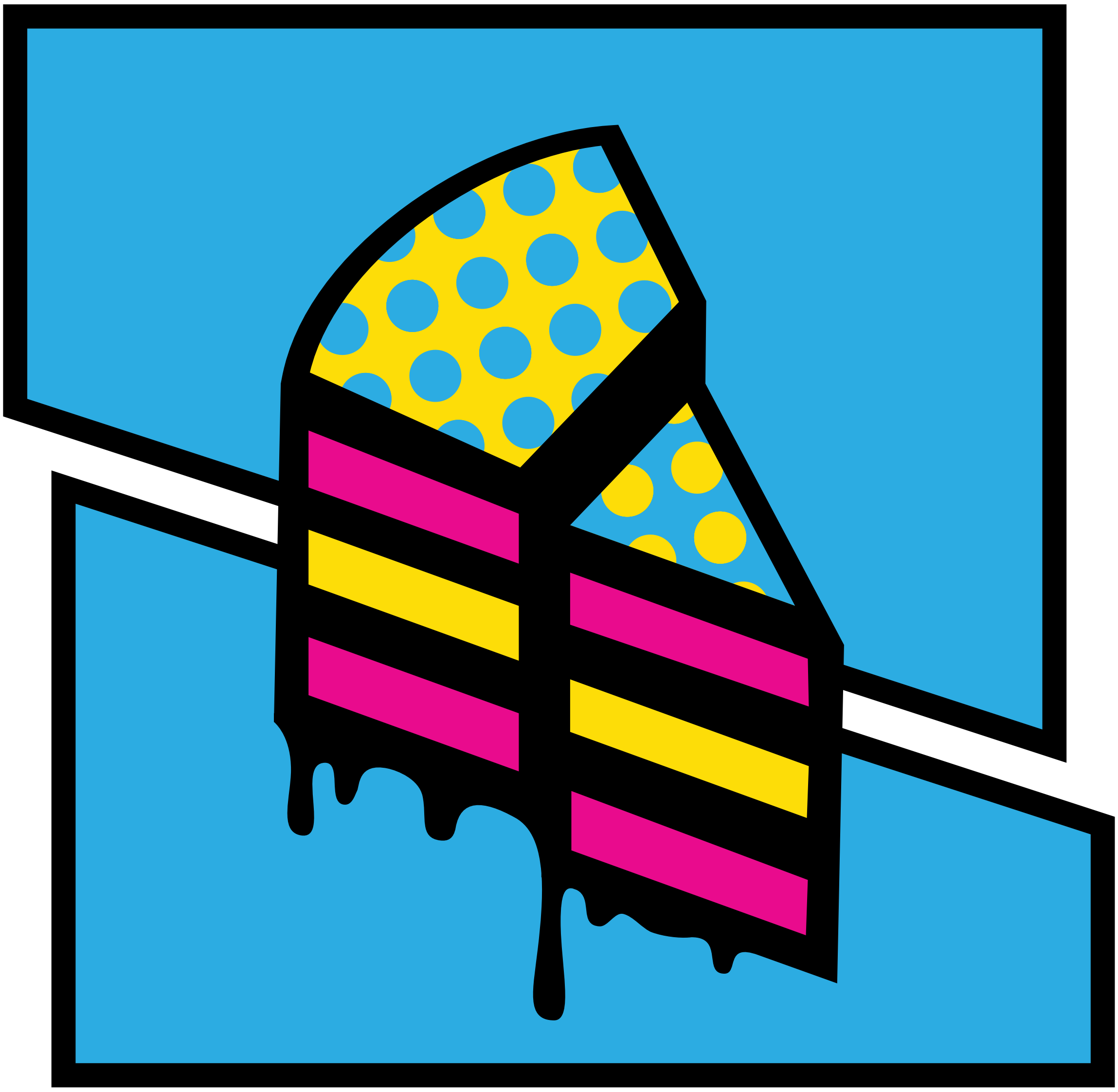
Flat Tax or Democracy?

Towards a Progressive Tax Reform in Bulgaria

Ognian Kassabov Ivaylo Atanasov Vanya Grigorova



COLLECTIVE FOR SOCIAL INTERVENTIONS

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Since January 1, 2008, a 10% flat tax regime has been operating in Bulgaria. Announced in July 2007 by the coalition cabinet of socialist PM Sergey Stanishev and passed by parliament in December, the flat tax replaced a mildly progressive tax rate. During the years of Bulgaria's post-1989 democratic transition, the progressivity of taxation had been continually decreased, and by 2007 the highest rate was only 24%. But soon after its accession to the EU, Bulgaria became one of the then 13 East European countries (7 of them EU members) to impose a flat tax. The 10% rate it imposes on personal income is the lowest in the whole EU and among the lowest globally. Corporations operating in Bulgaria are all taxed at the same rate.

For the 10 years of its existence, the Bulgarian flat tax has demonstrated its limited potential. What is more, it has exerted a strongly negative impact on society as a whole. It is time that Bulgaria revise its tax policy. The flat tax has to be replaced by progressive taxation.

- The flat tax without a non-taxable income minimum has turned Bulgaria into the country with the highest inequality ratio between rich and poor in the European Union. This inequality is growing. We have to turn this trend around.
- Progressive taxation affirms the values of solidarity and social justice. It provides the basis of more effective redistribution and contributes to an improved quality of life for all Bulgarians.
- The government must guarantee that those who earn the most using the resources of society actually pay their dues. This includes corporations.
- The levels of foreign investments and the fight against the so-called shadow economy in Bulgaria are stagnating. The government must implement counter-measures that do not punish working people.

The first goal of this study is to revive the tax system debate in Bulgaria, placing it on the basis of facts and sound arguments. At the same time, the study seeks to wrest the debate away from the hold of "experts", who appropriated the exclusive right to talk on this allegedly technical matter. A tax system might look highly abstract and complex, and may even provoke hostility – because it takes away from people part of their already low income. But in reality the taxes in a country are an integral part not only of its fiscal fundament, but also of its values. Taxes determine how the wealth produced by society is distributed and what kinds of common projects it is being invested in. That is why democratic values require that each citizen be able to provide their input into the tax debate.

Is it fair for wealth to be concentrated in the hands of corporations and a few rich citizens? Or isn't it fairer for society to guarantee that working people can get their proper share, that their children can access a good education, and that their parents can enjoy a comfortable old age? Who should be the one to bear the greatest burden of financing the state – those with the highest income or those with middle and low incomes? The answers to these questions require an extensive and all-inclusive debate.

This policy paper argues for a smooth transition towards progressive taxation. The proposals provided here are far from optimal, but Bulgaria's tax system is so heavily distorted that best-case scenarios continue to be beyond our reach. While guided by the values of justice, social responsibility, and solidarity, we base our arguments on the sad reality of both 10 years of flat tax in Bulgaria, and on a close study of comparable international experience.

