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Konstantin Pashev

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International Studies Program
Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
United States of America

Phone: (404) 651-1144
Fax: (404) 651-3996
Email: ispaysps@gsu.edu
Internet: http://isp-aysps.gsu.edu

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Tax Compliance of Small Business in Transition Economies: Lessons from Bulgaria

Konstantin Pashev[1]

Abstract

This paper studies the challenges of raising tax compliance in the small business sector in transition economies, drawing from the experience of Bulgaria. It identifies the elements of tax design and enforcement that discriminate against the small business and drive non-compliance. It argues that these drivers are related mainly to the disproportionate tax burden of compulsory social insurance contributions and income taxation of sole proprietors, as well as to the higher compliance costs faced by the small business in Bulgaria. In this framework it studies Bulgarian experience with two presumptive taxes - the patent tax and the minimum insurance income thresholds - and discusses the opportunities and costs of their optimization.

1. Introduction

The rapid expansion of the small business sector in transition economies poses a number of questions and challenges to tax policy and administration. Does the small business sector need a special tax treatment? What are the policy objectives of such treatment? Does it aim at reducing the direct tax burden, or does it rather seek to reduce compliance and enforcement costs? Does it aim to raise more revenues from the hard-to-tax, or to allocate scarce administrative resources more efficiently? What are the respective benefits and costs?

[1] This study was completed during a Fulbright senior scholarship research exchange hosted by the Andrew Young School of Policy Studies, Georgia State University, Atlanta GA. I am much indebted to Jorge Martinez-Vazquez and Luc Noiset for helpful comments on the original version.

The small business is the major engine of employment creation and growth, but it is as well a major challenge in terms of compliance management. The answers to those questions are essential in the politicized environment of tax policy making, where politicians tend to emphasize tax incentives for growth, while actual tax design often tends to prioritize revenue targets, sometimes at the expense of economic and administrative efficiency.

There is no doubt about the primary importance of small and medium-size enterprises (SME) in East European transformation. First and foremost, small business' capacity to create employment and provide some source of income are crucial when structural reforms and privatization of state enterprises leave large part of the labor force out of the payroll. Apart from their indirect social function at the start of transition, later, small enterprises are a major driver of competitiveness. Their creation and growth enhance competition, drive restructuring and venturing into new technology and product lines, thus being an important prerequisite for a dynamic and competitive economy. Moreover, in today's highly integrated production networks, where sub-contracting, outsourcing, and flexibility are crucial for the survival of the large companies, the competitiveness of the latter depends much on the SMEs' efficiency. This is especially important in the context of the challenges of accession to the EU and convergence. The European Charter for Small Enterprises[2] recognizes SMEs as the backbone of EU economy and the key to implementing its Lisbon strategy of making Europe the most competitive and dynamic knowledge-based economy in the world. Last but not least, the importance of the small entrepreneurs is related to the political economy of transition. The small business is the key to the formation and expansion of a middle class and a civil society, which provide the main checks and balances against both backsliding in democratic reforms and political clientelism.[3]

There is little doubt that relative to large enterprises, small businesses face more severe liquidity constraints. As argued below, they incur higher compliance costs as well. This reinforces the case for a special tax treatment for them. Generally, policy choices comprise two groups of instruments. The first one comprises the use of tax preferences and incentives to support the start-up and the growth of small companies. These include lower corporate income tax rates, special tax exemptions and other relieves for small businesses.[4] The European Charter for Small Enterprises for instance, sets the objective that "Tax systems should be adapted to reward success, encourage start-ups, favor small business expansion and job creation, and facilitate the creation and the succession in small enterprises. Member States should apply best practice to taxation and to personal performance incentives."

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[2] The Charter was adopted in June 2000 and joined by candidate countries in April 2002. See http://europa.eu.int/comm/enterprise/enterprise_policy/charter/charter_en.pdf; for the text and http://europa.eu.int/comm/enterprise/enterprise_policy/charter/charter-2004_cc.htm for 2003 implementation reports by candidate countries.

[3] Political clientelism (or state capture) denotes forms of grand corruption, when democratic institutions are captured by powerful business groups and public policy serves the vested interests of this small clientele.

[4] Even though tax preferences for SMEs are common in many advanced countries, its rationale has been seriously challenged in the optimal tax literature (see Holtz-Eakin, 1995).

Apart from incentives, a special tax regime for the small entrepreneurs may seek to raise efficiency of tax collection and compliance management. The relative weight of this kind of policy objectives in transition economies has been growing with the expansion of the informal economy. Its boom has been largely attributed to the rapid expansion of the hard-to-tax segments of the business sector such as micro firms, service providers and self employed. Tax administrations have tried to address this challenge through better auditing, risk management and anti-corruption policies. In addition to the conventional emphasis on enforcement efficiency, they started to attach higher priority to improving the services for the taxpayers and reducing the cost of voluntary compliance. Parallel to establishing large taxpayer units, which account for the collection of more than half of all tax revenues, tax administrations often try to address the challenges of the small business sector's low compliance rates by forms of simplified or presumptive taxes.

Unlike large taxpayers, however, small entrepreneurs are large in number and far from homogenous in terms of income and revenue potential. Therefore, the design of a simplified tax presents challenging dilemmas in regard to efficiency and equity trade-offs. What is the contribution of the small business sector to the shadow economy? How to find the optimal balance between stringent law enforcement, reduced compliance costs and more efficient allocation of administrative resources? Is it better to leave a larger part of the hard-to-tax outside the income tax net and rely instead mainly on consumption taxes? Or, should they better be taxed through some form of simplified tax, such as presumptive or single tax? Do these special regimes help or impede small entrepreneurs' transfer to the standard tax net as they grow? What are the respective benefits and costs of a presumptive tax for the taxpayers and the administration? The international experience and the literature offer a wide range of answers to these questions with a variety of incentive, as well as distributional and revenue outcomes and different costs of collection for the private and the public sector. Taking stock of it, this paper studies the tax administration side of optimizing the taxation of small business. The focus is on the costs and benefits of presumptive taxation. Tax incentives and preferences for the small business remain outside the scope of this paper, even though it also looks at the efficiency and equity consequences of presumptive taxes.

Section one of the paper puts the question of small business compliance in the context of the specific challenges faced by the tax administrations in transition countries. It draws heavily on the literature on the shadow economy and tax evasion. Section two studies the specific tax and compliance costs, which place the small business in Bulgaria at a disadvantage relative to other taxpayers and provide strong incentives to non-compliance. It argues that these incentives are mainly related to the disproportionate tax burden of compulsory social insurance contributions and income taxation of sole proprietors, as well as the higher compliance costs faced by the small business in Bulgaria. Section three reviews the theory and practice of presumptive taxation as one of the common tools used to address the challenges of small business non-compliance, and studies their benefits and costs in terms of efficiency and equity. Section four looks at the experience of Bulgaria with two presumptive taxes: the patent tax; and the minimum insurance income thresholds. Section five discusses the opportunities and respective costs of the optimization of the patent tax. The last section offers some conclusions.

2. The small business and the shadow economy in transition countries

Small entrepreneurs, self-employed professionals and farmers, are broadly referred to as the "hard-to-tax".[5] The question of why they are a challenge to the tax administrations in transition countries, and how big this challenge is, has attracted recently much attention in the literature. In general it pertains to the role and the relative weight of the small business sector in the shadow economy of these countries.

Schneider and Enste (2000) define the shadow economy in terms of income unreported to tax authorities, which is generated in the production of legal goods and services by agents that are not registered, or do not pay taxes. Even though the expansion of the shadow economy is a world-wide problem,[6] it is much more pronounced in the countries of transition. Between 1990 and 2001 the shadow economy in the countries of the former Soviet Union grew by 36 percent to an average of 44,8 percent of formal output, while in Central and South-East Europe it increased by 25 percent to an average of 29,2 percent (Schneider 2003). The severity of the problem for transition countries stems as well from the higher costs they incur relative to more developed countries in terms of losses of revenues, efficiency and equity (Alm and Martinez-Vazquez, 2003).

The underlying causes of the boom of the shadow economy in the former centrally planned economies (CPE) have been well documented in the literature.[7] Some of them lie outside the field of taxation. Excessive costs of compliance with non-tax regulations - such as licenses and permits, hiring and firing restrictions, and related bribe costs - are strong drivers of informality in transition countries with the related consequences for tax compliance. For reasons, to which I will return below, these costs tend to be regressive, affecting more the small entrepreneurs. Therefore non-tax constraints may be strong drivers of tax evasion by the small business. Here, however, we are concerned about the drivers of informality that can be redressed through the instruments of tax policy and administration.

Tax-related constraints have been well studied too. In general they appear to be more in the domain of tax administration and related to compliance costs rather than to

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[5] Musgrave (1990). For more detailed discussion of the concept and its policy implications see the papers presented at the conference "The Hard to Tax: An International Perspective", Andrew Young School of Policy Studies, Georgia State University, Stone Mountain, May 15-16, 2003, at http://isp-aysps.gsu.edu/academics/conferences/conf2003/index.html

[6] Estimates by Schneider and Klinglmair (2004) of the size of the shadow economy in 110 countries of the world indicate that even in the most advanced 21 OECD countries covered by the survey, it expanded by about a quarter between 1989 and 2003, from 13,2 to 16,4 percent in average. Even though there is slight reversal in this trend in the last years, the size of the shadow economy in each of these 21 countries is higher in 2003 relative to 1989. The problem is of much larger magnitude, however, in developing and transition countries. In 61 out of 82 non-OECD countries covered by the survey the shadow economy exceeds 30 percent of official GDP. The remaining 21 (15 of which are in Asia) include countries like Hong Kong, Taiwan, Singapore, Israel, South Africa, which even though not OECD members do not fit well in the group of developing countries.

[7] See Johnson, Kaufmann and Shleifer (1997); Schneider, (2003), Schneider and Burger (2004), and the contributions to Belev (ed. 2003)

tax policy. It is indicative that transition countries have larger informal sectors than advanced countries, even though many of them enjoy lower tax rates.

In the case of Bulgaria the tendency of non-compliance may be attributed first to the legacy of the tax system of the soviet type of state socialism and the wide gap that it should overcome towards serving the market.[8] Under central planning the state owned the enterprises and set input and output prices, as well as final individual tax liabilities. The system implied virtually audit of 100 percent of the enterprises. In result, at the start of the transition the tax administration of most former CPE lacked traditions of servicing the taxpayer. Conversely, taxpayers lacked traditions of voluntary compliance. Newly emerged business ventures have never before paid taxes.

Furthermore, the negative effect of the legacy of central planning on tax compliance was reinforced by the harsh realities of transition. The failure of the state to perform its social functions and to deliver the public good, as well as the way state resources were transferred to private hands resulted in strong public distrust in government. The contrast with the previous regime in regard to protection from crime and poverty and access to health and education services generated wide perceptions that taxpayers did not owe anything to the state as they could not expect much from it.[9]

The boom of the shadow economy in transition countries is largely attributed to the lack of administrative capacity of the nascent tax administrations. Tax offices had neither the experience, nor the human and information technology resources of a modern compliance and enforcement management. It is worth noting however, that even well-equipped modern administration might not be able to handle much better the challenges of an economy, which in the absence of functioning financial and goods markets, was largely dominated by cash and barter transactions. These challenges have been aggravated by disparities in the pace and sequencing of the various components of institutional reforms.

Bulgaria for instance followed the Polish example in a version of a big-bang type of market liberalization. It however was not matched by privatization and restructuring of state-owned enterprises. As industrial output collapsed, a large part of sole entrepreneurships were created in the first half of the 1990s in result of layouts of state enterprise employees. Another substantial part emerged driven by the opportunities of siphoning out the income of the state enterprises - or rather the state under pervasive soft budget constraints - through creating supplier and distributor firms at the entrance and exit of the production lines. The 5-6 year vacuum between the liberalization and the privatization explains the large portion of "subsistence" and rent-seeking types of small business ventures. This in turn led to a boom of the hard to tax private business in the sectors of trade and services, and a public enterprise sector operating at a loss, which drastically eroded the tax base. Moreover, limited access to financing and bank services made cash and barter transactions without accounting records pervasive.

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[8] For a comprehensive study of tax reforms in transition see Martinez-Vazquez and McNab (2000).
[9] See for instance MBMD (2003) survey on taxpayers' attitude to public services and tax obligations.

There are important mismatches in the pace of tax reforms as well. Martinez-Vazquez and McNab (2003) identify a common flaw in most transition countries: the delay of tax administration reforms relative to tax policy reforms. This is hardly surprising. It is easier and faster to change the regulations than to build the institutional capacity needed for their enforcement. Tax policy reforms however did not advance at the same pace across the various components either. Social insurance and fiscal decentralization reforms in general lagged behind the restructuring of the indirect taxes (VAT, excises and customs duties) and income taxes. The depth and dynamics of tax restructuring, coupled with the poor coordination between the various components of tax reforms, could not but make regulations complex, unstable and hard to enforce.

There is no doubt however, that tax administration reforms in transition countries were substantially delayed. There may be two reasons for that. First, modernization of tax administration requires some adequate level of institutional autonomy of the tax office, which the political elites were not ready to provide on issues as sensitive as the collection of revenues. Second, as far as outside incentives are concerned, at least for the accession countries, the reform priorities were mainly guided by the *acquis communautaires* of the EU. This may partly explain the relative delay in areas which remain more or less outside the scope of the *acquis*, such as social security, local revenue autonomy and tax administration.

The delay in modernizing the administration in transition countries can be identified in the following major deficiencies of tax collection today:

- bias towards stringent enforcement rather than encouraging voluntary compliance;
- underdeveloped taxpayers' services and especially online services
- obsolete enforcement technology with excessive reliance on extensive coverage rather than better targeting of audits and risk assessment;
- limited resort to third-party reporting and withholding;
- limited human and information resources

All these imply higher costs of collection for both the private and the public sector and explain the large share of tax evasion in transition economies.

