent tax profits.

Abatements, assignments, and exemptions from taxation with corporation tax are allowed. For instance, in assignment companies do not pay the tax due which remains in their patrimony and has to be used for purposes determined by law. Assignment or abatement is applicable in cases of employment of long term unemployed people or such of reduced capacity for work. Collective investment schemes which are admitted to being offered to the public at large, the licensed closed-type investment companies, etc. are not liable for corporate tax.

Comparison between the Flat Tax and the Bulgarian Income Tax

Simplicity

The income tax was introduced in Bulgaria in 1997 and at that time it covered 135 paragraphs written out on 56 pages. Ten years later in 2007 (before the introduction of the flat tax) paragraphs were 364 and pages 135. In 2012, four years after introduction of flat tax, the paragraph and page numbers remain almost the same as before. Moreover, the actual income tax forms are spread over more then 30 pages in total (including enclosures). Obviously, the introduction of the flat tax in Bulgaria has nothing to do with "postcard tax reform" and simplicity. Bulgarian income tax remains as complicated as before.

General Design

Various principles (for example economic, judicial, and other principles) can provide the basis for the structure of a tax system. It is these principles that render different the tax systems. The next level of comparison between the flat tax and the Bulgarian income tax would be at system level.

The flat tax classifies all income as either business income or wages. The wage tax is levied only on wages, salaries, and pensions and it is not a complete income tax on individuals. The business tax covers all other income sources. Both tax structures form a very clear and simple tax system.

Unlike the flat tax, the separation of both taxation structures in Bulgaria does not follow economic logic but legal sense, which in turn creates a number of organizational problems and significant complications. Income taxation consists of a complete income tax on individuals and a tax on the profits of legal entities (companies, corporations etc.). This (traditional) design not only implies double regulation of a business income – by the *Law on Corporate Income Taxation* and by the *Law on Taxes on the Income of Natural Persons,* but also results in different tax treatment of alternative forms of business organizations.

To overcome this problem to some extent, sole proprietors which as natural persons are subject to the individual income tax have to calculate their tax base under the corporation tax regulations and then to "import" them back into the framework of the deductible individual income tax.

One-time Taxation

A major feature of the flat tax is that all income is taxed exactly one time.

Unlike the flat tax, in Bulgaria some income components (e.g. fringe benefits, some kinds of interest, pensions) are never taxed, while, for example, dividends and capital gains are taxed twice under the so-called classic system.

Tax Rates

The flat tax of Hall and Rabushka consists of R-cash-flow tax on business income and a tax on workers' income, both levied at the same single rate.

On the contrary, under the Bulgarian tax system worker's income is taxed at 10 percent and business income at 10 percent corporation tax plus 5 per cent tax on dividends. The income of sole proprietorships is taxed directly at 15 percent.

Individual Tax

The individual wage tax stipulates generous personal allowance, providing progressivity, but no exceptions or other deductions. Pension contributions are exempt from taxes, but when the retired worker actually receives the pension it is taxed as "worker's income" at the usual single tax rate.

Conversely, the taxation on workers' income in Bulgaria does not provide for a personal allowance but for numerous deductions, exemptions, and exceptions. For those taxpayers, who can exempt components of their income from taxation or are allowed to realize deductions the Bulgarian individual tax is progressive. For the other taxpayers it is proportional.

Business Tax

The business tax does not predict deductions (expenses)/revenues for/from financial transactions (e.g. interest payments, dividends). Only expenses for costs of goods, materials, services, wages, salaries, and pensions are recognized. Moreover, an immediate 100 percent first-year tax write-off of all investment spending is allowed, which characterizes the flat tax as a consumption tax. In fact, the base of the business tax is the cash flow of real business.

Contrariwise, the corporation tax recognizes expenses/revenues for/from interest payments, dividends, etc. as well as deductions for costs of goods, materials, services, wages, salaries, and pensions. However, it does not allow expensing of investments and a very complicated apparatus of depreciation deductions has to be applied. The Bulgarian corporation tax is not a consumption tax but a component of a traditional income tax. Its base is not the cash flow of real business.

The business sources of income under the personal income tax have also to be compared to the giant business tax. Sole proprietorships calculate their tax base under the corporation tax and all said abut corporations is also valid for them. Typically, the base for income from other personal businesses, rents, and the transfer of rights or property is formed as fix expense rates and social contributions are deducted from revenues. In fact, this is not characteristic of the cash-flow tax but of potential taxes (e.g. poll tax). The base of the income from other sources (e.g. compensations for loss of profit, interest, some awards in games and competitions, production dividends from cooperatives etc.) is the income by the social contributions. It is the only one which is based on the cash flow.

Conclusion

The comparative analysis shows that the differences between the flat tax and the Bulgarian income taxation are the rule, whereas similarities are only rare exceptions. Therefore, we can conclude that the current Bulgarian income tax is not a flat tax. It is something else referred to the public as a "flat tax". To characterize them we can use the words of Hall and Rabushka written on the US federal income tax: The Bulgarian " … income tax is a complete mess. It is not efficient. It is not fair. It is not simple. It is not comprehensible. It fosters tax avoidance and evasion. … It costs taxpayers billions of dollars in wasting time on filling out tax forms and other forms of compliance. It costs the economy billions of dollars in lost output of goods and services from investments being made for tax rather than for economic purposes" (Hall and Rabushka, 2007, p. 1-2).

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