Contents

1. The introduction of the flat tax to Bulgaria: a short history

The July 2007 announcement of a government plan to introduce a flat tax in Bulgaria came as a surprise, but discussion regarding the tax had been ongoing since at least the late 1990s, under then prime minister Ivan Kostov. In 2004, a group of economists and NGO members sent an open letter to then finance minister Milen Velchev requesting "a unified rate of 10% for direct taxes – the income tax, the profit tax and the social security contributions". The Institute for Market Economics (IME) had been especially vocal in this campaign, as one of the country's most important neoliberal NGOs. As a result of IME's efforts, corporate tax in the country had already been reduced to 10% (starting 2007).

In summer 2007, the Institute celebrated the introduction of the "purest version" of the flat income tax in Bulgaria. This purest version included the absence of any non-taxable minimum or tax break for people of low income. This was in sharp contrast to all other European flat tax countries, where low-income taxpayers receive various kinds of tax relief. It is remarkable that in 2007, this measure was introduced with practically no debate, with minister of economy Petar Dimitrov and minister of finance Plamen Oresharski arguing that a non-taxable minimum is in principle incompatible with the flat tax. Major Bulgarian trade unions opposed the measure, but their positions did not receive much public uptake. A the same time, the European Central Bank published a review of existing flat taxes in various countries in Eastern Europe, arguing that the benefits from them were at best debatable. These concerns were also ignored in Bulgaria.

Instead, the Bulgarian government raised the minimum salary in the country by 22% to render the actual tax increase for the poorest Bulgarians imperceptible in absolute terms. Later on, experts have repeatedly argued that the rise of incomes has amply compensated the absence of a tax break. But this is a manifestly faulty argument, since at any level of income a non-taxable minimum would manifestly result in less taxes paid. And of course, this minimum represents a much greater part of the income of low earners than of high earners.

That is why the Bulgarian flat tax has hit Bulgaria's poorest citizens the hardest ~~at~~. In addition, as we shall see, the flat tax also raised the burden on medium earners in the country. In July 2007, the

Dnevnik daily, generally supportive of the flat tax, wrote that its main drawback was that "people of lower incomes bear a relatively higher burden than those of higher income". But the in-favour arguments seemed to be much stronger.

Experts, ministers and MPs sang their usual praises to the flat tax as practised elsewhere too: it supposedly attracted more foreign investments to Bulgaria, improved the economy's competitiveness, increased tax collection and simplified tax administration. Indeed, tax simplification had been the leading argument of Hoover Institute's Robert Hall and Alvin Rabushka, who gave an impetus to the flat tax idea with a now classic article in the *Wall Street Journal* from 1981. Since then, these economists have been tirelessly campaigning for the flat tax, and even though their original idea was designed for the USA, they have contributed to flat tax's introduction in Eastern Europe. But even the "fathers" of the flat tax were not as radical as their Bulgarian followers. In various versions of their flat tax design, they have consistently argued for a non-taxable minimum income for low earners:

> *The good news is that the flat tax is progressive in that families with higher incomes pay a larger fraction of their income in taxes. Families with income below the personal allowance pay no tax at all.*[1]

To solve the issue of the non-taxable income, IME experts proposed raising it to the stunning BGN 1400 (at the time, the social security cap), arguing that it was not fair to tax the same income twice. But had the proposal been accepted, it would have manifestly shrunk tax revenues. In retrospect, the proposal looks like a bluff. But ever since this moment, the absence of non-taxable minimum has been inextricably tied to the flat tax for the Bulgarian public.[2]

But some Bulgarian experts also availed themselves of a more radical argument. They have suggested that taxes in principle are unfair and therefore should be maximally decreased – according to the principle "the lower, the better." Here is a typical formulation by an IME expert:

> *Taxes are a coercive, mandatory payment to the government – i.e. they are not a voluntary means for financing state expenditures. In that sense taxes cannot be fair,*

1 Hall, R. E. & A. Rabushka. *The Flat Tax*. Stanford: Hoover Institution Press, 2007, p. 186. See also the article above as well as Hall, R.E. *et al. Fairness and Efficiency in the Flat Tax*. Washington: American Enterprise Institute Press, 1996, p. 4.

2 See a representative 2013 article in *Capital* , as well as an IME article from the same year.

> *because people have part of their income taken away from them without their consent. Therefore, we cannot talk about fair taxes; but the lower the tax rate, the less harmful the tax.*[3]

Any review of media and NGO materials from Bulgaria reveals how deeply ingrained that radically libertarian view is. Thus many economic experts in the country do not view taxes as that part of the national wealth that society invests in vital activities such as government agencies, education, and the support of its most vulnerable members. Instead, they view taxes as an inevitable evil, ~~as~~ a coercive taking away of private property and hence – as a hindrance to business initiative and the freedom to use one's own property as one sees fit. This "taxes are theft" agenda is still exerting its noxious influence on the Bulgarian public. But as we shall see here, the flat tax in Bulgaria indeed *is* theft – it is theft from ordinary Bulgarians, to the benefit of corporations and the rich.

The statement that taxes as such are unjust is deeply ideological. As such, it also expresses certain values. Given the very dubiously positive effects of the flat tax 10 years on, the only thing that "experts" have on their side is their ideological assertions. But since the issue of taxes is a political issue concerning values, everyone has the right to participate. Or, as noted economist Thomas Piketty put it:

> *Taxation is not a technical matter. It is pre-eminently a political and philosophical issue, perhaps the most important of all political issues. Without taxes, society has no common destiny, and collective action is impossible. This has always been true. At the heart of every major political upheaval lies a fiscal revolution.*[4]

Nevertheless, as we are going to see in what follows, the fiscal coup that was the introduction of the flat tax in Bulgaria 10 years ago led to changes disempowering the political influence of the vast majority of Bulgarian citizens and depriving them of a good life.

What is more, current political parties in Bulgaria do not provide real alternatives on this issue. Since 2008, four parliaments and three GERB cabinets led by PM Boyko Borisov, as well as the Bulgarian

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3 Chobanov, Dimitar, "The Proportional Tax", IME, 2007. [Titles of Bulgarian publications have been translated into English in footnotes.]
4 Piketty, Thomas. *Capital in the Twenty-First Century*. Cambridge: Belknap Press, 2014, p. 493.

Socialist Party (BSP) and Movement for Rights and Freedoms (MRF) coalition cabinet led by PM Plamen Oresharski (PM Stanishev's financial minister), have not taken any steps toward abolishing the flat tax.