The identified drivers of non-compliance are generic for the process of transition and affect large and small businesses alike.[10] But they are likely to have much stronger impact on the small business. Small businesses bear higher costs of compliance as a share of income for at least three reasons. First, there is a fixed cost of understanding tax regulations and adapting to their requirements irrespective of the company's size. The large businesses can benefit from economies of scale, by spreading the fixed cost over more units of output. The small business can save some of these fixed costs mainly by

[10] In fact the challenges related to large businesses' tax frauds - such as transfer pricing, fraudulent VAT refunds, e-commerce, etc. – may be of much larger magnitude than non-reporting of income by the hard-to-tax. In general large companies in transition countries may have much more power to avoid enforcement through bribes or political connections. Non-compliance of large businesses however, present different challenges to tax administration, which remain outside the focus of this study.

outsourcing of tax accounting.[11] Second, large businesses receive usually better services within the large taxpayer units, while small businesses are taken care of small, understaffed and under-equipped local units. Third, incidence-wise, small companies operate in tougher and more competitive environment than large companies, and are far less in a position to shift the costs of taxation and compliance forth to customers, or back to suppliers. Therefore compliance costs tend to be regressive in the sense that they are negatively related to taxpayers size and income.

To sum up the arguments so far, the process of transition has generated excessive compliance and enforcement costs, which present serious challenges to the emerging small entrepreneurs and the nascent tax administration. This brings us to the core issue in our positive analysis – the impact of the instruments of tax policy and enforcement on small business compliance. Before looking into the concrete economic and tax situation of the small business in Bulgaria, we need to see how small business' evasion patterns relate to the tax policy and enforcement parameters. Next I turn briefly to the literature on tax evasion for some of its theoretical predictions and empirical findings, which are most relevant in this context. These concern mainly the interactions between taxpayer's size (income) and the parameters of tax policy (tax rates) and tax enforcement (probability of detection and penalty rates).

Classical models of tax evasion study individual decision to evade taxes as a choice under uncertainty. It implies a tradeoff between the benefit of successful (undetected) evasion; versus the loss in case of detection and penalty. In the pioneering model of Allingham and Sandmo (1972) the expected gain depends on the tax rate, while the cost depends on the penalty and the probability of detection. The attitude towards risk is determined by income, which is exogenous. If utility-maximizing taxpayers are risk averse, their propensity to evade taxes is positively related to income. Intuitively, the lower the taxpayers' income, the heavier the weight of the penalty as a percentage of income, the less likely s/he would be to take the risk of being penalized. In this setting, self-employed and small entrepreneurs are less likely to evade taxes than large business owners. Moreover, for the incorporated businesses the relation between owners' income and evasion decision by the managers is not straightforward. Corporate entities may act as risk-neutral evaders even though their owners may be risk averse.

The effect of the tax rate however is ambiguous, depending on attitudes towards risk and the penalty structure. If utility-maximizing evaders are risk neutral, the higher the rate, the more they are likely to evade taxes, as the expected marginal utility of evasion grows with the tax rate. Under assumption of risk aversion, however, this substitution effect may be offset by an opposite income effect. The higher the tax rate, the lower the taxpayer's disposable income, the less willing s/he is to take the risk of being penalized. Yitzhaki (1974) points out, however, that the substitution effect under assumption of risk aversion is in place only if the penalty is proportional to the evaded

[11] Tax compliance studies of small business in the US reviewed by Slemrod (2004:80), indicate that on average self-employed taxpayers spend nearly three times as much of their time on tax compliance as other taxpayers and are almost twice as likely to use professional assistance to prepare their taxes. According to the IRS between 80 and 88 percent of small businesses rely on tax practitioners to file their returns.

income. If the penalty is levied on the evaded tax, then the net benefit does not grow with the rate and there is only income effect. Contrary to common intuition, the evaded amount falls with the rise of the tax rate.

The growing literature[12] has extended the original work to incorporate labor supply (making income endogenous); compliance and enforcement costs, avoidance, multiple modes of evasion. Other extensions go beyond the static parameters and model behavior over time, including interactions with the collector. Furthermore, large part of research extends the original framework beyond the mere gamble-like weighting of expected gains and losses towards incorporating such determinants as ethics, reputation, the public tolerance to evasion, etc. Despite their importance for understanding the mechanism of compliance choices, they could not reduce much the ambiguities about the effect of income and the tax rate on compliance.

The persistent ambiguities of the theoretical models make empirical evidence the more so important. Most empirical tests are derived from the US Taxpayers' Compliance Measurement Program (TCMP). It provides unique data on individual returns, but does not cover non-filers. Results on the effect of the tax rate are mixed, but on balance findings that lower tax rate leads to higher compliance rates prevail.[13] In regard to income, however, TCMP data seem to confirm that higher income is related to larger underreporting. But it indicates as well that source of income rather than income level may be a stronger determinant of evasion. A much higher share of self-employed than wage income is concealed. This however, is an issue of third-party reporting and probability of detection rather than taxpayer's ability to pay, and brings us to the question of enforcement parameters.

The policy implications of the theory of tax evasion are most straightforward in regard to the effect of deterrents of evasion, such as the penalty rate and intensity of audits. In line with the predictions of the classical models, most empirical tests report positive relation between probability of detection and penalty versus income reporting compliance. Martinez-Vazquez and Rider (2005) find that taxpayers may employ more than one mode of evasion as substitutes, i.e. switching between modes according to the respective probability of detection. Thus, self-employed taxpayers seem to prefer to understate income, while wage earners tend to prefer to overstate deductions. The opportunity of a second mode of evasion reduces the effect of enforcement in the targeted mode, but not in a magnitude large enough to offset it. In this context they find that a 10 percent increase in income subject to third party reporting increases income reporting compliance by 1.1 percent. The compliance gain from eliminating itemized deductions is even much bigger.

The theoretical and empirical findings discussed above call for a closer look at the concrete parameters of tax policy and tax enforcement in Bulgaria. In this section I

[12] For a comprehensive review of the literature see Slemrod and Yitzhaki (2002), Cowell (2004), Sandmo (2004)

[13] See for instance Clotfelter (1983), Poterba (1987) Alms et al (1990) and Joulfaian and Rider (1998). For the opposite results see Feinstein (1991).

argued that the boom of the shadow economy confronted tax administration of transition countries with a serious challenge and that the small business has a central place in this challenge. Further on, if individual choice to evade taxes is a response to incentives and opportunities, we need to look at the specific incentives and opportunities that small entrepreneurs encounter relative to other taxpayers such as wage earners and large companies. The next section seeks the answers to the question why the small business sector in Bulgaria evades taxes by looking at the specific tax and compliance cost constraints that it faces.

3. Why does Bulgarian small business evade taxes?

3.1. The small business in the economy of Bulgaria

The SME sector has a large weight in the economy of Bulgaria.[14] It accounts for 99 percent of all enterprises and over half of the registered turnover and employment in the business economy. (Table 1). Its share in GVA expanded from 25.4 percent in 1998 to 34.2 in 2002. More importantly, with a growth rate above the economy's average, it is a major engine of growth and employment creation. While the economy grew by 5.5 percent in GVA terms in 2002 vs. 2001, the small business sector grew by 13.4 percent. Likewise, employment increased by 11.5 percent in the small business sector versus 1.5 percent in the whole economy.

Table 1. Relative weight of SMEs in the business economy (%)

	2000	2001	2002
Employment	50.7	51.6	53.8
Turnover	50.2	50.4	52.3
GVA	30.0	31.2	34.2

The robust growth of the sector, however, seems to reflect growing number of ventures rather than productivity gains. Productivity and profitability gaps in relation to large companies remain significant. In 2002

Table 2. Shares of enterprise groups in the business economy 2002

	Micro	Small	Medium	Large
% of companies	90.8	7.3	1.6	0.3
% of employed	25.9	18.9	21.7	33.5
% of value added	11.8	14.8	19.0	54.4
% of turnover	23.7	21.3	21.0	34.0
% of labor cost	8.1	13.9	21.9	56.1
% of gross investment	15.8	20.7	18.5	45.0
% of fixed asset	9.9	14.1	17.5	58.5

[14] If not otherwise indicated, the data used in this section are from ASME (2004). Small business includes small and medium-sized enterprises (SME) according to the pre-2004 definition in the Bulgarian law, i.e. enterprises with up to 100 employees, annual turnover of BGL3 million and/or assets of BGL2,4 million with subcategories for small enterprises of less than 50 employees; and micro enterprises of less than 10 employees. In 2004 Bulgarian SME law incorporated the EC Recommendation Concerning the Definition of Micro, Small and Medium-Sized Enterprises, (2003/361/EC of May 6, 2003). The ceilings on the number of employees was raised to 250, the turnover and balance sheet ceilings respectively to BGL15 million and BGL8 million for medium-sized companies (50-249 employees) and BGL5 million and BGL1 million for small companies (10-49 employees). Where the need of comparison with the EU requires, and if so indicated, the definition may cover enterprises of up to 249 employees. Departing from EC recommendation, Bulgarian law includes in the SME category only legal entities, while the EC definition includes any form of economic activity irrespective of its legal status, i.e. the self-employed, informal associations and partnerships as well. The business economy excludes agriculture, financial intermediation and most public services, i.e. it comprises the sectors from C to G and K according to Eurostat NACE classification.

productivity (measured as GVA per employee) grew by 4 percent in the economy, but only by 1.7 percent in the SME sector. Large enterprises (with more than 250 employees) are only 0.3 percent of all business sector enterprises, but account for 45% of total investment, 58.5% of all fixed assets, 56% of the labor expenses and 54% of the value added (Table 2).

The relative inefficiency of the sector reflects largely investment and productivity constraints faced by the sub-sector of the micro companies (with less than 10 employees). The productivity and income gaps separating them from the rest of the SME sector are significant. Micro companies account for 91 percent of all enterprises, but for only 16 percent of the investment and 12 percent of the value added in the business economy. In contrast, the rest of the SME sector accounts for 9 percent of all enterprises, but for 39 percent of overall investment, 32 percent of all assets, and 34 percent of total value added. Figures for 2002 indicate that the small enterprise sub-sector (10-49 employees) grows three times faster than the micro sector. Furthermore, there are large wage disparities. With about 2 employees in average in 2002, micro enterprises employ 26 percent of the workforce, but account for only 8 percent of labor expenses. The rest of the SME sector employs 41 percent of the workforce and accounts for 36 percent of labor costs. In comparison, the average micro enterprise sector in the EU is similar in size, but achieves 70 percent higher share in value added with about 30 percent lower share in turnover.

Table 3. Shares of enterprise groups in the business economy 2001

	Micro		Small		Medium		Large	
	Bulgaria	EU-15	Bulgaria	EU-15	Bulgaria	EU-15	Bulgaria	EU-15
% of companies	92.0	90.6	6.2	7.9	1.5	1.2	0.3	0.2
% of employed	25.9	27.7	17.0	21.5	21.9	16.3	35.2	34.5
% of value added	11.5	20.1	12.7	19.0	18.1	17.9	57.8	43.0
% of turnover	23.0	18.4	20.5	19.2	16.9	18.9	39.6	43.5

Source: Bulgaria: NSI; EU15: Eurostat: SMEs in Europe – Candidate countries, 2003 edition

The disparities between the micro business sector and the rest of the SME sector places the latter relatively closer to large enterprises than to micro enterprises. In fact some SMEs belong to the large taxpayers group.[15] Therefore in the context of this study it appears to be more relevant to depart from the conventional SME grouping and to focus on micro enterprises. This category fits best in the concept of the hard to tax.

It is beyond doubt that the business performance gap which separates Bulgarian micro enterprises from larger enterprises, as well as from micro business sector in the EU

[15] The initial criterion to include an enterprise in the large taxpayer group in 1998-1999 was a turnover above BGL2.5 million, balance sheet above BGL1 million and tax liabilities above BGL100000. At the same time up until 2004 Bulgarian legislation defined SME as enterprises with a turnover of up to BGL3 million and balance sheet of up to 2.4 million. The 2004 amendments of Bulgarian SME Law, which followed the EU recommendations on defining the SME categories, raised these ceilings 5 times. In result, the turnover ceiling for small enterprises (i.e. enterprises with 10 to 49 employees) now exceeds 100 times the VAT threshold, and twice the minimum threshold for placing an enterprise on the large taxpayers list.

reflects largely higher rates of underreporting of income and employment. But it seems to reflect as well the specifics of the formation of the micro-business sector of Bulgaria. As noted in section one, at the initial years of restructuring large part of Bulgarian small businesses emerged as means of survival of laid-out public sector employees rather than in response to business opportunities. Under conditions of sharp drop in incomes and savings, and lacking financial markets, start-ups had limited chances and short lifespan. The gap, documented in this paragraph, confirms that the majority of the small business sector face the challenges of survival rather than of innovation and expansion. This brings us to the question of their place in the shadow economy of Bulgaria and the related challenges to the tax administration.

Bulgaria has one of the largest shadow economies among accession countries.[16] Overall compliance gaps are estimated at about 25 percent (World Bank, 2003). Evasion of payroll taxes is a serious problem. According to survey data, 14 percent of the respondents acknowledge that they work without any contract of employment at all (MBMD 2003). Employers estimates are much higher: about 25 percent (Vitosha Research 2003). Large part of those that have formal registered contract of employment, are insured on lower than actual wages. About 30 percent of the respondents to the MBMD (2003) survey confirm that the deducted tax is not on the full wage. In fact only half of those with formal employment contracts confirm that the reported wage corresponds to the actual one.

