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Presumptive taxation and gray economy: Lessons for Bulgaria

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Abstract: This paper studies the theory and international practice of presumptive taxation in the context of Bulgaria’s tax reform agenda and the improvement of small-business environment. It analyses the economic and social effects of the two forms of presumptive taxes currently practiced in Bulgaria – the patent tax and the minimum social insurance income thresholds. It argues that there is inevitable trade-off between efficiency and equity objectives, which drives presumptive taxes far from their initial rationale of simplicity and lower compliance and enforcement costs. The paper puts to discussion the costs and benefits of optimizing presumptive taxes versus narrowing their scope and building incentives for transfer to the standard tax schedule.

JEL classification: H21; H26; K34

Презумптивно облагане и сива икономика: поуки за България

Направен е преглед на теорията и международната практика на презумптивното облагане в светлината на дневния ред на данъчната реформа в България и по-конкретно за подобряването на бизнес средата за малкия бизнес. Анализират се двете форми на презумптивно облагане в България: патентния данък и минималните осигурителни доходи. Аргументира се неизбежния риск презумптивният данък да стане жертва на опити чрез него да се постигат едновременно две групи цели: да се подобри социалната справедливост на облагането и да бъде данъкът икономически ефективен. Това обикновено го отдалечава от началните цели на простота и намалени разходи по доброволното изпълнение на данъчните задължения. Разгледани са възможностите за оптимизиране на презумптивните данъци и са сравнени те с алтернативата да бъде ограничен и по-добре насочен техния обхват и да бъде улеснен прехода на малкия бизнес към стандартното облагане.

Contents:

1. The rationale ................................................................................................................... 4
2. Types of presumptive taxation ........................................................................................ 6
3. Minimum insurance income thresholds ........................................................................ 11
4. The patent tax ................................................................................................................ 13
5. Optimizing the patent tax: benefits and costs ............................................................... 17
   5.1. Policy dilemmas ..................................................................................................... 17
   5.2. Coverage ................................................................................................................ 18
   5.3. Lump-sum or value tax .......................................................................................... 20
5. Conclusion ........................................................................................................................ 23
References .......................................................................................................................... 24

1 The author is Senior Fellow at the Economic Program of the Center for the Study of Democracy. The views, expressed in this paper are those of the author and do not necessarily reflect the views of the Center.
Introduction

A presumptive or imputed tax is generally a proxy for the standard tax. It 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, the 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.

Bulgaria applies two presumptive taxes. The older is the patent tax, introduced in 1998 along the lines of the classic IMF policy advice on tax administration reform.\(^2\) 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. Until 2005 insurance companies, organizers of gambling and lottery games, and telecommunication service providers used to pay corporate taxes on their gross receipts. 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. This paper studies the Bulgarian experience with presumptive taxes in the light of the theory of tax compliance and the international experience, as well as the benefits and costs of their optimization. There are more than a quarter of a million of patent tax payers in Bulgaria, which makes it an important policy issue for the small business. The MIITs affect even larger number of employers and employees.

The paper is organized as follows. Section one studies the underlying rationale of using presumptive taxation as a tool of reducing compliance and enforcement costs. It discusses the difficult tradeoffs between efficiency and equity. In this framework, section two reviews the typical applications of presumptive taxes around the worlds. Section three and four offer critical analysis of the application of presumptive taxation in Bulgaria. Section five studies the alternative policy dilemmas related to the future of presumptive taxation. The last section summarizes the policy implications of the study.

\(^2\) 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)
1. The rationale

Presumptive taxes are among the oldest taxes. Earliest forms date back to the 18th century when assets were the major source of income. 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 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.

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. 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.

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3 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

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

5 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)
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. 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.

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. In brief, the equity consequences of a presumptive tax

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6 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.

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

8 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
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 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.

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. 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

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9 See as well Bulutoglu (1995); Thuronyi (1996) for overview
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 1 is an attempt to a very rough illustration of 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 1. 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 the 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.10

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

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10 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.
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\textsuperscript{11} 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 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.

\textit{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 \textit{tachsiv} of Israel and the \textit{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 \textit{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.

\textsuperscript{11} See Tanzi and Sadka (1992) for analysis of this type of presumptive tax.
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. 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

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12 See Lapidoth (1977), for a more detailed discussion of the tachsiv.
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 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.

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.

The next two sections try to locate the place of the Bulgarian two presumptive taxes in the rationale and the typology outlined up to this point.

3. 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 1). The differential has shrunk since the introduction, but this reflects 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

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<td>Average MIIT (BGL)</td>
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<td>MIIT/minimum wage (%)</td>
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* Estimates from Gancheva (2004b)

13 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.
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 1 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.

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.\textsuperscript{14} 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.

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.

4. 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

\textsuperscript{14} 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.
natural persons whose activity is in the list of the patent tax, and whose gross income is less than a specified threshold.\textsuperscript{15} 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 expertise or third-party data.\textsuperscript{16} 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 raised.\textsuperscript{15} 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.

\textsuperscript{16} 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.
reduced.\textsuperscript{17} 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 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.\textsuperscript{18}

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.\textsuperscript{19} Furthermore, in order to enforce the principles of location-based taxation and to safeguard against opportunities for abuse and

\textsuperscript{17} In result it covers hotels up to 20 beds, retail outlets up to 100sq. m. of commercial area. \\
\textsuperscript{18} 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. \\
\textsuperscript{19} It was not before a long legal procedure that the Supreme administrative court ruled in 2004 against the practice of the tax administration.
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 patent tax payers paid roughly BGL56 million (EUR28 million) in taxes, which is about one percent of tax revenues. Taking into consideration that eligibility turnover ceiling coincides with the VAT registration threshold means that it covers entrepreneurs with widely diverging ability to pay. 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.
5. Optimizing the patent tax: benefits and costs

5.1. 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. 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

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20 Tax incentives for small business constitute a large topic in itself, which remains outside the scope of this study.
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, 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.²¹

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.

5.2. 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.²² 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.

²¹ 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.

²² 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.
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 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?23

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23 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.
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 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.

5.3. 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 also 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.24

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.25

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. 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.

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.

26 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 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.27

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 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.

27 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.
Conclusion

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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