The first Borisov cabinet, which assumed office in July 2009 after mounting sharp criticism against Stanishev's tenure and raising the slogan of overcoming "the difficult legacy of the former cabinet," did not see the flat tax as part of that bad legacy at all. Instead, Borisov and his center-right GERB party – who have been in office for the majority of the last 10 years – have become the main champions of the flat tax inherited by Stanishev. Even though during those years BSP has – not too resolutely – tabled measures against its own creation, almost all Bulgarian parties of any significance have been staunchly supporting it:

> *We stand categorically* for *the flat tax. Any change of taxes would increase the gray sector.* (Boyko Borisov, PM, GERB leader, February 2017)
>
> *Bulgaria is one of the countries which have profited from introducing the flat tax. If you even compare tax revenues, you would see that it is a lot fairer and thus it is more easily collected, and so more revenue is coming into the state budget. What can one mean by making the rich pay more? They always pay more, anyway.* (Vladislav Goranov, finance minister, GERB, November 2016)
>
> *The flat tax was not the fruit of flat political thinking, but rather of modern liberal thinking.* (Lutvi Mestan, MRF leader, November 2014)
>
> *Even in your favourite Russia, they have a flat tax. This kind of tax creates the condition for good collection.* (Martin Dimitrov, MP from the rightist Reform Bloc, November 2014)
>
> *We will need the flat tax for at least 10-15 more years, because Bulgaria has to catch up with developed countries.* (Simeon Djankov, finance minister, GERB, November 2012)
>
> *For the time being we will not change the flat tax, because tax stability is very important for businesses and investors.* (Boyko Borisov, PM, GERB leader, October 2012)

To recapitulate: the arguments in support of the flat tax can be divided into two groups: governance arguments (or technocratic arguments: it increases investments, collection, the "clean" economy) and value arguments (or political arguments: progressive taxation is unfair, taxes must be low). The two types, however, sometimes act together. Some people claim that lower taxes are not only fairer, but also more efficient.

> *No matter who is in power and lowers taxes, we strongly support such developments, because they have a positive effect on incomes and the economy. The flat tax has its greatest effect when it is low.*

On her part, when discussing that same year the flat tax in Slovakia and its spread in Eastern Europe, Harvard Business School economist Laura Alfaro remarked:

> *One could question whether the theoretical flat part of the flat tax concept is in fact what has been attractive or whether the flat aspect has been a political way to sell the overall tax reform, and hence mostly low taxes.*

No matter how things stand with this curious conundrum, 10 years after its introduction in Bulgaria, the flat tax with no non-taxable minimum enjoys consensus support from politicians and experts from the entire spectrum. But just what are the true achievements of the flat tax in Bulgaria?

2. Bulgaria after 10 years of flat tax

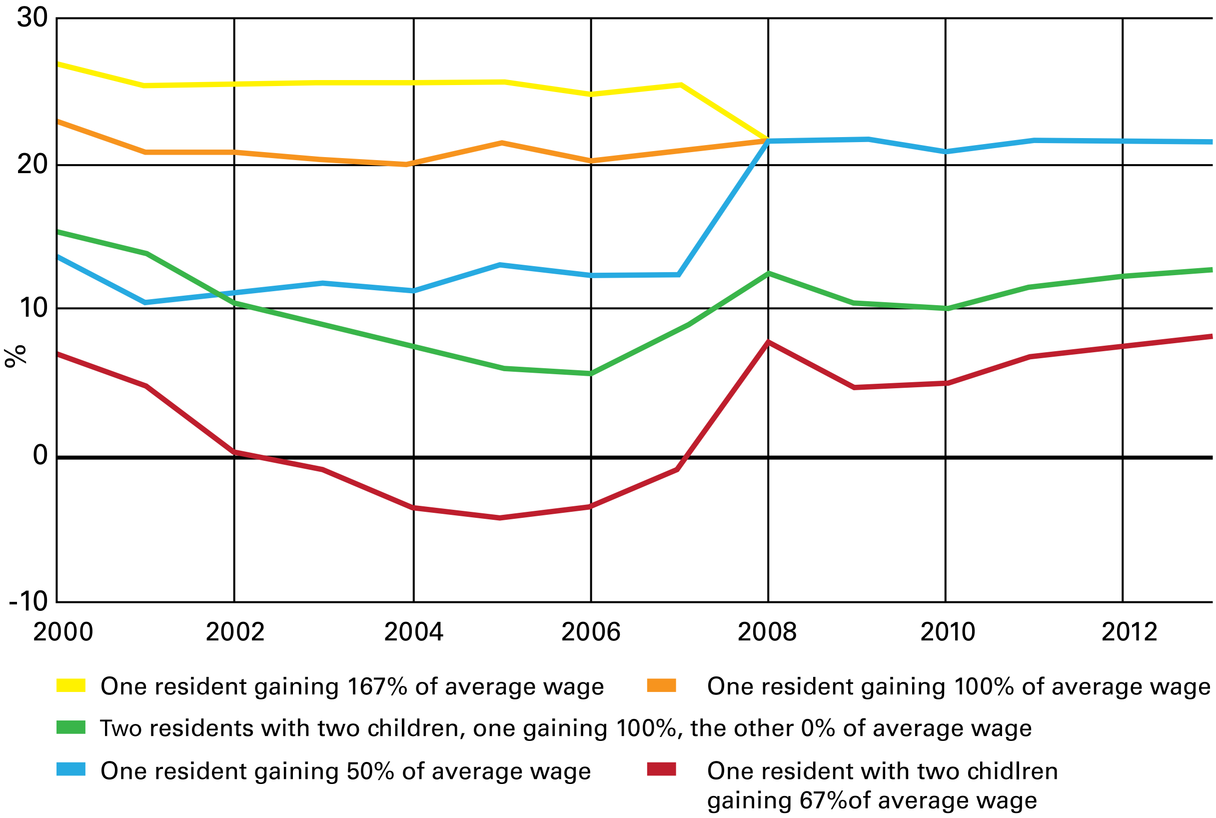
Here we will review the development of two key areas the flat tax was supposed to affect: investments and the so-called shadow or grey economy. Of course, this development is not a function of tax policy alone, but it can give us a sense of degree to which the flat tax has achieved its aims. Before we do that however, let us look at two interconnected facts, which are a direct result of the Bulgarian tax system.

> **Fact 1: Bulgaria is the EU country with the greatest economic inequality due to the low levels of redistribution, with wealth concentrating in corporations and the richest citizens.**

Eurostat data show that Bulgaria is the country with the highest income inequality in the European Union. This is a direct consequence of low revenue from direct taxes. As we are going to see, the main tax revenue in Bulgaria comes from consumption taxes, e.g. VAT. The effect is pressure on low earners. But one of the principal functions of taxes is redistribution, so as to reduce inequality in society. This means that in cases of a comparatively large VAT revenue, the state has to spend more to reduce poverty. This is not the case in Bulgaria. Consumption taxes are in effect regressive because people of low and medium income spend a greater part of their salary for consumption, compared to people of high income. In addition, corporations are free from VAT, and their owners can list personal spending as corporate costs.