There are no direct measures of compliance of the small business sector. Indirect indications from business surveys however, indicate that compliance gaps may be larger in the micro and small business sector. The evaluation by small entrepreneurs of the share of underreported income and profits in their sectors tend to exceed two-three times the estimates by the representatives of the larger companies. (Vitosha Research 2003) According to these estimates, sole proprietors hide in average 29 percent of their income. Micro and small companies (up to 50 employees) estimate the share of unreported wages at about 20 percent, while for the large companies it is less than 7 percent. The sector averages of respondents' estimates of evasion rates are highest in the traditional hard-to-tax sectors: 26 percent in retail trade, 20 percent in services, and 17.2 percent in construction[17]

3.2 Income taxation

The income of small entrepreneurs in Bulgaria is taxed either through a progressive personal income tax (PIT) when they operate as sole proprietors and self-employed, or a proportional corporate income tax (CIT) when they operate as limited liability companies. In both cases the tax base is calculated according to the CIT law. About 30-35 percent of all enterprises pay a lump-sum PIT, called *patent,* which is discussed in details in sections four and five of this paper.

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[16] Schneider (2003) estimate for 2000/2001 is 36,4 percent. The Global Competitiveness Report (2004) reflects the estimates of the business, and ranks Bulgaria 78th out of 102 countries with an average score equivalent to above 30 percent of GDP. See as well Vitosha Research (2003), CSD (2004).

[17] See CSD 2004:54-55

Bulgarian standard income taxes have been substantially reduced in the years following the crisis of 1996-97 and the introduction of the currency board (table 4). In six years the CIT rate was cut by half from a dual rate of 32.5/ 28 percent in 1999 to a single 15 percent rate in 2005. PIT rates underwent similar adjustment.[18]

Apart from these overall improvements in the tax treatment of business income in Bulgaria, tax reforms have actually led to losses in horizontal equity between the two legal forms of small entrepreneurship. Due to the progressive PIT schedule, the enterprises of the natural persons and the self-employed face tax disadvantage relative to the enterprises of the legal persons above certain income threshold, where the PIT average tax rate (ATR) equals the CIT proportional rate. Successive CIT cuts from 32.5 percent to 15 percent reduced this income threshold more than three times - from more than BGL18000 (EUR9000) in 1999 to less than BGL6000 in 2005. This increased the number of sole proprietors that pay higher taxes relative to legal entities with the same incomes. Furthermore, CIT payers enjoy preferences in the form of 10% income tax credit and zero tax rate on reinvested profits in areas of high unemployment. Neither of these incentives is available to sole entrepreneurs.

Table 4. Statutory income tax rates 1999-2005

	Corporate [a]			Personal					
	Central	Local	Combined[b]						
1999	25	10	32.5	rate	0	20	26	32	40
	20	10	28.0	Bracket[c]	900	1200	4200	15600	
2000	20	10	28.0	rate	0	20	26	32	40
	15	10	23.5	bracket	960	1380	4560	16800	
2001	15	10	23.5	rate	0	20	26	32	38
				bracket	1200	1620	4800	16800	
2002	15	10	23.5	rate	0	18	24	28	29
				bracket	1320	1680	4800	12000	
2003	23.5			rate	0	15	22	26	29
				bracket	1320	1800	3000	7200	
2004	19.5			rate	0	12	22	26	29
				bracket	1440	1800	3000	7200	
2005	15			rate	0	10	20	22	24
				bracket	1560	1800	3000	7200	

[a] Until 2000 a lower income tax rate was applied to companies with a profit below BGL 50000 (EUR 25000)
[b] local + (100-local) x central; [c] Ceilings of annual income brackets in BGL. The lev is tied to the euro in a rate of EUR 1 = BGL 1.59983

Sole proprietors account for about 80 percent of all business entities and more than 90 percent of the small business. [19] Even if the number of those paying patent tax is

[18] In result, Bulgaria has relatively low income tax rates by international standards. The Global Competitiveness Report (2004; table 2.25, 2.26) ranks Bulgaria 8th of 79 countries in regard to the CIT rate and 47th in regard to its PIT rate.

[19] Out of all 877,5 thousand companies registered under the Bulgarian Commercial code as of November 2004, 676, 3 thousand (77%) are enterprises of natural persons registered as sole entrepreneurs, and 168

subtracted, still the overwhelming majority of the small entrepreneurs face increasing tax rates as they grow, and thus stronger incentives to underreport income. In fact, the maximum eligibility threshold of the patent tax also provides incentives to higher-income small enterprises to underreport turnover (and consequently income) in order to operate under the patent tax.

3.3. Social insurance contributions

Perhaps the major tax constraint faced by the small business in Bulgaria is the mandatory social insurance contributions (SIC). In contrast to income taxes, they remained outside the focus of tax cuts (table 5). At the rate of 42.7[20] percent in 2005, of which 70 percent is paid by the employer, Bulgarian social and health insurance contributions are high by international standards. Above all they affect small entrepreneurs as a payroll tax. In the case of natural persons, however they additionally affect them as a tax on personal business income. In both cases the cost of evading them is larger than the direct revenue losses, as it implies evasion of PIT as well. In this context, it is understandable why reduction of PIT rates cannot reduce much PIT evasion. In the case of Bulgaria, PIT reporting compliance reflects excessive SIC burden rather than high income tax rates. The former is heavier both in terms of statutory rates and in terms of tax base (as SIC are deducted from gross income). Consequently, in trying to raise small business compliance through cutting only income taxes, tax designers may be pushing the wrong button.

Table 5. Employer's SIC cost of reporting wages

Insurance of employees (% of wage)	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Pension	35.7	32	29	29	29	29	29
o/w private fund			2	2	3	3	3
Sickness/maternity leave		3	3	3	3	3	3
Accident at work [a]		0.7	0.7	0.7	0.7	0.7	0.7 [b]
Unemployment	4	4	4	4	4	4	3.5
Insolvency Fund [a]							0.5
Total Social Insurance	39.7	39.7	36.7	36.7	36.7	36.7	36.7
Health Insurance	6	6	6	6	6	6	6
Total Insurance	**45.7**	**45.7**	**42.7**	**42.7**	**42.7**	**42.7**	**42.7**
o/w employer	41.2	36.7	34.3	32.2	32.2	32.2	30.25
employee	4.5	9	8.4	10.5	10.5	10.5	12.45
CIT rate [c]	28	23.5	23.5	23.5	23.5	19.5	15
The SIC cost of reporting wages (%)	**1.66**	**4.58**	**2.74**	**1.13**	**1.13**	**6.42**	**10.71**

[a] Paid entirely by the employer. [b] The middle of five rates (from 0.4 to 1.1 %) differentiated by economic activity that replaced the single rate of 0.7% in 2005. [c] 1999 - 2000 show the lower of the two effective CIT rates.

thousand (19%) are limited liability companies. http://www.bulstat.nsi.bg/Data.html In regional perspective, the share of sole proprietors is higher than that in all CEEC except for the Czech Republic (Doudeva, 2001).

[20] This rate, which includes social and health insurance, is applied to the standard (third category) of employees. The SIC for the special early retirement first and second categories are about 30-40 percent higher, but they are not typical for the small business sector.

Table 5 indicates that tax reforms might have increased employers' incentive to hide wage expenses. SIC rates not only remained more or less intact during the years of major tax restructuring, but because of the reduction in the CIT rates employer's cost of reporting wages went up.[21] In result, the wage segment of the PIT compliance gap is driven by employers' SIC costs rather than the income tax. For about two thirds of the workforce PIT is withheld at the source. This includes full time and part time wage expenses as well as expenses on professional services, provided by natural persons, who are not registered as employees or sole proprietors. If they have only one source of wage income, employees are not even obliged to tax file returns. In practice, they cannot underreport income. Data on compliance gaps for the withheld and the self-assessed PIT are not available. Rough estimates however suggest that with about 80 percent of PIT receipts collected by withholding at the source, at least 2/3 of potential PIT revenues may be independent of the PIT rate, as the decision to report income is not made by the taxpayer but by the withholding third party. [22] Other things equal, employer's choice to report wage income is driven mainly by SIC costs.

Of course excessive SIC costs affect not only the small business. In combination with other typical constraints, however, they are strong driver of underreporting of wage expenses by micro enterprises. Most importantly in this context, many of the micro business ventures in practice encounter SIC rates that are higher then the statutory rates shown in table 5. The reason is that as a countermeasure to underreporting, the government introduced in 2003 minimum insurance income thresholds (MIITs). They act as a presumptive payroll tax differentiated according to industry and job level (see section 4.1 below). As they were introduced at 46 percent above the statutory minimum monthly wage in average, they led to higher SIC rates on all wages that are below the respective MIIT. As already noted in the previous section micro and start-up companies are paying lowest wages and are most likely to face higher than statutory payroll tax rates. Thus, MIITs provide strong disincentive to the micro businesses to employ, or register labor.

Apart from encouraging the underreporting of employees' incomes, the excessive SIC burden influences as well decision to report business income. There are about 700 thousand sole proprietors and 150000 registered self-employed, (i.e. about one third of the labor force). Unlike wage-earners, the decision to report or hide their personal income is entirely theirs. But again it is likely to be driven by higher SIC (relative to PIT) costs. Moreover, there are large disparities in the tax treatment of the different type

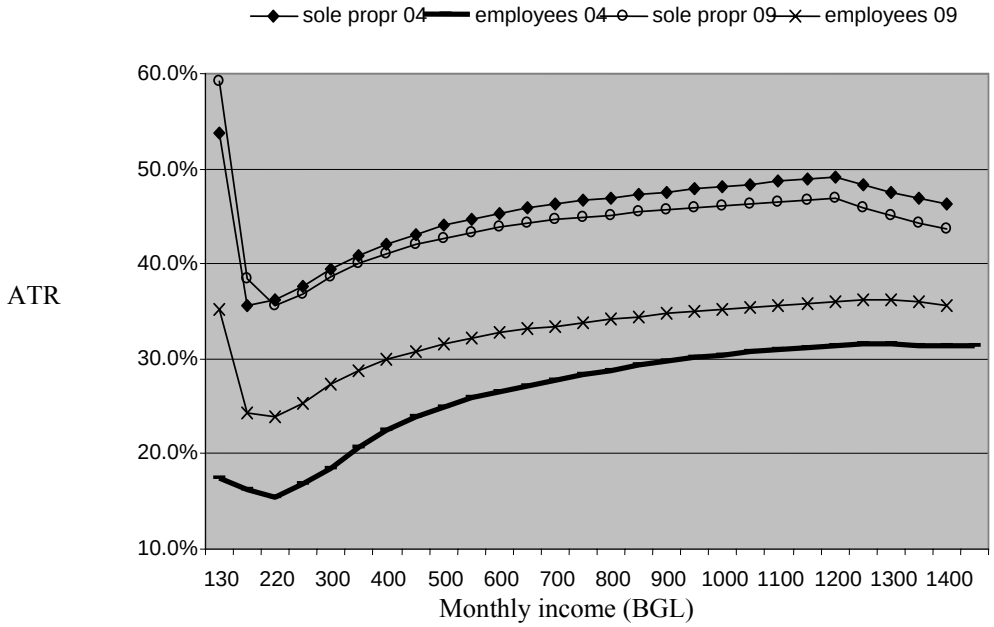
[21] The cost of wage reporting is calculated as the difference between the cost of the compulsory insurance less the savings from CIT as the wage and insurance expenses are deducted from the tax base CWR = SIC-CIT-SIC*CIT.

[22] This conclusion holds under the assumption that the incidence of the income tax falls largely on the employee, which is largely confirmed by empirical work on labor supply elasticities in other countries. Because of the large share of unreported labor in Bulgaria, reliable data on labor elasticities are not available. It may be argued, however, that in theory, if incidence falls on the employee, then, insurance contributions may not influence that much employer's decision to report wage expenses either. The large-scale actual underreporting of wages however shows that employers choose to evade the tax rather than to reduce wages. This, however, is an issue, the explanation of which requires more empirical work and space than the scope of this paper allows.

of income, with sole proprietors' and self-employed facing highest SIC rates. They pay 35 percent insurance tax on their income (which includes only pension and health insurance at that), while an employee used to pay less than third of that for wider risk coverage (table 5). A dividend earner would pay SIC based on the MIIT, while a state employee would have the SIC paid by the budget. Even when they have no income, entrepreneurs that operate as natural persons, pay a minimum insurance contribution equal to about 60 percent of the minimum wage. The unfavorable tax treatment of the business income of sole proprietors and self employed relative to wage and corporate income explains large part of the SIC compliance gap in the hard-to-tax sector of Bulgaria. According to insurance authorities, only half of the self-employed and a quarter of the farmers pay the compulsory insurance contributions (CSD 2004: 12).

Figure 1 shows that employees enjoy considerable tax advantage at all levels of income. Other things equal, with the increase of their share in SIC to 50 percent by 2009[23] the gap will decrease, but still remain significant.

Figure 1. Combined SIC and PIT rates: sole proprietors vs. employees 2004-2009



The figure projects only the effect of the change in the shares of the employer and employee contributions from 70/30 respectively in 2005 to 50/50 in 2009. All other parameters are assumed to remain in 2009 as of 2005. Employee's MIIT is assumed equal to the MIIT of self-employed.