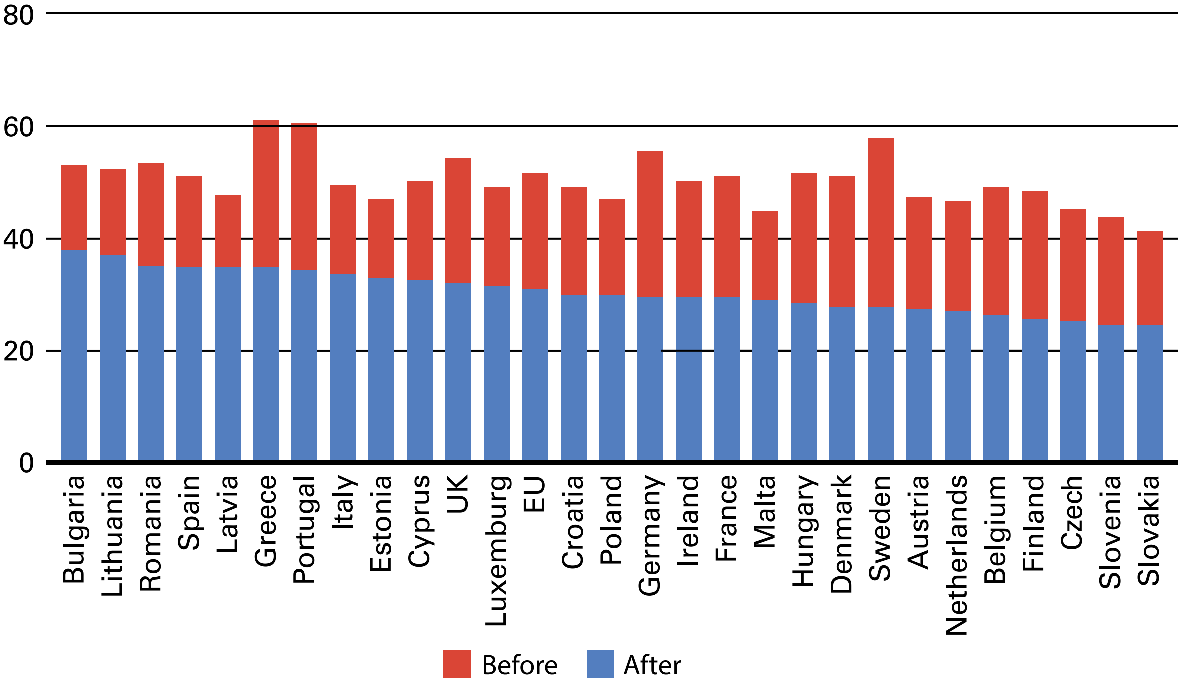
Moreover, a recent report by the European Commission has clearly demonstrated that under flat taxation, the tax burden is heavier on mid- and low earners than on the rest of society. In the Bulgarian case, if we review the tax burden, we can see that persons whose salary exceeds the medium by 67% or more have borne a smaller burden since 2008. By contrast, the tax burden on all other Bulgarian households has risen.

Average tax burden on different households



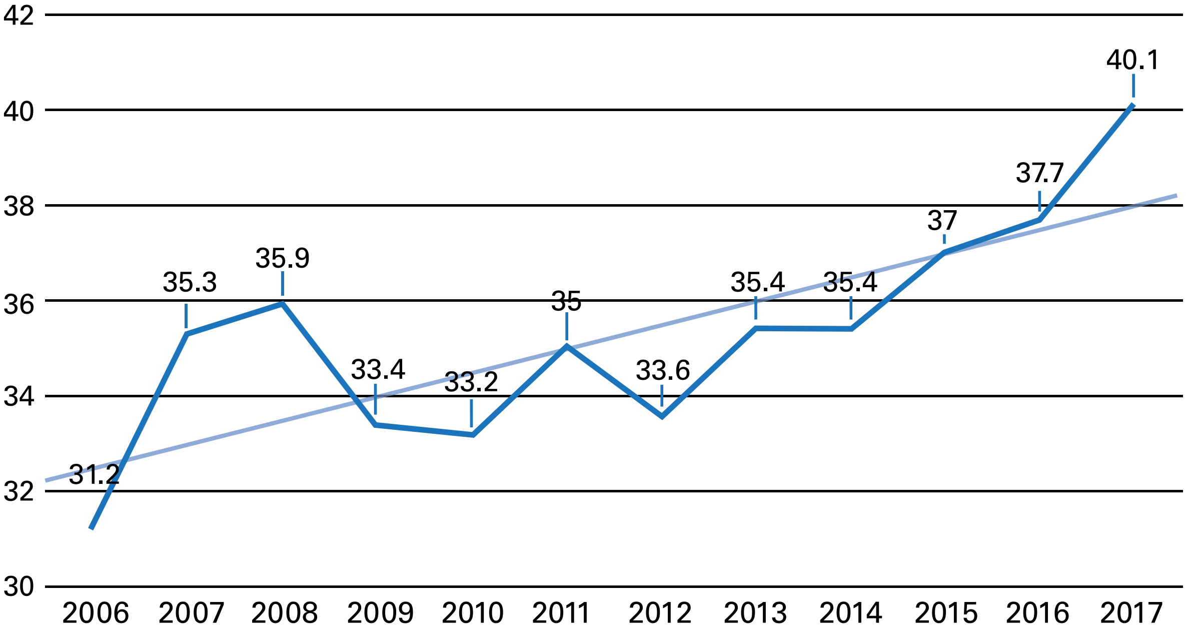
A vivid proof that inequality in Bulgaria is a function of the tax system is recent data by Eurostat showing that the country does not have the highest inequality in the EU before redistribution, but gets the top place *after*; i.e., the contrast in incomes before taxes is relatively weaker than after taxes are paid and social payments are made. For 2016, the Gini coefficient for Bulgaria was 52.8 before social transfers, with Germany, Greece, Portugal, Romania, Sweden and the UK more unequal. After social transfers, the coefficient dropped only to 37.7 and Bulgaria ranked most unequal.

Gini coefficient before and after social transfers, 2016



For 2017, the Gini coefficient for the country was even higher – 55.2 and 40.2, respectively. According to the other chief inequality index – the proportion between the incomes of the top and lowest 20% of society – Bulgaria once more takes the lead with 8.2, far ahead of the second country, Lithuania, where the index is 7.1.

Gini coefficient, Bulgaria 2006-2017

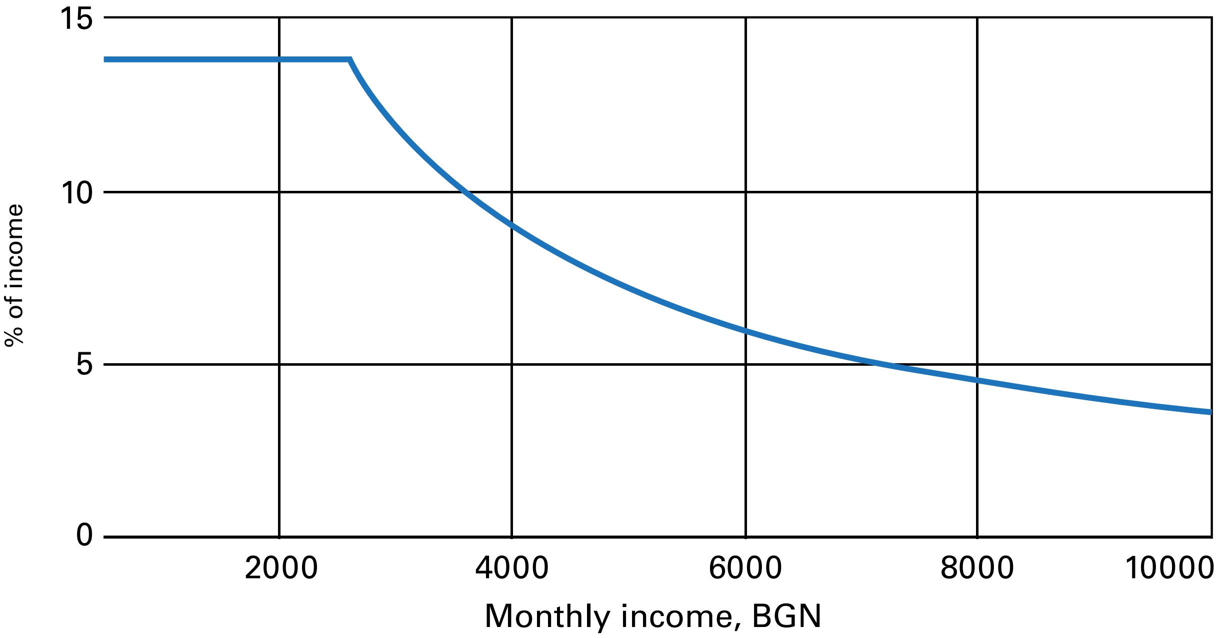


In other words, in Bulgaria there is reverse redistribution: from poor to rich. That is why the European Commission European Semester Country Report for Bulgaria mounts serious criticism at the failing battle against increasing inequality in the country. Among the EC's conclusions is the following:

> *Growth has not been inclusive enough to reduce poverty and economic and social inequalities. ... Market income inequality for the working age population is only slightly higher than the EU average. However, the effect of taxes and transfers on reducing inequality is among the weakest in the EU. This is partly due to the relatively small redistribution impact of the flat personal income tax system, as well as the relatively low spending on social protection and the absence of a mechanism to better target and update social transfers to the population in need. Inequality of opportunities is also high.*[5]

Reverse redistribution is further increased by the presence of a social security cap of BGN 2600, above which personal incomes are not taxed with social security. Persons above that threshold in effect pay a smaller percentage for social security than the rest.

Household expenditure on social protection, 2018



In other words, we have ample evidence that the Bulgarian tax system is a veritable machine for the production of inequality. Instead of soothing the lives of the losers of a risky economy and of a society that does not really provide equal opportunities to all, the

5 European Commission, *Country Report Bulgaria, 2018. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*, p. 7.

Bulgarian tax policy in effect punishes the low income earners by freeing high earners from progressive taxation. This means that the machine of inequality in effect redirects a sizeable portion of the already limited incomes of the large majority of Bulgarians into the pockets of a small, already rich elite.

For 2016 (the last year for which detailed data available at the time of writing), some BGN 1.236 billion or as much as 40% of revenue from income tax have come from the absence of non-taxable minimum income. For the same year, people with a monthly wage no bigger than BGN 600 (the minimum wage being BGN 420) have contributed some BGN 683 million to the budget in the form of taxes from their modest incomes. On the opposite end, people with salaries over BGN 5,000 per month have contributed only BGN 530 million.

As noted by the EC Semester report, inequality in Bulgaria is on the increase, even though the country's economy is growing. This means that the product created in the country gets concentrated in the hands of a few, instead of spreading relatively evenly in society. This is yet another piece of evidence that the 'invisible hand of the market' expected to facilitate the trickling down of wealth in society does not work. Instead, another invisible hand is on the move: armed with the machine for inequality, it redistributes public wealth towards the richest.

A recent study by Ivaylo Atanasov (co-author of the present paper) revealed <u>the astonishing level of concentration of wealth in the handful of people at the top of the Bulgarian income pyramid</u>:

> *The effect of the flat income and low corporate tax is positive for a rather small minority – so small it is hardly perceptible with the instruments of official statistics. On its turn, the analysis of larger databases, such as are at the disposal of the Bulgarian revenue agency, reveals even more grotesque dimensions of inequality in Bulgaria. It turns out that some 98% of Bulgarian citizens receive the same or a smaller share of public wealth, to the benefit of the top percent or two*.

This renders very problematic the claims by some economic experts in Bulgaria that education is a leading factor for inequality. It may be an important factor for the difference between the extremely and the 'moderately' poor, but the top 1-2% are not likely to be educated much better than the rest of the population. What is more, even if educational inequality is a partial cause for income inequality, we know for certain that income inequality engenders educational inequality. This has been confirmed by multiple PISA reports for Bulgaria, which have pointed out that educational outcomes in Bulgaria are heavily dependent on the economic background of the students' parents. This fact is also confirmed by the EC Semester Report on Bulgaria, which puts it in a broader context:

> *Social transfers have a very limited impact on reducing poverty and inequality. Inequality of opportunity – in education, healthcare and housing – is among the highest in the EU, which makes success in life largely dependent on the parents' achievements.*[6]

We cannot expect people to self-educate in order to earn more. Instead, we should invest in public education by raising tax revenue coming from the richest members of society, who greatly profit from the wealth generated in society, including by the workforce.

Fact 2: The Bulgarian state gets financed by the everyday consumption of Bulgarians, instead of taxing the wealth generated within society.

More than half of the tax revenue in Bulgaria comes from indirect taxes. They are a part of the price that every Bulgarian pays for the purchase of any type of goods. Since, unlike in other countries, in Bulgaria there is no differentiation in VAT rates for things such as water, basic foods, medicines, and books, this means that everything – from bread and water to luxury cars and yachts – are taxed at 20%. What does this have to do with the flat tax?

A society has to find a way to somehow finance the institutions and systems it needs for its functioning. When revenue from direct taxation is low, the state is driven to compensating what it lacks by collecting more indirect taxes. The high VAT price that Bulgarians pay every day is a direct result of the flat tax and the low corporate tax rate.

We can visualize even more clearly the degree of distortion of Bulgaria's tax system if we compare it to the structure of tax revenue in other EU countries. Bulgaria is in the first place in the Union in the share of revenue from indirect taxes – a whopping 53.6% (according to the last EC data, 2016).[7] The average for the EU is 34.9%, from which the Bulgarian case is a major deviation; the average for OECD countries is around 31%.