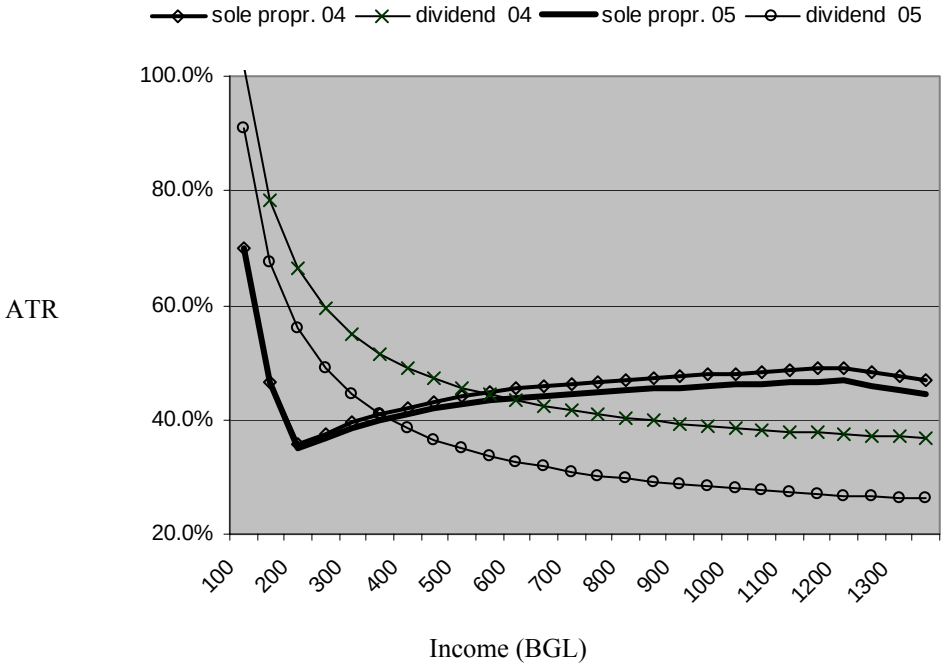
The tax disadvantage of sole proprietors in regard to income from dividends is even increasing with the 2005 reductions of the CIT from 19.5 to 15 percent and the dividend tax from 15 to 7 percent. Figure 2 illustrates the "opening scissors" between

[23] The shares of the employer and the employee are fixed in the Social Insurance Code as follows: 80:20 in 2000-2001; 75:25 in 2002-2004; 70:30 in 2005; 65:35 in 2006; 60:40 in 2007; 55:45 in 2008; and 50:50 from 2009 on.

sole proprietors' and dividend earners' average cumulative (i.e. including SIC) income tax rates.[24]

A preferential tax treatment of capital versus personal income is usually justified on efficiency grounds as an instrument to encourage investment and entrepreneurship. It may be a result as well of international tax competition and efforts to attract FDI or prevent capital flight to lower tax areas. To what extent might this increasing disparity promote entrepreneurship and increase investment is questionable in a transition country, where 4/5 of all business entities are natural persons. It is even more difficult to justify the preferential treatment of employee's income, relative to income from sole proprietorship and self employment.

Figure 2. Taxation of sole proprietor's income versus dividend income 2004-2005



[24] A sole entrepreneur's taxable income is calculated according to the CIT law, but taxed according to the PIT law after paying and deducting 35 percent SIC. In the case of income from dividends, the company pays CIT (19.5 percent in 2004 and 15 percent in 2005), and the distributed profit is subject to a dividend tax at the rate of 15% in 2004 and 7 percent in 2005. Dividend earners pay as well SIC on a minimum insurance income of BGL200 in 2004 and BGL220 in 2005. For illustration it is assumed here that the company owner is indifferent between company tax cost and his personal tax cost. In reality, the owner may have stronger incentives to transfer tax cost to the company, but this will only reduce his personal cost and reinforce the conclusion. Furthermore, s/he might choose to take an executive remuneration up to the amount of the MIIT, so that the company can benefit from CIT savings, while the shareholder will benefit from sharing the SIC cost with the company. But this again would only open further the scissors in figure 2. The underlying assumption in this comparison is that the company owner does not have an incentive to take executive remuneration instead of dividends above the level of MIIT, as the combined weight of PIT and SIC is higher than the combined weight of CIT and dividend tax for any level of income.

3.4. The cost of regulatory and administrative deficiencies

Apart from the direct costs of taxation, taxpayers incur the cost of complying with the tax laws.[25] Administrative deficiencies and legislative inconsistencies make these costs quite high for the small business in transition countries. Furthermore, as already argued in section one, they are regressive and thus have stronger negative effect on compliance of small relative to big business.

In Bulgaria however, small businesses may encounter higher compliance costs in absolute terms as well. They stem from the complexity or incompleteness of their tax treatment. The income taxation of sole entrepreneurs is a case in point. As noted above, taxable income is calculated according to the provisions of the CIT law on accrual basis, but taxes are paid according to the rate schedule of the PIT law, which defines income on cash basis. Insurance income is also based on CIT legislation, and is equal to gross personal income. Even the patent taxpayers are obliged to keep accounting records in line with the CIT law for the purpose of SIC payments.

Further to regulatory flaws, higher compliance costs borne by the micro business ventures stem from the lower quality of administrative services provided to them. In general, the concepts of better compliance management through improved taxpayer services and risk assessment are relatively new for Bulgaria. They have become a priority of tax administration reform only in the context of the launching in 2006 of the new unified revenue agency. As for the present, they may be more in effect in the large taxpayer unit.[26] Services to the micro businesses are supplied by the smallest administrative units in the periphery of the tax administration. They suffer most from the typical for transition countries shortage of skilled staff and information technology resources and delayed decentralization reforms. Enforcement there is also hard to monitor and control internally.

Consequently, constraining tax evasion in the hard-to-tax sector has been oriented primarily on stringent law enforcement, driven largely by the presumption that non-compliance is the norm rather than the exception. A governmental program on improving tax collection for the period 2001-2005 is a good illustration of this bias. It contains mainly measures towards "strengthening the control (ex-ante and ex-post)". There is neither any mentioning of reduced compliance costs through better risk management and efficient taxpayer services, nor any measure towards curbing administrative corruption. Instead, in obvious discrimination against small companies, this program envisages exclusion from public procurement bidding of companies that have not reported profits above some fixed minimum thresholds.[27] A notorious example of an administrative bias towards sanctioning rather than servicing the taxpayer is the treatment of VAT refund. The tax office refuses VAT refund to compliant taxpayers, if there is a non-compliant taxpayer somewhere in the transaction chain.

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[25] On the definition of compliance and administrative costs see Sanford et al (1989: Ch 1, pp3-23)

[26] Bulgarian large taxpayer unit was established in 1997 and after somewhat long path towards centralization and optimization of its size, in 2003 includes 478 companies, which provide 58 percent of tax revenues (66 percent of central taxes), employing only about 1.5 percent of tax administration workforce.

[27] www.minfin.government.bg

Despite the priority attached to detection and punishment, the two major policy parameters of enforcement – the penalty structure and the administration of control seem far from optimal and more likely to generate briberies than to deter evasion. The penalty structure for instance does not establish a link between the penalty and the concealed income or the evaded tax. The legislation fixes instead the floor and the ceiling of the penalty in absolute terms,[28] leaving the actual amount to be decided by the administration. On the one hand in the context of the classical models of tax evasion, this increases the uncertainty in regard to the cost of detection. But on the other it leaves much room for administrative discretion and corruption, making compliance choice much more a function of taxpayer's estimates of his chances and costs of working out a deal with the auditor. Furthermore this penalty structure is regressive. Above the statutory ceiling the marginal penalty rate is zero, which in fact encourages large-scale evasion.

As for the administration of audits and inspections, enforcement appear to be biased to expanding the coverage and intensity, rather than improving selection. Business surveys report excessive frequency and duration of tax and social insurance inspections. [29] In addition, requirements for monthly and quarterly filing and lack of online services result in large proportion of staff time and resources being spent on filing and reporting to tax and insurance authorities. In brief, instead of reducing compliance costs, Bulgarian tax administration has been trying to enforce the law through more stringent advance payments and filing requirements (what is labeled "ex-ante control"), and increased number and duration of audits and inspections. This bias in fact creates more opportunities for corruption and increases the cost of collection incurred by compliant taxpayers. It is worth noting, that according to FIAS (2004) survey, Bulgaria ranks first among comparator transition countries in indicators like time spent with the administration (the time tax) and the percentage of sales paid in bribes (the bribe tax). Furthermore, the bribe tax is much heavier for the small enterprises. While large firms report a bribe tax of 4 percent in average, the micro enterprises report that 6 percent of their sales are paid in bribes.[30] This result suggests that micro ventures are much more exposed to corruption pressure. The large business is protected in many ways from random bribe extortions by the services of experienced accountants and lawyers, politicians and high-rank administrators, and in general has larger opportunities to avoid taxes.

Tax corruption and inequitable enforcement of the law entails as well another important cost of administrative deficiencies borne by compliant micro businesses in transition countries – i.e. the cost of competitors' non-compliance. Competitors' competitive advantages in result to non-compliance is in fact a bigger challenge to compliant small businesses relative to the time and money they spent on compliance. Surveys of the leading constraints to investment in Bulgaria rank unfair competition (which includes competition through tax evasion as well) above the burden of tax rates (Vitosha Research 2004a; FIAS, 2004). Similarly, an OECD (2003) report finds that small business owners in Bulgaria are especially sensitive to the administration's failure

[28] The penalty for underreporting of income for instance ranges from BGL100 to BGL1000.
[29] See for instance FIAS (2004) and Vitosha Research (2004b) for recent data.
[30] Data refer to overall corruption costs, not tax compliance only.

to enforce tax laws. It registers as well wide spread perceptions that law enforcement favors large enterprises. In the context of our analysis, perceptions of unfair competition (through non-compliance) appear to be strong driver of tax evasion in transition countries parallel to the direct cost of compliance.

4. Presumptive taxation: theory and practice

4.1 Efficiency and equity

A presumptive or imputed tax is generally a proxy for the standard tax, which is applied when the tax base is too small or hard to verify, due to limited administrative resources, or improper accounting practices. According to a definition by Ahmed and Stern (1991), "The term presumptive taxation covers a number of procedures under which the 'desired' base for taxation (direct or indirect) is not itself measured, but is inferred from some simple indicators which are more easily measured than the base itself." For instance, in its most common application as a proxy for income tax, tax liability is based on the presumed capacity to earn income, measured through indirect indicators, rather than on actual income. In this context, a presumptive tax is largely a tool that addresses administrative inefficiency (i.e. high cost per unit of revenue). It may reflect low revenue capacity of the taxpayer or high propensity to evade taxes. This implies that presumptive taxation is best used to reach the hard to tax sectors of the economy, such as the small business, agriculture or service sectors, self employed, as well as sectors or cases, where compliance gaps are above the average.

Presumptive taxes are among the oldest taxes. Earliest forms date back to the 18th century when assets were the major source of income.[31] Back then taxes were based on measures of wealth rather than income: size or value of land and other assets, including number of doors and windows as an indicator of the value of residence and the living standards. Last two centuries witnessed profound changes in earning patterns, with increasing share of income and wealth generated through supplying labor, capital and fixed assets through the factor markets in return for wages, interest, dividends and rents. The emergence of the "social state" in the 20th century in turn raised the significance of equity considerations and drove the move to progressive taxation. In result, taxation evolved away from taxes based on measures of wealth towards taxes based on actual earnings in its various forms. On the other hand, equity objectives required globalization of income, i.e. taxing total income, rather than its separate components (the so called "schedular" taxation). Furthermore, with the development of accounting, tax collection evolved towards system of self-assessment of liability and filing tax returns.

The last decades of the 20th century marked certain departure from the principles of self-assessment and globalization of income. Wherever possible, taxes would be withheld at the source, while indicator-based presumptive taxation was brought back to active use. The driver of these new trends in tax collection is above all the fast expansion

[31] Sadka and Tanzi (1992) refer to a 1760 introduction of agricultural tax based on the value of land in the Principality of Milan as the origin of presumptive taxation. See as well Tanzi and Casanegra, (1987) for historical background

of the shadow economy around the world. The challenges of reducing tax evasion required that compliance and enforcement management distinguish better between different types of earnings and taxpayers and related risks and costs. Large taxpayer units became indispensable part of tax administration reforms in transition economies, while small taxpayer compliance and enforcement were addressed through various forms of imputed or presumptive taxation.[32]

Presumptive tax aims at improving the efficiency of collection by targeting three groups of effects: a) reducing taxpayers' compliance costs; b) reducing the administrative costs of compliance and enforcement management; and c) bridging the way from informal to formal activities and from assessment based on indicators to self-assessment based on actual income. In practice, the relative weight of these objectives in the policy mix may vary substantially across countries according to the level of market and institutional development; the average quality of company management, and the capacity of the tax administration.

In line with above formulated policy objectives, the major benefits of a presumptive tax are the reduction of compliance gaps and of the share of the grey economy. Furthermore, a presumptive tax is believed to reduce the opportunities for corruption, as it minimizes the direct interaction between taxpayers and tax inspectors.[33] The tasks of the administration are essentially reduced to ensuring that the eligibility and payment terms are observed. Self-assessment and reporting compliance is irrelevant.

Apart from gains in administrative efficiency, there are other important efficiency and equity consequences. Even though incentives and equity gains should not be the prime targets of the introduction of a presumptive tax, positive and negative efficiency and equity effects are important in identifying the related costs and benefits.

The recognition in the literature of the efficiency advantages of taxes based on average earning capacity rather than actual earnings dates back to the first half of the 19th century.[34] The argument is essentially that taxpayers have an incentive to produce above the average level because the marginal tax rate on these additional earnings is zero. Thus, it is a regressive tax: higher income is taxed at a lower average rate, as measured in proportion to actual income. Furthermore, there might be efficiency gains from the reduction of the excess burden generated by tax evasion.[35]

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[32] For recent update on accession countries see EC (2004), for overall survey of transition countries see Engelschalk (2004)

[33] This is not true, however in the cases when the tax is set through negotiations between the tax collector and the taxpayer (see next paragraph)

[34] Sadka and Tanzi (1992) refer to the work by Carlo Cattaneo in 1839, where he praises the effect of the land tax in the principality of Milan as punishing leisure and stimulating efforts, and thus leading to the economic prosperity of the principality of Milan after its introduction. These ideas were further developed in the works of Luigi Einaudi in the 1920s and 1930s, and by Maurice Allais in 1977.

[35] A model by Alm and Martinez-Vazquez (2003) illustrates that this excess burden may be quite large depending especially on demand elasticities.