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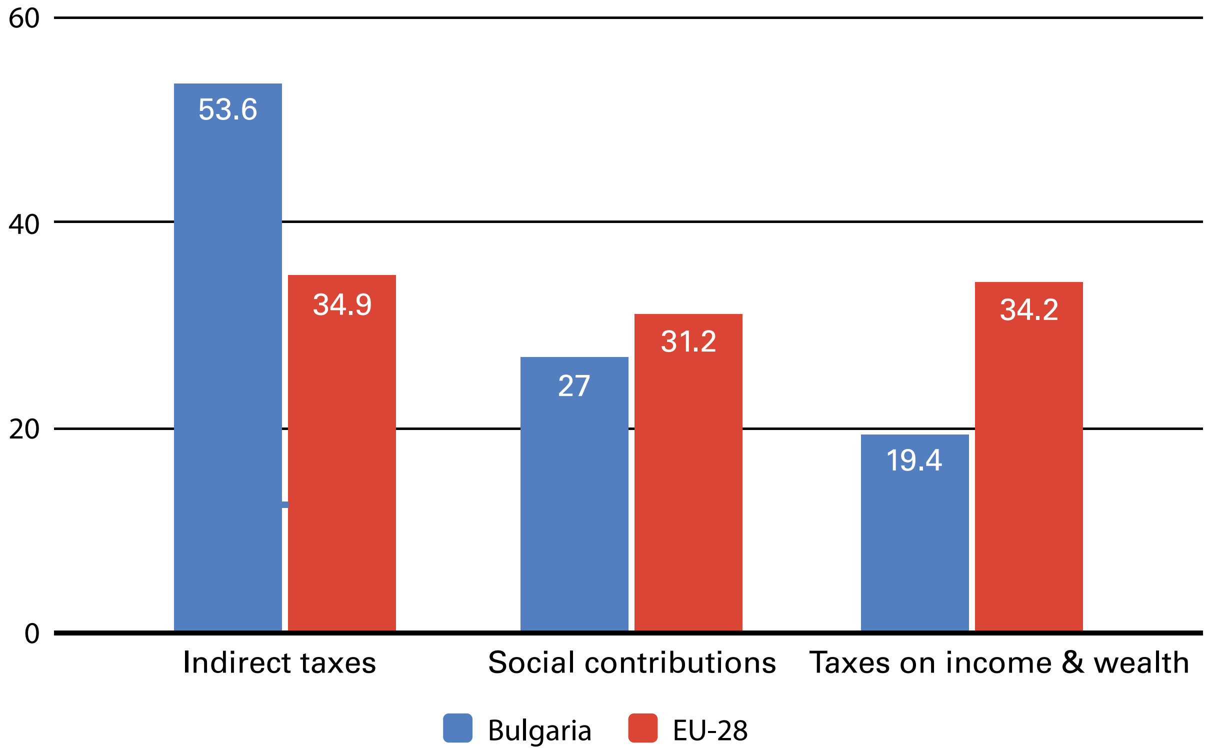
6 European Commission, *Country Report Bulgaria, 2018*, p. 36.

7 European Commission. *Taxation Trends in the EU, 2018*: p. 18-19.

Household expenditure on social protection, 2018



It is to be noted that the other countries that lead the EU ranking in this respect include some other East European member-states. It turns out that other countries are successful in collecting revenue by taxing corporations and rich citizens, but some East European countries do that by taxing consumption. Here Bulgaria holds the first place, the trend being one of growth of the share indirect taxes.

If we look at revenue from direct taxes, we will see that corporate contribution to the state coffers is very modest, to say the least. Companies manage to avoid taxation not only by evasion, but also by completely legal methods. As a study by the Tax Justice Project noted:

> *In 2015, the ten companies with the highest revenue in Bulgaria have contributed to the state budget a total of BGN 44 M. This amount is hardly large, because the total turnover of those largest companies operating in Bulgaria is over BGN 22.6 B. This means that the top 10 companies pay a profit tax equal to 0.2% of their income. This is tens of times less than the tax burden on personal incomes in Bulgaria.*

Data published by EC in 2018 show that in Bulgaria direct taxes are only 19.4% of the tax revenue, with an average EU level of 34.2%. On this parameter, Bulgaria is followed only by Lithuania, Hungary, and Croatia – the first two of which also impose a flat tax. According to the share of corporate taxes Bulgaria holds the unenviable 22nd place in the EU (2.1% ofGDP), while according to the share of personal income tax – next to last (3%). But in terms of the total share of direct taxes in the GDP, Bulgaria holds the last place, with 5.6%.[8]

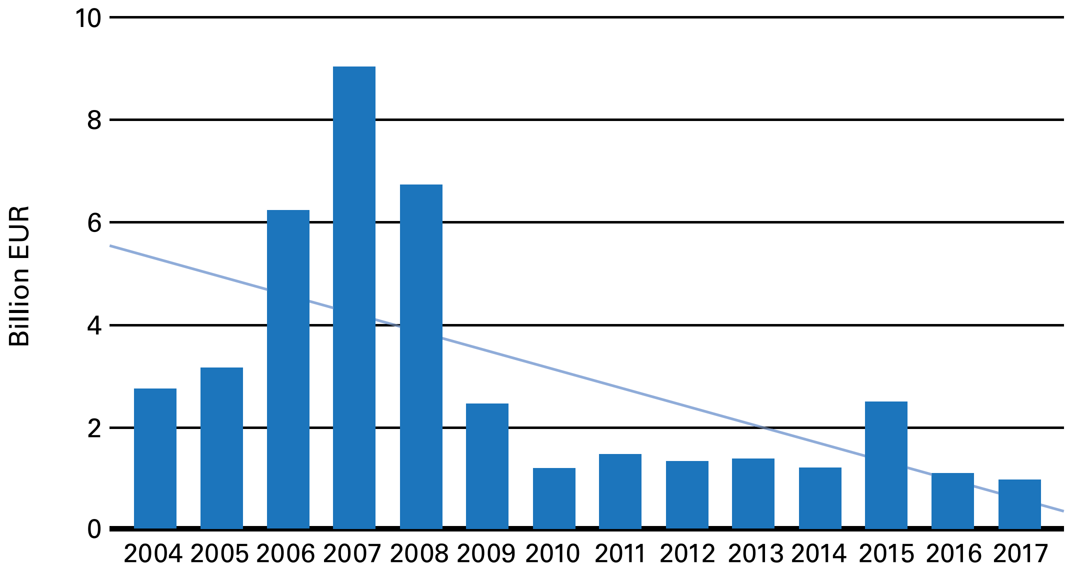
The low revenue from direct taxes and the strong taxation of consumption are among the leading factors for inequality in Bulgaria. At the same time, the rich and the corporations refuse to take up their fair share of the tax burden. That is why, together with an increase of the tax rate and a broadening of the tax base for the corporate tax, a sweeping and fair tax reform requires also reforming the various types of property taxes, so that they start generating revenue more efficiently and fairly.