The efficiency potential of a presumptive tax should not be overestimated. There are inherent risks in presumptive tax design that may drive it away from efficiency. In a transition economy equity concerns may have more weight in policy making as they are more appealing and easy to grasp by the majority of voters than concerns about excess burden. Accordingly, the presumptive tax falls under pressures towards more equity. They usually lead either to multiple presumptive tax rates that seek to differentiate among groups of taxpayers with different earning capacity, or to the use of some quantity or value indicators, such as lump sum tax per square meter of shop floor, or tax per value of assets or gross receipts. In both cases equity-oriented differentiation inevitably drives tax design away from simplicity and efficiency. Thus, if the tax is differentiated by number of employees or number of equipment, it may discourage investment or employment.

Equity implications are far from straightforward either. The rationale behind presumptive taxation is that if compliance rates are low, it is a closer approximation of the ability to pay than standard taxation. In this sense it improves horizontal equity by reducing the disparity between compliant and non-compliant tax-payers (e.g. wage earners and self-employed). But at the same, it may deteriorate horizontal equity between eligible and non-eligible taxpayers. The impact of presumptive tax in terms of vertical equity is even more ambiguous. If there is no taxable income threshold, (or it is set too low), presumptive tax in practice deteriorates vertical equity, as it reduces the effective progressivity of taxation. The same effect is in place if there is no upper (eligibility) threshold, or it is set too high, or is not well enforced by the administration. Furthermore, high eligibility threshold entails two risks. It either calls for multiple tax rates, or in the case of a single rate, based on average income capacity, it is either too high tax hurdle for small companies, operating in the informal economy, or too strong temptation for large companies operating under the standard tax regime to go under the shelter of presumptive taxation.[36] In brief, the equity consequences of a presumptive tax would depend on the incentives and opportunities that it creates for informal entrepreneurs to go formal, and for larger taxpayers to avoid or evade taxes by filing under the presumptive tax. If tax design, including rates and eligibility threshold, are set at a level that brings more companies above the borderline between underground and legal economy, the impact may offset the impact of regressivity. If tax rates and threshold are set so high that it essentially urges outflow of small companies into the informal sector, while providing legal opportunities for large companies not to report their actual income, then it effectively leads to losses of equity. This brings forth the importance of the sector dimension. When applied to sectors with high rates of tax evasion, it improves equity and collection efficiency, but this may not be the case in sectors with high compliance rates and lower audit costs.

The equity impact of presumptive taxation is made even more uncertain due to the issue of incidence of tax evasion. All above considerations are based on the assumption

[36] In the latter case, if tax evasion under the standard net results in effective rates that are below the presumptive tax rates, then higher eligibility threshold may improve collection rates and vertical equity, if it is unconditional. If the presumptive tax is optional, then the choice of the larger companies would depend on the level of the presumptive tax and the cost of tax evasion including risk, bribes, the cost of parallel accounting etc.

that tax evaders benefit exclusively from the advantage to evade taxes. As noted by Martinez-Vazquez (1996), the benefits of tax evasion can be largely reduced, or even eliminated in the process of adjustment of relative prices. The incidence would depend on the opportunities to enter and compete on the market of the untaxed good or service. Under excess supply of services, the failure to tax for instance repair workers (e.g. self-employed plumbers), may benefit the users rather than the providers of the services.

The precarious tradeoffs between efficiency, equity and revenue objectives in the design of a presumptive tax have important implications in regard to its costs. Even though it is introduced as a simple tax meant to improve collection through reduced compliance and enforcement costs, it falls under constant pressures towards equity adjustments in its coverage, rate structure and indicators. This may not only drive it away from the original objectives of simplicity and efficiency, making it hard to enforce and comply with, but entails significant policy-making costs as well. The Bulgarian patent tax, examined below is a case in point. Despite its very small share in revenues, it has been often in the center of tax policy debate, subject to pressures from professional groups and stakeholders towards various improvements and adjustments. Apart from diverting disproportionate share of administrative and legislative resources, these adjustments do not contribute to the stability and predictability of the tax environment.

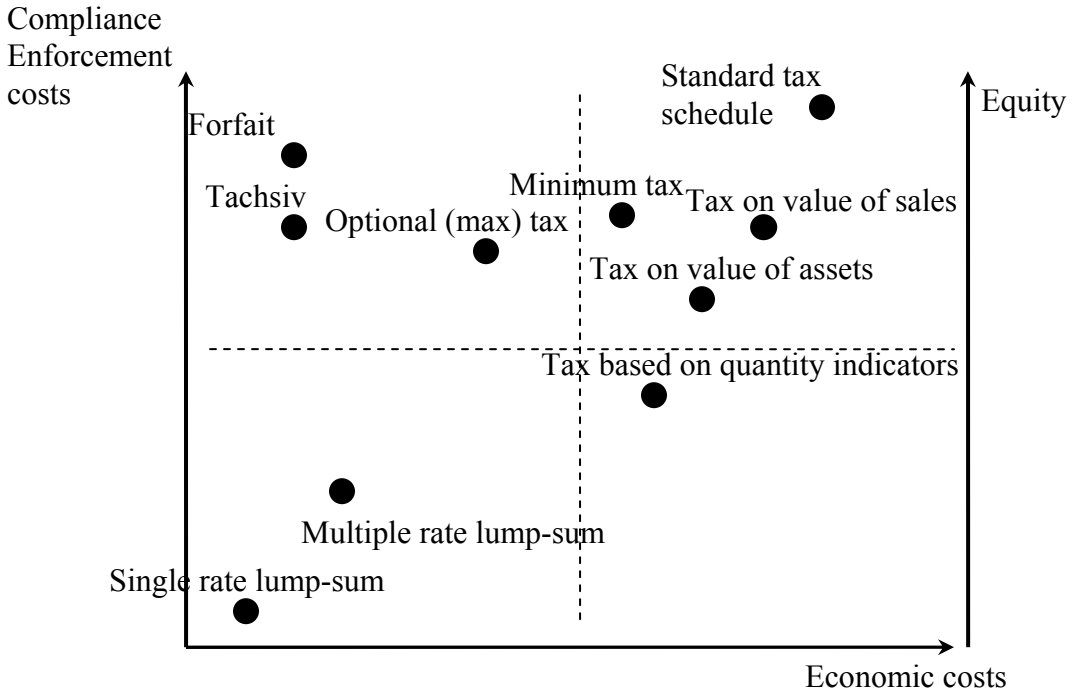
4.2. Types of presumptive taxation

Presumptive taxes can be divided into three broad categories according to the indicators they use: a) lump-sum taxes; b) taxes based on indirect quantity indicators of income capacity; c) taxes based on indirect value indicators of business performance. Besides, a distinction can be made between taxes that are based on agreement with the taxpayer, those that are rebuttable, and those that allow the taxpayer to choose between the presumptive tax and the standard tax. Accordingly, a presumptive tax may fix the minimum tax liability, or may have the effect of providing a tax ceiling as a maximum tax. These types are examined below with reference to international experience.[37] Actual tax designs may combine various elements of them. For instance, lump-sum taxation may divide taxpayers by occupation, or product and services, but may go further along the equity scale by setting multiple rates within the industry based on location of the activity, size of the business, or sales volumes. Or, in the cases of negotiable assessment, taxpayers and tax authorities may use a combination of above criteria to agree on the amount of tax liability. Therefore generalization or distinction between the various types is far from absolute. It rather aims at identifying the benefits and costs of various policy choices, rather than analyzing actual designs. This paragraph discusses the tradeoffs between efficiency and equity of presumptive taxes, starting from forms that are simple but not that fair, and going through various mixes of simplicity versus fairness to forms that are fair but not simple at all. This path may be very close to the actual life-cycle of a presumptive tax, whereas improvements, adjustment and fine-tuning lead to a sophisticated tool that is a negation of the original objectives of simplicity and efficiency. As already noted, the likeliness of such a bias in tax design stems from the very nature of the political economy of taxation in transition, where fairness and equity considerations may override efficiency arguments. Figure 3 is an attempt to a very rough illustration of

[37] See as well Bulutoglu (1995); Thuronyi (1996) for overview

these tradeoffs. Efficiency is divided into administrative efficiency and allocative efficiency or the excess burden. Administrative efficiency reflects the cost of collection incurred by the private sector (i.e. voluntary compliance costs); and by the public sector (i.e. enforcement cost). The figure hides tradeoffs between compliance and enforcement costs, or between horizontal and vertical equity and therefore is far from complete or precise graphical presentation.

Figure 3. Types of presumptive taxes: Efficiency and equity



The lump-sum tax is the simplest form of presumptive taxation. It is as well most widely used in transition and accession countries. Lump-sum taxation of small business has been applied in Hungary, Poland, the Czech Republic, Slovakia, in most Balkan countries and in many of the former Soviet republics. In the extreme form of a poll tax, it has no relation whatsoever to actual or potential income. Thus, it does not affect behavior unless taxpayers can easily move to other tax jurisdiction. Despite its superiority in terms of efficiency, it belongs to the theory rather than to the practice of modern taxation. Usually lump-sum presumptive taxes try to achieve some degree of equity through differentiation among groups of taxpayers. Groups are delineated by economic activity or profession, and the tax liability is set according to the average income potential of the respective group. As already noted, the regressivity of this type of tax may have strong incentive effects. It is noteworthy, however, that if not set at the proper level, it may discourage informal and start-up entrepreneurs to go formal. Thus, the practical application hinges crucially on the proper setting of the tax level. This is not an easy task, as the administration may not have reliable information on the average profitability of the industries. Moreover, these levels may be highly volatile in emerging markets, or a taxpayer may not easily fit into a single category or economic activity. In result, such estimates in practice may depart significantly from the optimal tax level. If it

is overvalued, it will act as disincentive to go formal, or cause outflow of resources to other activities. Moreover, the assumed average level of earning capacity is hard to achieve at he start of the business. Furthermore, as already noted, this tax design is susceptible to fairness-driven adjustments. As it evolves from simplicity towards more equity, and if upward adjustments prevail, this leads to higher tax barriers to business start-up, and may drive resources away from optimal allocation.[38]

Quantity indicators are used as a measure of taxpayers' production and income potential, and are superior to the single or multiple fixed rates in terms of equity and fairness. They are based either on the size of production facility (e.g. size of shop, restaurant, or arable land), or on the quantity of equipment, such as number of beds in a family hotel, number of seats and tables in a restaurant. They may be based as well on the number of employees. Some of these indicators may be used directly for calculating individual tax liability: e.g. fixed sum per square meter, or per seat in a restaurant. They may be used as well for setting the tax brackets of the multiple rates. This type is similar to the single or multiple-rate lump sum tax. The latter, however, derives the estimate of the capacity to earn income from indicators that are related rather to the demand side and the environment in which the entrepreneur operates: i.e. type of product or service, location, etc. Quantity indicators focus on factors that are internal for the entrepreneur, estimating individual supply capacity. A tax based on such indicators, however, is in effect a tax on the expansion of the business. Furthermore, there is the administrative cost of inspections verifying that actual number of employees, or of seats and tables in a restaurant corresponds to the reported number. Therefore, they create more opportunities for corruption and tax evasion relative to audits of written accounting records.

Value indicators are a further step towards more individual setting of the tax liability, and thus towards more equity and fairness. Often they are based on the value of assets, or the value of gross receipts or some combination of the two. Taxes on gross assets were introduced in Argentina and Mexico in the early 1990s[39] Taxes on gross receipts for small enterprises are applied by Romania and Serbia on the Balkans, and Azerbaijan, Kyrgyzstan and Uzbekistan. Compared to fixed-sum and quantity indicator taxes, they seem a superior measure of individual ability to pay, as they provide indirect measures of actual business performance rather than of capacity to earn income. But they may still be inferior relative to the standard system in terms of equity. The asset based tax, for instance, ignores income spent on consumption. In the case of a tax, based on gross receipts, similar turnover may account for considerable income disparities across sectors and products. Furthermore, even within the same industry, income may vary over

[38] There are supply-side rigidities in the sector of the small business and the self-employed that reduce the probability of such reallocation of resources compared to owners of capital for instance. Often the "resources to be shifted" are limited to the land or shop they own, or the service skills and specialization and the customer relations they have built over the years. Therefore closing the business, or going informal is more probable response to upward adjustment in the level of presumptive taxation, rather than shifting resources to another activity. However the latter response is not excluded if the presumptive tax structure has been driven to excessive differentiation across retail products, or activities that can be substituted at minimum cost: e.g. restructuring a video-rental shop into a coffee shop as a response to a rise in the presumptive tax of the former.

[39] See Tanzi and Sadka (1992) for analysis of this type of presumptive tax.

time. Accordingly, equity concerns expose it to pressures towards multiple rates, and their repeated adjustments and corrections. In result it may be neither simple nor a stable substitution of the standard income tax.

Disincentive effects of the value-based presumptive taxes are not to be ignored either. A tax based on the value of assets may not only discourage an increase of the equipment, but more importantly its replacement by new equipment. But on the other hand it encourages best utilization of the existing capacity, which may have positive efficiency and employment effects. The major efficiency problem of a tax on gross receipts is its cascade effect, i.e. multiple taxation of the same base in the process of production and exchange between companies (Thuronyi 1996). It creates incentives for vertical integration. A firm which unifies several stages of the production process bears lower tax burden than specialized separate companies that trade inputs and intermediate goods with each other. Finally, compliance and enforcement costs are higher than the previous two types, as the use of values of assets or sales as proxies for actual income requires some form of individual bookkeeping and reporting. Thus, the enforcement of a tax based on the value of gross receipts relies on proper recording of sales, even though the main reasons for a resort to presumptive taxation is that gross income is not properly reflected into the books. Therefore it does not reduce substantially the compliance and enforcement costs of audits and inspections except for the need to verify expenditures.

Negotiable assessment is perhaps the most sophisticated form of presumptive taxation. It is superior to all in terms of fairness and incentives. Its famous representatives are the *tachsiv* of Israel and the *forfait* of France, which have been emulated by Spain, Turkey and other countries. These are presumptive tax systems that pull together various elements and indicators of presumptive taxation in comprehensive guidelines to agree on income and liability assessment. The French *forfait* is among the most referred to modern form of presumptive tax. In the 1960s it expanded in scope to about a million individual entrepreneurs, but its relative importance declined since then. (Thuronyi 2003) The forfait has been applied to eligible entrepreneurs whose turnover does not exceed a specified ceiling. Assessment of potential income is based on actual data on the business performance in the preceding year. In this regard it overcomes the flaws inherent to fixed tax treatment. Data include purchases, sales, year-end inventory, number of employees and wage bill, as well as assets. The only missing element of production costs and revenues is business services and general business expenses, which are imputed by the tax administration. The forfait is applicable only through an advanced agreement between the taxpayer and the administration, after which it is not rebuttable. Taxpayers can opt for the standard taxation instead of the forfait, but this commits them to actual income taxation for at least three successive years. The advantages of the forfait are in the fact that once the liability is agreed upon, it provides an incentive to the taxpayer to produce above the respective output level where the marginal tax rate will be zero. Besides, it is not rebuttable as it is based on agreement with the taxpayer.

The major problem of the forfait-type arrangement, especially for a country in transition is that its efficiency hinges on objective administrative assessment, which in turn depends on information methodology and technology, but even more critically, on

the professional integrity and on the efficiency of the internal checks and balances of the administration. In brief, it requires administrative capacity, which might not be in place in an emerging market economy. Lacking such capacity, excessive administrative discretion in tax setting may only increase opportunities for corruption and tax evasion, rather than lead to more equity and efficiency. Even for an advanced country this method raises questions, as the rate of tax evasion, which is the main reason for presumptive assessment, is significantly correlated to the level of administrative corruption (Alm and Martinez-Vazquez, 2003). This means that if a country has administration that is capable of running the forfait, very probably it does not need so much the forfait.

The tachsiv in Israel might be more appropriate for a transition country.[40] It has the advantages of a negotiable arrangement, but negotiations are collective, rather than individual – they are conducted between respective business organization and the tax administration. Such a system minimizes the corruption opportunities by eliminating direct individual interaction in the contracting of the tax liability. The major specific of the tachsiv is that it allows individual taxpayers to opt for it or to pay taxes according to their actual records. This makes it a *maximum income tax*. Taxpayers pay it when the liability, based on actual income exceeds the tachsiv. Otherwise they would use the standard self-assessment method. As a ceiling tax, it has all the efficiency advantages of a zero marginal tax rate over the respective income level, and all the equity disadvantages of a regressive taxation. Its revenue capacity is also limited to a fixed ceiling.

A major problem with the tachsiv seems to be that it does not provide a bridge to the standard schedule. On the contrary, as the company grows, keeping good records for tax purposes becomes unnecessary, while, conversely, for small companies, which are less capable of keeping books, it is important so that they can choose the lower of the two liabilities. Therefore, if tax policy seeks to achieve a minimum compliance cost for micro businesses and efficient and fair taxation of larger businesses an optional presumptive tax may not be the best tool.

Many administrations would use rather a *minimum* presumptive tax to that end. In this case the presumptive tax sets the minimum liability. In the case of maximum tax taxpayers have the incentive to keep records in order to be able to choose the lower of the standard and the presumptive tax liability. In contrast, under the minimum tax, taxpayers are obliged to keep records, so that the two tax liabilities are compared, and they pay the higher one. Its primary objective is to guarantee some target level of revenues and horizontal equity. Consequently, it is not optional and is hard to fit into the common notion of presumptive taxpayers as "eligible beneficiaries". While the classic type presumptive tax seeks to find a more reliable estimate of income based on some informative indicators, the minimum tax ignores equity concerns below the level of income presumed by the tax rate, and uses the standard schedule to attain equity above it. Thus, it gives priority to simplicity and incentives at the lower levels of income, and to equity and fairness at the higher levels of income. If it is overvalued, it may be a high barrier into the formal economy. Its major advantage is that it provides a natural transition to the standard tax net. However, it does little to reduce compliance and audit

[40] See Lapidoth (1977), for a more detailed discussion of the tachsiv

costs. Small compliant companies not only need to keep books of accounts, but face higher average tax rates when their income is below the presumed minimum.[41]

Under some presumptive taxes the taxpayer is allowed to rebut the assessment. On the one hand, this seems to be a further move towards equity. But its administrative costs, including corruption opportunities need not be ignored.

5. The Bulgarian experience with presumptive taxation

Bulgaria applies two presumptive taxes[42]. The older is *the patent tax***,** introduced in 1998 along the lines of the classic IMF policy advice on tax administration reform.[43] The recent one is a minimum tax on labor expenses, introduced in 2003 as *minimum insurance income thresholds (MIITs)*. Apart from them, there are various elements of presumptive taxation in the business tax structure of Bulgaria. The personal income tax for instance, has statutory expense deductions for self-employed farmers (70 percent) professionals (35 percent) and rent earners (20 percent). There are presumptive tax arrangements in the CIT law as well. Insurance companies, organizers of gambling and lottery games, and telecommunication service providers pay corporate taxes on their gross receipts[44]. Since 2005 the sea cargo industry is given the option to choose between paying corporate tax based on the capacity of the ship, or on the standard tax base.

The common feature of these presumptive taxes and methods of defining the tax base is that all of them seem to be more or less a policy response to enforcement failures rather than an instrument for raising voluntary compliance of small entrepreneurs. The elements of imputed taxation in the corporate income tax do not target the small business at all. The MIITs are applied to all employers irrespective of their size, but place at a disadvantage the smaller ones. The patent tax is targeted at the small business, but its effect in terms of revenue efficiency through reduced compliance and enforcement costs is far from certain. The MIITs and the patent tax are discussed in the next two paragraphs.

5.1. Minimum insurance income thresholds

The MIITs were introduced in 2003 as a countermeasure to wide spread practices of insuring employees at the level of the statutory minimum monthly wage instead of the actual wage. Underreporting of wages resulted in widening pension fund deficits. MIITs were set by sectors and job categories at levels supposedly closer to the actual wage levels. In result the economy average MIITs exceeded the minimum wage by 46.4 percent (table 6). The differential has shrunk since the introduction, but this reflects

[41] The inequity effect of a minimum tax on the lowest income levels can be partially overcome by non-taxable income threshold. The requirement of keeping records allows that these records are used to exempt from taxation micro companies and self-employed, whose income does not exceed certain minimum.
[42] Where not otherwise indicated, this section reflects effective tax legislation in 2004.
[43] The patent tax was introduced almost simultaneously with the establishment of the Large Taxpayer Unit. On IMF reform framework see for instance Tanzi and Pellechio (1995)
[44] Effective from 2005, however, the tax on gross insurance income (insurance premiums) has been replaced by standard CIT.

unprecedented 25 percent increase in the minimum wage in 2005, rather than keeping taxes low. In practice they operate as a lump sum minimum presumptive tax on labor expenses. Actual wages, in the range between the minimum monthly wage and the minimum insurance income threshold are taxed at regressive average tax rates above the statutory SIC rates of 42.7 percent. Large wage disparities between the micro business sector and the rest of the business economy indicate that micro business ventures are most likely to encounter these excessive tax rates. Moreover, even though large enterprises may have large share of low paid workers too, they have better opportunities to spread these excessive costs on the whole labor force, including through underreporting higher wages. Therefore rising MIITs together with rising minimum wage requirements provide strong incentives to the micro business to employ unregistered or part time labor.

The short time since the introduction of the MIITs, as well as the lack of compliance data do not allow conclusions about their effect on small business compliance. In 2003 SIC revenues soared reportedly by 40 percent relative to 2002. Part of this remarkable growth however, must be credited to the simultaneous introduction of the requirement for preliminary registration of employment contracts, and the related wide scale labor inspections. Furthermore large part of the growth reflects the increase in the effective tax rates of compliant taxpayers, rather than increased compliance. Table 3 shows that MIITs adjustment have in fact substantially increased the average payroll tax rates. In only two years average MIITs rose by 14.8 percent, exceeding almost twice the rate of CPI inflation over the same period.

Table 6 Minimum insurance income thresholds

	2003	2004	2005
Number of categories			
Economic activities	48	55	68
Job and qualification	9	9	9
Average MIIT (BGL) [a]	161	172.94	184.85
Statutory minimum wage (BGL)	110	120	150
MIIT/minimum wage (%)	146.4	144.1	123.23

[a] Estimates from Gancheva (2004b)

Even though it is too early to identify the impact of the MIITs on small business compliance, there are certain risks in this regard that are apparent even at this preliminary stage. First the MIITs provide opportunity for the administration to raise effective rates, which has been actively employed in the first two years. Rising minimum wage requirements together with rising MIITs provide strong incentive to employers either not to register labor, or to use full-time employees as "part-timers". Moreover, annual upward adjustments create expectations of growing labor costs for low-paid workers.

In principle MIITs are set in consultations between the government, the business and the syndicates. Agreement between the three parties however, is not a prerequisite for raising the MIITs levels. Moreover, the small business, which is most affected, is not adequately represented in these tripartite consultations (EC, 2003:84; EC, 2004:98). According to National Social Insurance Institute (NSSI) reports MIITs are not overvalued. This conclusion is based on the observation that in 2003 only in 5 of the 55 MIIT sectors actual reported insurance income is in average below the minimum

thresholds (Gancheva 2004a) Among those are the sectors of retail trade, hotels and catering, and construction. This is explained by the large share of part-time workers in these sectors, which are not subject to MIITs. In fact these are the sectors with highest concentration of micro businesses and lowest average wages. The large share of part-timers may be an indication that the MIITs are too high barrier to employing or rather registering full-time employees. The NSSI admits that a large part of SIC is evaded through reporting full-timers as part-time employees, as this is less likely to be detected than the use of non-registered labor. Furthermore, reference to reported insurance income is hardly indicative, as it does not provide information on the share of wages below the minimum tax. Finally, they fail to capture those wages that remain unregistered.

Second, this design is susceptible to ever-lasting adjustments and growing complexity. In 2003 the new system was launched with 48 groups of activities, and 9 qualification or job levels. By 2005 it expanded to more than 600 rates.

Third, the effect of the MIITs in regard to compliance at the higher wage/income levels is far from certain. Practically it addresses only evasion at the lowest wage levels. As for the higher wage levels it may even create perverse incentive to increase underreporting if the MIITs are perceived by employers as the safe lower limit of underreporting of wages. Previous attempts to raise compliance through minimum wages and minimum import prices indicate that in the absence of complementary efficient inspection practices, reporting levels tend to adjust in average down to the levels of the statutory minimum levels. The short time span since the introduction of the MIITs and the annual adjustment in their level does not allow to test this hypothesis in regard to wages.[45] Such a response at the higher wage levels however is likely, given the reduced probability of detection of disparities between the reported and actual wages of the upper segments of wage earners, as well as disparities between actual responsibilities relative to the registered position. There is also strategic incentive to underreport wages, as MIITs are set on the basis of reported insurance incomes in the previous year. In other words higher reporting compliance on average this year means higher MIIT for the sector next year.

The limited collection capacity at the higher wage levels entails also the risk of excessive reliance on upward adjustments of the minimum tax. As the administration is unable to assess the actual wage levels, or to enforce the MIITs according to actual positions, its only option would be to raise the MIITs towards what is perceived as a better approximation of actual average payments. This would further aggravate the problem of excessive taxation of the wages that are below the MIITs level. The response of the companies that rely mainly on unqualified labor would be either not to register their employees, or to use them as part-time employees.

[45] Moreover it is difficult to know whether the narrowing of the differential between the average sector wage and the MIITs is in result of upward adjustment of the MIITs towards the actual wage levels, or downward adjustment of reporting towards the administratively set MIITs.

It is noteworthy in this context, that in contrast to the logic of tax administration reforms, payroll tax collection efforts targeted first the small rather than the big taxpayers. Attempts to collect arrears from large SIC debtors and to separate administratively large taxpayers started after the introduction of the minimum presumptive payroll tax. In this context, the MIITs was largely interpreted by small entrepreneurs as an attempt by the administration to collect from employers who pay minimum wages, what it fails to collect from larger tax evaders and debtors.

Obviously, there is a need for differentiated approach in the application of MIITs. First of all, tax administration should focus its resources on establishing a large taxpayer unit for SIC as well, and enforce the law in regard to the large debtors. As for the low wages, the leading objective should be to have employees registered and insured rather than to rely on MIITs for closing the deficits of the pension system. The differential between the minimum wage and the minimum insurance threshold needs to be eliminated in order to avoid regressive taxation. Upward adjustment of the minimum wage level is hardly the right instrument in this regard. Furthermore, an explicit midterm (3-year) commitment by the authorities about future MIITs levels, or a commitment to adjust them only according to inflation may make labor costs more predictable for the small business and encourage labor expenses reporting compliance. This would have important positive effect on personal income tax compliance as well.

5.2 The patent tax

The Bulgarian patent tax is a fixed-sum proxy for income tax with multiple rates, differentiated by economic activity, location and the service or output capacity of the business unit. Its introduction in 1998 was driven by concerns about the post-communist boom of the informal economy and the large weight in it of small traders and service providers. Its design bears the signs of these leading concerns. The patent tax does not allow any choice between it and the standard income taxation. It unconditionally lists the groups of taxpayers that are liable under it. The obligation concerns both legal and natural persons whose activity is in the list of the patent tax, and whose gross income is less than a specified threshold.[46] Even though it is a part of the Personal Income Tax Law, it is applied as well to the corporate income of limited liability companies included in the patent list.