Given these very palpable negative effects of the flat tax on Bulgarian society, its contributions to the Bulgarian economy should raise more than an eyebrow. With respect to two of its main declared purposes, the flat tax has been a failure.

Fact 3: Since 2018 investments in Bulgaria have been dropping, instead of rising.

Investments are an undisputed failure of the flat tax. Between 2007 and 2013, FDI in Bulgaria was on the steady decline. This time marked the period between the end in office of the Stanishev cabinet and that of the first Borisov cabinet. After hitting this bottom, investments started recovering very slowly. There was a peak in 2015, but this was anomalous, as shown in 2016 and 2017 when under the rule of the second Borisov cabinet, Bulgaria got only some EUR 1 billion of FDI per year. This is comparable to what Bulgarian migrant workers send back home as remittances.

Direct foreign investment



8 *Ibid.*, p. 60-63.

Some would try to explain these developments with the fact that the introduction of the flat tax in Bulgaria coincided with the global financial crisis and the global outflow of investments. In response we would suggest looking at how investments in Bulgaria have recovered in comparison with their pre-crisis peak of BGN 9 billion in 2007. The post-crisis peak in the anomalous 2015 was 5 times less than that. By contrast, according to OECD data, the total level of FDI in the EU in 2015 was only 2 times less than the amount for the record year of 2007. According to June 2018 data, although businesses operating in Bulgaria have recorded growing profits, the level of FDI continues to fall.

At the end of August 2018, the Bulgarian Chamber of Commerce published an analysis describing the investment situation as one of "total collapse". The study underscores the downward trend of the share of FDI in Bulgaria's GDP – from 28% in 2007 to 2% in 2017. After record low investments in 2017, the data shows that for the first half of 2018 they are two times less than those of the same period last year.

Until now, no one has succeeded in presenting empirical data or other convincing evidence that flat taxation and the low corporate tax have led to the increase of foreign investments in Bulgaria. (As we shall see, this is also the case for other countries.) Some experts occasionally claim that under a progressive taxation, investments would be even lower. But this means that a tax system that hits hard on people's incomes is being used as an instrument to mitigate the governance failures of those in power.

Fact 4: The shadow economy in Bulgaria has not shrunk, while the rate of tax collection has not grown significantly.

All data that we have for the shadow economy in Bulgaria for the 10 years since the flat tax's introduction shows that the "grey" economy has more or less stayed at the same levels, without any signs of shrinking. Even though, due to the nature of the matter, various assessments of the share of the "grey" economy in the GDP can at times produce diverging numbers, these assessments are all in agreement as to the trends through the years.

What is more, existing data shows that the volume of businesses "in the shadows" follows more or less the overall European trend. Most other EU member-states did not introduce tax reforms similar to the ones in Bulgaria, and therefore we cannot argue that the grey economy in Bulgaria has shrunk as a result of that reform.

Calculations by the IMF published in early 2018 state that between 2007 and 2015 the share of the shadow economy in Bulgaria has fallen from 23.7% to 20.83% of the GDP. Still, this makes Bulgaria the most "shadowy" economy in the EU. In other words, even though that share has dropped, the development has not put Bulgaria in a position better than that of the countries with which Bulgaria directly competes, supposedly using its tax policy.

Data by the Association of Chartered Certified Accountants from July 2017 points to levels of the grey sector of around 30% of the GDP for 2011, with ACCA arguing that this level has been maintained since and is expected to remain stable until 2025. The Bulgarian Chamber of Commerce has also noted more or less stable levels of the shadow economy. In its Semester Report on Bulgaria, the EC has noted that even though the grey economy has been slightly shrinking, it still remains a grave problem.

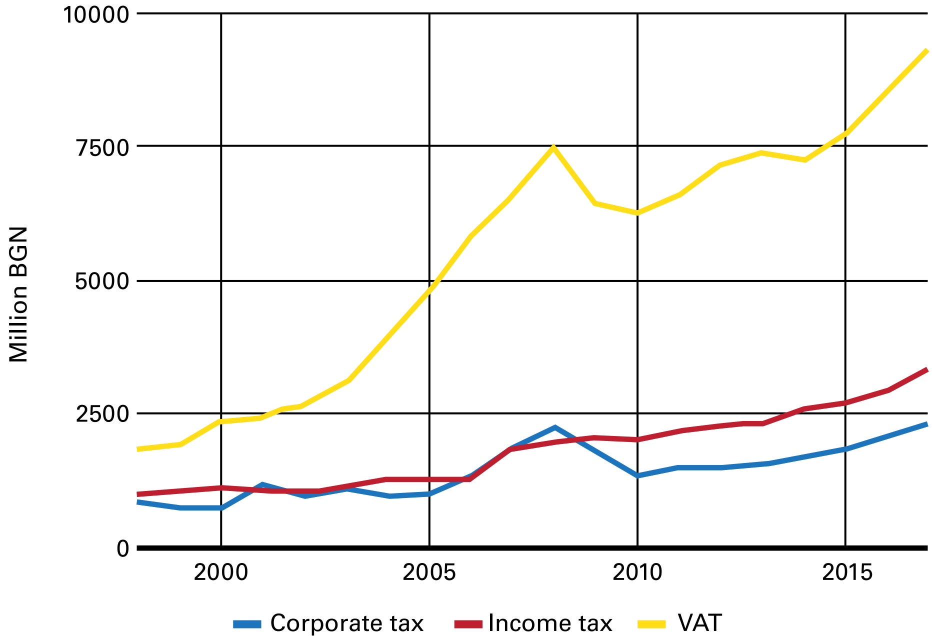
The analyses of the Center for the Study of Democracy – one of the most experienced Bulgarian organizations in the study of the "shadow economy" – also concur with this broad diagnosis. In their most recently published documents, the CSD even noted that by 2015 the "grey economy" levels were slightly higher than those before the introduction of the flat tax. The following conclusion is alarming:

> *With time, high earners leave the shadow economy more slowly than others. We even note a certain "withdrawal" from the payment of social security (for those who can afford that – self-employed, company owners). This "withdrawal" from social responsibility through taxes is to be observed most clearly among the richest – company owners, professional managers and senior officers – who "swap" the income (on which they have to pay social and health contributions, as well as income tax) by means of "corporate consumption" of goods and services, for which their low earning fellow citizens have to pay from their income after being taxed.*

The shadow economy is an important way in which corporations and high earners in Bulgaria heap profit for themselves at the expense of everyone else. The flat tax has failed to amend in any way this regrettable situation.