Furthermore, it does not reduce the accounting costs of the "beneficiaries". Under the patent legislation, they need to record net income according to the provisions of the accountancy law. In the case of sole proprietors, this requirement is justified by the need to calculate insurance income. In result, even though they pay fixed-sum patent tax, as a substitute of personal income tax, they still need to calculate their personal income for the purpose of their own social insurance liabilities. This entails higher cost not only of voluntary compliance, but of enforcement as well: insurance inspectors need to verify compliance with the corporate income legislation, for which they may not have adequate

[46] This threshold has been usually set at the level of VAT threshold except for 2003, when the VAT threshold was reduced to BGL 50000, while the patent tax threshold remained at the old level of BGL75000, thus obliging VAT-registered companies with double-entry bookkeeping to pay patent tax if their turnover is between BGL50000 and BGL 75000.

expertise or third-party data. [47] While full accounting records might be necessary for determining insurance contributions of sole proprietors, the need of them is less clear in the case of limited liability companies under the patent tax. As they pay insurance based on payroll records, those should be sufficient for insurance audits. It is worth noting, that all traders are obliged to have cash registers with electronic memory, which in itself is sufficient for the purpose of enforcement of the turnover threshold of the patent tax.

The evolution in the coverage and the structure of the Bulgarian patent tax in the seven years since its introduction are indicative of the inherent controversies and difficulties of reconciling simplicity, efficiency and equity objectives in a presumptive tax design. As it affects relatively large groups of taxpayers, whose interests at that are clearly defined along professional and sectoral lines, and even locations, it has always been in the center of the politics of taxation and among the most criticized and frequently amended pieces of legislation. At its very start its constitutionality was challenged in court because it was introduced as a local tax, while Bulgarian constitution does not allow local governments to set taxes. In result, the responsibility of setting taxes that are meant to be local, i.e. reflect adequately local conditions, was entrusted to the Parliament with all consequent inherent drivers to numerous adjustments. On the other hand, local governments were compensated with local license fees for certain activities, which in effect doubled the tax burden of small entrepreneurs. Small hotels and restaurants subject to categorization (up to 2-3 stars), are licensed by the local government, for which they pay not only initial fee, but also an annual license fee. According to the law, the local fee should reflect the administrative cost of licensing. In practice it has the progressivity of a tax, thus being a local duplicate of the central patent tax, disguised under the cover of a local fee.

Some of the changes did contribute to its optimization and better targeting of the hard-to-tax. Activities, which are not typical for the small business were withdrawn from its coverage (e.g. wholesale trade), the rates of others such as city parking lots, were raised. The size of certain business facilities covered by the patent tax was also reduced.[48] The indicator "number of employees" was dropped in 2001 from the list of rate-setting indicators in an attempt to eliminate the inherent in this indicator disincentive to expanding off employment.

Other adjustments in its coverage and rates however, indicate a lack of clear vision and direction. Some reflect the contradiction between tax designers' efforts to expand the coverage of the standard tax net versus the limited administrative capacity to handle the resultant inflow of hard-to-tax taxpayers in it. A 2003 amendment, for instance, tried to lower the eligibility threshold for restaurants to those under 100 seats. After a year that threshold was removed. In 2003-2004 construction and manufacturing activities were excluded from the patent tax list, making it largely a tax on retail trade and services. But on the other hand, some of the higher-income professional and business

[47] A unified revenue agency, managing tax and insurance contributions collections and audits is to become operational in 2006 and is expected to solve partly the institutional problem of enforcement. But the problem of excessive compliance burden still remains a major one.

[48] In result it covers hotels up to 20 beds, retail outlets up to 100sq. m. of commercial area.

services, provided by doctors, dentists, lawyers and consultants are excluded, others, such as real estate agents are included. Agricultural income, where presumptive taxation is widely used around the world, is also excluded. Some changes and arrangements even reflect political clientelism, i.e. changes in tax design under the pressure of powerful business lobbies, often to the detriment of the small business.[49]

On balance, the changes and adjustments of the patent tax brought it far from the initial objective of simplicity and low enforcement cost. In 2005 the Bulgarian patent tax schedule has over 900 rates, differentiated horizontally in 9 groups according to location; and vertically in over 100 services. It uses wide range of indicators to estimate taxpayer's average income capacity. The hotel and restaurant patent tax is set per room and seat respectively, according to the facility's tourist category; shops are taxed per square meter; hairdressers etc. - per working place; others - per number of equipment. Above all, this makes it costly to enforce. Significant resources are allocated to inspecting and enforcing the conformity of declared to actual "circumstances" (i.e. the facility's capacity). In contrast to checking of records, verifying the number of seats in a restaurant may be never complete, and may have limited enforcement effect, but provides good opportunities for petty corruption with little chances for internal control. Moreover, some of these indicators are not clearly established by the law, and perhaps cannot be. The size of the population, as a criterion to differentiate tax rates by location is a case in point. Tax rates have been based on the national classification of the size of the settlements, which may depart substantially from the actual number of residents as consumers of local services. In small cities, the tax is overvalued relative to actual number of consumers, while in larger cities and resorts with large number of temporary residents and visitors it may be undervalued.[50] Furthermore, in order to enforce the principles of location-based taxation and to safeguard against opportunities for abuse and evasion, the patent tax is levied on facility basis and only for the activity listed in the patent tax regulation. Thus an entrepreneur whose activities fall under more than one business category may need to apply different patent taxes, or even to apply simultaneously the patent tax and the standard tax.

These specifics of the Bulgarian patent tax lead to the conclusion that a reduction in taxpayers' compliance cost has not been among the guiding objectives of its design. Apart from its enforcement and compliance costs, there is as well the significant legislative and policy-making cost of its constant amendments. Relative to the revenues from the patent tax, adjustment and enforcement costs appear excessive. After all improvements and adjustments its revenue effect is negligible. In 2002 about 268000

[49] There are some indicative examples in this regard. Running of city parking lots and fancy restaurants and bars for instance, has never been a typical domain for the small business, and is clearly a way to large-scale tax avoidance. Reportedly, it is usually controlled by controversial "businessmen" with suspected connections to organized crime. In other cases, the patent tax might have been for driving the small business out of business. A rise in the patent tax for video rentals, for instance reportedly made the acquisition of small family shops by the monopoly distributors much easier. Similarly, the decision of self-employed taxi drivers to start working for the large business groups was among other factors facilitated by rising patent taxes.

[50] It was not before a long legal procedure that the Supreme administrative court ruled in 2004 against the practice of the tax administration.

patent tax payers paid roughly BGL56 million (EUR28 million) in taxes, which is about 1% of all tax revenues. Taking into consideration that eligibility turnover ceiling coincides with the VAT registration threshold means that it covers entrepreneurs with considerable earning disparities. The limited revenue outcome however indicates that despite the excessive differentiation of the rate schedule, its equity benefits are dubious as well. The most probable benefit of the patent tax is in its incentive effect for the middle income patent business ventures. But, as already argued, presumptive taxation would better be used for optimizing compliance and enforcement costs rather than for tax preferences. Moreover, if it is used as a tax shelter, it is in itself an impediment to the taxpayer's transition to the standard net and to higher voluntary compliance rates. Last but not least, the tax advantages must have been significantly eroded by the reduction of the income tax rates, while the patent taxes have either remained intact, or been raised.

Summing up the Bulgarian experience with the patent tax, over the years, its coverage has been narrowed by dropping activities from the list and lowering the turnover ceiling to BGL 50000, while the advantages over the standard income tax have shrunk. This path may suggest its gradual phasing out. Is this the better alternative? Probably yes, especially in the long run. International experience shows that there is hardly a good substitute to the standard income tax. Most advanced countries do not use presumptive taxes to tax small businesses at all. But the more relevant question is if it is feasible option for Bulgaria in the short run? More than a third of Bulgarian entrepreneurs are paying patent taxes. Transferring them overnight to the standard tax net might be a serious shock both to the small business sector and to the tax administration. Constraints related to the political economy of transition and accession, and above all to the insufficient administrative capacity to handle the abrupt expansion of the coverage of tax services and audits, may render such an option unrealistic in the short run. On the other hand, in its present form it does not make much sense neither as an instrument of raising revenue efficiency, nor as an instrument of reducing small businesses' compliance costs. This leads us to the question of the opportunities and alternative costs of its optimization.

6. Optimizing the patent tax: benefits and costs

6.1. Policy dilemmas

The optimization of the patent tax depends above all on the clear definition of the policy objectives that this kind of presumptive tax pursues. The choice is essentially about the relative weight of revenue, efficiency and equity objectives in its design.

The current lump-sum arrangement is more appropriate if the priority is on incentives. But then, design should not be pushed towards more equity. The Bulgarian experience is a good example of the possible costs of equity adjustments in a fixed-sum presumptive tax. Essentially, this means that the fixed-sum tax should be limited to one or two rates. In this case equity concerns are to be addressed through the standard tax system and the public expenditures, not through adjusting the presumptive tax schedule.

Of course this may be easier said than done. Ignoring pressures towards more equity in presumptive taxation may not be feasible policy option in a transition economy. Furthermore, setting the single rate at the appropriate level is a bigger challenge than setting multiple rates, and may render one-size-fits-all solution fairly unstable. The more so, as prioritizing efficiency gains is likely to be in conflict with revenue objectives. In essence the revenue efficiency of presumptive tax arrangement depends on how close the approximation of income is to actual income. Practically, concerns abut revenue efficiency puts design on the same slippery slope of rate differentiation and numerous adjustments as would concerns about equity. Once tax design cuts clear lines between sectors and locations, it becomes more susceptible to pressures from various interest groups.

The better policy alternative may be to prioritize revenue targets, and assign incentive objectives to other instruments. The more so as taxes and especially presumptive taxes are hardly the best tool to encourage entrepreneurship. There are other more direct and better targeted tax, and above all non-tax instruments available to policymakers.[51] There are difficult tradeoffs in such a choice too. Boosting revenue efficiency requires above all reduction of compliance and enforcement costs. On the other hand, attaching priority to revenue targets may imply that it is better to substitute the fixed-sum design by a tax based on gross receipts, or a minimum-tax type arrangement rather than to try to adjust the fixed-sum presumptive schedule. Such a solution , however entails higher compliance and enforcement costs.

On the other hand it is also true, that the revenue potential of the presumptive tax should not be overestimated. As Terkper (2003) warns, its revenue effects may be realized only in the mid and long term. The revenue benefits of a presumptive tax depend mainly on its capacity to tax the hard to tax, i.e. to reduce the size of the informal economy on one hand, and to transfer higher-income small business to the standard income tax schedule. The task of curbing the shadow economy may also contain a conflict of instruments. If the prime objective is to attract entrepreneurs to the formal economy, then sufficiently low and simple fixed-sum arrangement might be more appropriate. But if the prime objective is to reduce underreporting of income by registered entities, then the presumptive tax is expected to provide better approximation of actual income. It may be more efficient to assign the presumptive tax mainly to reducing underreporting, while curbing illegal (non-registered) activities may be better handled through increased control.

Closely related to the issue of clear setting of objectives is the issue of evaluating of the presumptive tax efficiency and effectiveness. Should presumptive taxation be evaluated through collection and compliance rates, or alternative grey economy indicators such as inflow and outflow rates of small taxpayers, or should its impact be assessed through small business performance indicators, such as birth/death rates and productivity? It is an important issue in view of the possible ambiguity of objectives. For instance, it may be difficult to evaluate it, if it is designed to improve collection rates,

[51] Tax incentives for small business constitute a large topic in itself, which remains outside the scope of this study.

but when fails to do so is justified on grounds of incentives effects. Or, vice versa, if it is designed to encourage small entrepreneurship, but is expected instead it to raise collection rates.[52]

Once the objective is clearly set, the tax restructuring could be guided by the standard and interrelated policy questions of whom, what and how to tax. In this case tax designers' choice boils down to the coverage and the indicators, the latter being essentially a choice between a fixed-sum and a value-tax arrangement.

There are two additional policy issues. The first one is about the place of the tax in the intergovernmental fiscal relations: i.e. whether it is a central or local tax. The second issue is about the interface between the presumptive and standard tax arrangements and the mechanism of graduating from the former into the latter. Bird and Wallace (2003) refer to it as a "stepping stone" to the standard net. This function is especially important in the context of above argument that the revenue gains from the presumptive tax are not immediate, and perhaps not only direct. They depend as well on how effective it is in bridging the way of the micro businesses first to the formal economy and later to the standard tax net. It is the more so relevant if the presumptive tax is a central tax.

In what follows I briefly review the opportunities and costs of these alternative policy choices.

6.2. Coverage

The first question relates to the coverage and eligibility criteria and thresholds. Presumptive taxes may be applied not only to the small business. Collection efficiency however, requires that a distinction be made in principle between those for whom compliance costs are too high, and those who can afford it, but choose to evade taxes in order to increase their income.[53] In the latter case, tax evasion may be more efficiently constrained by the conventional audit and risk management instruments based on accounting records. In the case of larger companies, presumptive assessment techniques could help to improve targeting of audits and risk management rather than being used as a direct instrument of tax collection.

If presumptive tax is to be targeted to the small business mainly, this first raises the question of what exactly is the "small business"? The common reference to the legal definition of SME (see footnote 13) is hardly useful for the purpose of tax design, as it puts in this category fairly heterogeneous groups with largely differing ability to pay and related compliance costs and risks. As already mentioned, some of them may meet the

[52] Sometimes the literature on presumptive taxation also bears the signs of that ambiguity. For instance it often refers to taxpayers as "beneficiaries" who are "eligible" for this kind of taxation even when it is unconditional and like in the case of a minimum tax, is guided by the sole objective to guarantee some minimum level of revenue targets.

[53] Such a distinction is feasible only in principle. In practice a distinction between those who evade taxes "because of need" from those who evade taxes "because of greed" implies a high degree of value judgment and can hardly be applied objectively in individual enforcement.

criteria for classifying them as large taxpayers. One way to narrow the coverage of the patent tax to the core "hard-to-tax" group, while still remaining within the legal categories, would be to target what is defined by the law as micro companies, i.e. those with less than 10 employees. There are good reasons for such narrowing of the size category. As shown in section 2.1 (table 2) micro enterprises account for 91% of all Bulgarian enterprises and with worst productivity indicators on average are more likely to be unable to bear the compliance costs of standard taxation than the rest of the SME sector. Moreover, this is the subgroup, which includes practically all start-up companies. It is as well the segment with decisive weight in the overall performance of the sector and in the informal economy. In sum, assigning the patent tax to the micro business would allow considerable gains in terms of homogeneity of the target group (which means reduced pressures towards equity adjustments), without considerable increase in the number of taxpayers under the standard tax net. Further gains in homogeneity of the patent taxpayers may be achieved through raising the minimum taxable business income threshold or allowing special standard tax deduction for the micro businesses. Of course despite such narrowing of the target group, it will remain far from homogeneous. As already noted, however, after all, a presumptive tax design is not about equity. It is more realistic if it is guided rather by collection efficiency through reduced compliance and enforcement costs.

Putting the stress on compliance and enforcement costs has another important implication for the coverage of the patent tax. It is not just the size, that matters, but also the VAT status of the micro enterprise. If it is VAT registered, it can hardly benefit from presumptive income tax in terms of reduced compliance costs. Tax administration cannot benefit from reduced enforcement and audit costs either. In this context the optimal level of turnover ceiling for the presumptive taxpayers group is the VAT registration threshold. With minor exceptions (see footnote 45), this principle has been observed in the Bulgarian patent tax design as well. There is less agreement, however, on the optimal level of the joint VAT/presumptive tax division line. One line of reasoning, derived from collection and enforcement efficiency, argues that this threshold should be high enough to optimize audit and compliance costs (see for instance Thuronyi, 2003). A different logic, based on equity concerns, favors lower levels of the VAT registration thresholds and option for voluntary registration, so that small companies do not bear higher consumption tax burden than larger companies (e.g. Shome, 2004). The latter is in line with the EU practice as well. If Bulgarian VAT regulations follow European best practices, the VAT threshold is to be further reduced and voluntary registration allowed below it. This will further shrink the coverage and the share of the presumptive tax.

If the patent tax is limited to micro non-VAT entrepreneurs, there is the basic question of whether they should be taxed at all. Should not they be exempt from income taxation on grounds that they bear enough tax weight through the consumption tax?[54] Estonia for instance exempts retained profits from income taxation. This is in effect not only in regard to incorporated entities, but to sole proprietors as well. The latter are allowed to retain part of their income in a special saving account, which is not taxed, and

[54] There is no income tax exemption for legal persons, while for sole proprietors under the PIT law it was until 2005 at the level of the minimum wage for the country.

can be used for investment and expansion of the business. Of course the efficiency and administrative benefits of such a move need to be weighted against the costs of revenue losses and increased opportunities for tax evasion and avoidance.

6.3. Lump-sum or value tax

The second major issue of tax design is related to the set of indicators used to approximate income. Should the tax be based on quantity indicators or on value indicators, such as turnover or value of fixed assets? The current system applies fixed-sum rates based on quantity indicators. The flaws of this type of solution have been discussed above. Apart from the need of constant updates and adjustments, the multiple-rate tax acts as a quantity tax on capital and creates disincentive to expand the production capacity (restaurant seats, or work places, or equipment). Its effect on employment is also dubious. In the short run it may act as an incentive to increase the labor to capital ratio through introducing shifts, etc. But such an increase of employment has its limits, as this tax design creates disincentives to expand production capacity through investment in equipment. In the case of Bulgaria, the indicator "number of employees" was dropped, but the criterion "number of work places" or equipment is used wherever possible to set the tax rate, encouraging labor intensive organization of the business.

There is as well the problem of enforcement and the opportunities for corruption. Among other benefits, an unconditional fixed-sum arrangement is supposed to minimize compliance and enforcement costs and opportunities for corruption through reducing personal interactions between taxpayers and inspectors. Therefore, it is normally used as a substitute of taxes whose base is derived from accounting records.[55]

In a departure from that logic, the PIT law requires patent taxpayers to keep full accounting records, which are audited for the purpose of social and health insurance collection. On top of that, for the purpose of the patent tax enforcement they are inspected for verification of their eligibility (the turnover threshold) as well as on the conformity of the declared to the actual business "circumstances".

Audit costs for both the patent taxpayer and the social insurance office could be significantly reduced if SIC are levied on the MIITs, i.e. if MIITs are applied as final tax rather than minimum tax. Moreover, in the case of business owners' insurance income such an adjustment will redress the discriminatory treatment of sole proprietors relative to corporate shareholders and will optimize both the patent and payroll tax in terms of incentives and compliance cost.[56]

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[55] . Thuronyi (2003) argues that there is not much benefit either in terms of administrative or in term of compliance cost to replace property taxes (vehicles and other assets). In practice, however, single taxes, used by some countries, may incorporate income, consumption and asset taxes (e.g. company car taxes). An example is Hungary's simplified corporation tax (EVA), which is a single tax in place of corporation tax, entrepreneur's PIT, the VAT, and the company car tax.

[56] An even more favorable solution would be in case the patent tax is optional, to give to provide a similar option in case of the SIC: taxpayers would have the option either to pay on the MIIT basis, or to file tax return, if s/he can prove insurance income lower than the applicable MIIT.

In brief, the lessons form Bulgaria show that an unconditional fixed-sum presumptive tax is hardly a simple and stable solution unless it is limited to few rates and is used primarily to encourage business activities. Establishing these rates, however may be politically and administratively unfeasible. There are four ways to reduce possible pressures that may block the design.

The first one is to set low the tax rate, and narrow the presumed income band of the patent taxpayers by lowering the threshold, applying it only to micro-enterprises. This will increase the homogeneity of the beneficiaries and reduce the pressures towards equity adjustments. The revenues from the patent tax may decline, but the losses will perhaps be more than offset by the inflow of entrepreneurs to the standard income tax schedule. Of course, the overall revenue effect would depend on the administrative capacity to enforce the standard tax among the new-comers. The capacity of third party reporting are not yet sufficiently utilized. It might improve collection efficiency and equity to allow subtracting from the PIT base some expenses for professional services (e.g. rents and repair services) by non-business users in order to have them on the supplier tax returns.

The second option is to set higher the rates, but to allow taxpayers who can prove income levels lower than those implied by the tax, to apply the standard PIT or CIT rate. In essence this is a maximum tax. The taxpayer enjoys the option to pay the lower of the two liabilities. The choice may be in advance, at the start of the fiscal year, or, in the end of the tax period. [57] This option implies that the taxpayer needs to keep complete books of accounts in order to be able to claim a tax return. The optional arrangement has advantages in terms of incentives, but disadvantages in terms of compliance and enforcement costs and equity consequences. As for compliance and enforcement costs, however they are not likely to grow relative to the current patent tax arrangement, which requires full accounting records. As for equity, it may lead to losses in equity, but at least it provides to taxpayers equal opportunities. This may be more efficient instrument for overcoming pressures from interest groups than direct equity-oriented adjustments of the coverage and rate structure.

The major problem in this design is the lack of bridge between it and the standard tax schedule. It does not provide incentives to grow or report receipts above the threshold, if this implies shift to progressive taxation. Therefore it may best be used as a complement rather than substitute of the standard tax. This makes it especially good for a local tax. Otherwise, on a central level, this flaw can be addressed through limiting the number of years of eligibility, and through reducing the tax cost of transition from presumptive to standard taxation. Depreciation allowances and existing CIT exemptions may be the rewards of graduating to the standard tax net.

[57] The ex-post option may be realized through advance payments based on the patent tax and setting the final liability through filing tax return. To encourage advance commitment the ex-post settlement may be available as a financial option: the right to exercise the option by the end of the tax period may be on a chargeable basis.

The third option is a minimum tax arrangement similar to the one applied for the payroll tax (MIITs). As already noted it seems to be the worst option in regard to the small business. Not only it fails to reduce compliance and enforcement costs, but results in regressive average tax rates up to the level of the minimum tax. Its major advantage is that there is no problem of transition from the presumptive to the standard tax net, and that it is superior to the other forms in revenue potential.

The fourth, and may be the best option is to leave the design of the patent tax to the local government. In principle, as a tax on small business it is closer to local than central taxes. This would help the process of fiscal decentralization and raise collection efficiency as the local authorities may be in much better position to enforce it (especially if it is based on the value of assets). In the case of Bulgaria, however, such a solution may be in conflict with the Constitution. Bulgarian supreme law does not allow the local government to set tax rates. Using the patent tax as local tax would require constitutional amendment.[58]

The difficulties and tradeoffs related to taxing the small businesses by a fixed sum tax poses the question about the potential of a value-based presumptive taxation to achieve the objectives of reduced compliance costs with relatively less losses in equity. There are two types of arrangements to be considered.

The tax based on the value of assets has the same disincentive effect as the tax based on the number of equipment. But in this case, the need to evaluate the stock of assets may increase further compliance cost. Therefore, the value of the stock of assets may be best used not as a direct tax base, but as useful indicator to direct tax audits to tax payers, where the risk of tax-evasion is higher than average.

Many of the dilemmas of a presumptive tax seem to be solved if it is levied on gross receipts. Moreover, in Bulgaria all entrepreneurs, registered under the commercial code are obliged to keep electronic records of cash receipts. Therefore such a tax would not increase compliance and enforcement costs relative to the current system. But such a tax is also susceptible to the risk of multiple rates and constant adjustments on the grounds that profit margins vary largely across economic activities and over time. Besides, there is the problem of cascading and the incentives to vertical integration, which may have adverse impact on competitiveness of the economy and on revenues.

To summarize, the best option would be to make the patent tax a local tax. As a central tax it cannot be a perfect substitute of the standard tax and may be used mainly as temporary tool. Therefore it may be primarily designed to reduce the shadow economy and increase collection efficiency in the short and medium term. In this context a tax on gross receipts may have lowest costs. If, however, switching from the fixed-sum to value based arrangement is politically unfeasible, then it might be better to make it optional maximum tax. In other words, if it cannot be used for revenue purposes, it better be more

[58] There are also ideas to substitute them with local annual license fees, or to allow municipalities to set them within bands fixed by the central government, but the constitutionality of such solutions may also be challenged.

efficiently used to help the small business grow (at the cost of leaving legally part of this growth off the records). Any of these options would be an improvement relative to the current tax design.

7. Conclusion

The focus of recent Bulgarian tax reforms has been on the reduction of income taxes. Even though this is a positive development, there are certain elements of the design of income taxation and social insurance contributions, which discriminate against the most common form of small business, the sole proprietorship, and which have been intensified in the course of the tax reforms. This paper argues that together with regressive compliance costs, these constraints constitute the major source of non-compliance in the small business sector. Therefore the immediate priority in the design of a favorable tax environment for the small entrepreneurs is not a preferential treatment, but eliminating those features in current tax design that put them in a disadvantage.

First, a more neutral treatment of business income from sole proprietorship versus corporate income may have strong incentive to investment in a country, where the overwhelming form of entrepreneurship is the natural person. The gradual elimination of the double taxation of corporate income through phasing out the tax on dividends is a move in the right direction, but it widens the gap in the treatment of the two forms of entrepreneurship. The best instrument in this regard would be to allow sole proprietors to benefit from the requirement to record their taxable income according to the CIT law by granting them the option to choose between the progressive PIT rate and the proportional CIT rate in settling their final income liability.

Second, a more neutral VAT treatment of small enterprises through allowing registration below the threshold may improve further horizontal equity.

Third, the SIC treatment of the corporate investment income may be extended to the business income of natural persons and self employed. This means to apply the MIITs as a final tax rather than as a minimum tax. It would not only improve equity between different legal forms of entrepreneurship, but would also free more than quarter of a million patent taxpayers from the obligation to keep accounting records for the purpose of their personal social insurance enforcement. A further step towards more equitable treatment of the small business would require restructuring of the minimum presumptive tax on labor expenses, which now taxes the lowest wages at rates above the fairly high statutory ones. The solution may be sought along the lines of applying the minimum wage as a base for a final payroll tax to start-up and micro business ventures, rather than as a minimum tax. The compliance effect of these adjustments would be two-fold. By reducing employers' incentives to underreport wages, it will have stronger impact on PIT compliance rates as well.

The drivers of non-compliance, however are not only and not mainly in the domain of excessive tax costs. The small business encounters higher costs of voluntary compliance. Similarly, higher enforcement costs reduce the probability of detection and

encourage tax evasion. In this context, a presumptive tax is believed to be a central instrument of reducing the compliance and enforcement costs of taxing the hard-to-tax. The experience of the two current presumptive taxes in Bulgaria, however, show that they tend to get complicated and drift away from the objectives of simplicity and low costs. The current patent tax structure has expanded to more than 900 rates in 7 years, and the recently introduced minimum insurance income thresholds is following a similar path. The Bulgarian experience indicates that a presumptive tax can hardly be a perfect substitute of the standard tax schedule, especially if it is overloaded with equity objectives. It should be regarded rather as a complementary instrument that can help the tax administration in transition countries in the short and medium run to handle the challenges of the shadow economy and the large hard-to-tax sector. As a complimentary instrument its best place is in the system of local taxes. Due to delay in Bulgaria's decentralization reforms however, this may be hard to achieve in the short term. Therefore if it is to be used as a central tax, this study suggests that it may be best to apply it as a tax on gross receipts, which is the better alternative in terms of revenues and equity, or as a single but optional lump-sum tax, which is the better alternative in terms of incentives for the small business. Of course, its revenue effect should not be overestimated. Therefore it should allow easy graduation of the presumptive taxpayer to the standard tax net, where compliance and enforcement are managed through more efficient instruments, such as third party reporting and withholding at the source, improving the efficiency of audits, improving taxpayer services and optimizing the rate schedule. In this regard, the opportunities of increased third-party reporting through allowing deductions from gross personal income of expenses on professional services provided by many micro businesses and self employed should be given serious consideration.

Finally, there is always the risk that a presumptive tax can overtax start-up companies, and undertax established companies with more ability to pay. But the idea behind it is not to compete with the standard tax schedule in terms of equity. If it is designed with this limitation in mind, it can boost collection efficiency, reduce evasion and thus even distribute the tax burden more fairly.

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