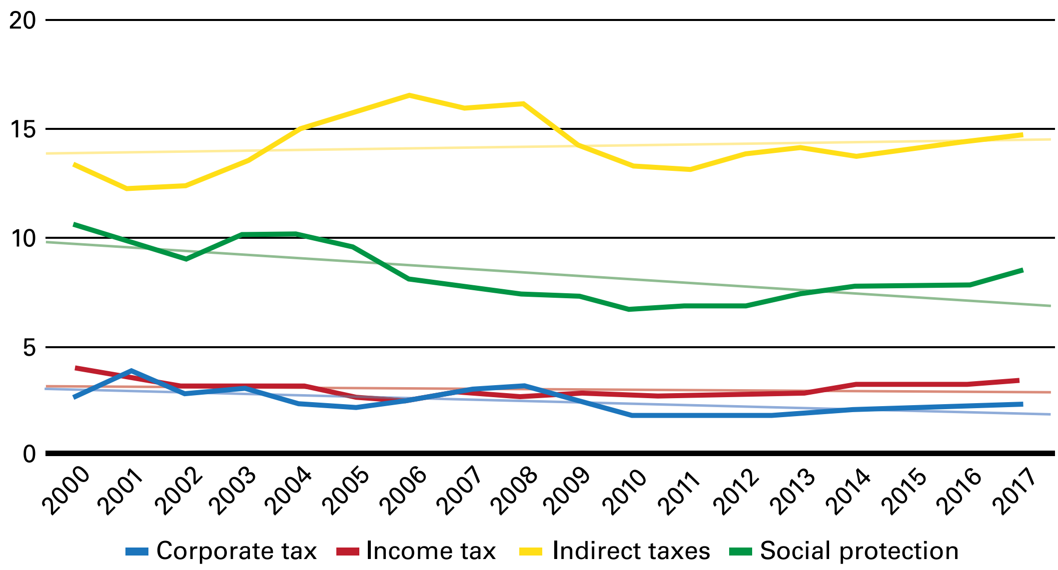
This is also reflected in the rate tax revenue is collected in Bulgaria. If by tax collection we understand the absolute level of tax revenue, then since 2008 this level has indeed risen. But these numbers do not reflect what portion of the taxes due has been collected. Moreover, as we saw in the first chapter, an increased efficiency of tax collection is one of the main arguments for the supporters of the flat tax. Therefore it would be more to the point to understand the rate of tax collection as the percentage of the GDP collected by the government via taxes. Then, if the tax system is efficient, that percentage should rise together or faster than the GDP does. A recent analysis by the Bulgarian Chamber of Commerce uses a similar approach.

Tax revenue by main tax category



If we look at the data, the vast part of the rise in the absolute value of tax collection comes from indirect taxes. On the other hand, the stagnation of the absolute value of corporate tax revenue is alarming. Alarming is also the fact that the percentage of tax revenue in Bulgaria's GDP has actually fallen for the period. This means that the tax revenue has not grown proportionally with the GDP. In other words, the growth of the Bulgarian economy has failed to adequately express itself in terms of national wealth.

Tax revenue as percentage of GDP



In particular, the share of corporate tax revenue in the GDP has fallen, while that of income tax has almost stagnated. But the former has fallen not only as a result of the abolition of the non-taxable minimum income. In other words, it cannot be argued that the flat tax has increased the efficiency of tax collection. If there is a causal relationship, it is the converse.

The obvious recapitulation of the picture we drew in this chapter is as follows: ten years later, the flat tax has produced strongly negative effects for Bulgarian society and almost no positive effects for the Bulgarian economy. Certainly, there *are* positive effects from the flat tax – but they are limited to the rich and their companies.

3. Introducing progressive taxation – a necessary policy

We need to abolish the flat tax and introduce progressive taxation in Bulgaria. This is dictated both by the imperatives of social justice and by the need for economic development of the poorest and most unequal country in the EU. As we saw, the technocratic arguments for the Bulgarian flat tax have failed. What remains is to refute the ideological arguments. In theory, this should be easy, because these arguments are completely invalid. In practice however, it requires a hard struggle against the media machine, which with the help of "experts" attempts to impose a certain ideological viewpoint as the only one possible.

We have to get rid of the neoliberal illusion that taxes are a coercive appropriation of private property. Let us repeat: we should instead think of taxes as that part of the product created in a society which that same society has agreed to invest in financing the public systems and institutions that support its existence. The absence of such public infrastructure would render impossible the existence of society, private persons, and private businesses. Taxes are the price paid to use this shared wealth.

Among the main functions of any tax system is redistribution. Inequality is a result not only of the efforts and accomplishments of separate individuals, but also of luck and most importantly – of the different standing of those individuals within society. Society's members never have the same starting positions; market relations are never risk-free; and the economic system is never perfectly fair. Redistribution comes in to partially ameliorate these objective conditions in the context of a market economy.

Without redistribution, the unequal social standing of individuals and social groups would reproduce itself indefinitely in the future. An unequal start would systematically lead to an unequal outcome, for generations on. This unfair situation condemns many people – along with their children, and the children of their children – to systematic exclusion. What is more, inequalities tend to increase over time, with excluded groups suffering further exclusion and wealth getting more and more concentrated in private hands. Such a situation should not be acceptable for even the supporters of neoliberalism – if they truly believe in fair competition.

The first great theorist of market society – Scottish economist and philosopher Adam Smith – saw the necessary connection between the increase of wealth of some members of society and the poverty of others. It is a pity that some neoliberal experts have idolized Smith, creating a fals image of him that reduces his deep analysis to a set of simplistic clichés. In his fundamental *Inquiry into the Nature and Causes of the Wealth of Nations* (1776), the Scottish thinker wrote:

> Wherever there is a great property, there is great inequality. *For one very rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many.*

In other words, Adam Smith had already discovered that market society – which he highly valued – systematically creates inequalities and poverty. But apart from being perfectly honest about this fact, Smith did not see it as "fair" or a "necessary evil" (we can often encounter both positions today). To the contrary – he argued that society must fight against inequality. Smith writes:

> *What improves the circumstances of the greater part can never be regarded as an inconveniency to the whole.* No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. *It is but equity, besides, that they who feed, cloath and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged.*

The idea of progressive taxation has received the support of serious liberal economists either, such as Nobel Prize laureate Joseph Stieglitz and noted French economist Thomas Piketty. In the year Bulgaria introduced the flat tax, a report by the influential Brookings Institution in the US recommended more progressive taxation precisely so as to fight growing inequalities:

> *At some point inequality in outcomes becomes so great that the quintessential American promise of equality of opportunity becomes unattainable. ... Our economy and society work best when more opportunities are available to all—a goal that progressive taxation can help serve. Extreme inequality threatens to undermine political support for a competitive market economy.*[9]

Richer citizens tend to use public resources to a greater extent than others, which is why even a purely economic logic dictates that they should pay higher taxes. This is so because the institutions of the state designed to protect private property as a rule service those who have more private property. Much more than others, those same social groups reap the profits from the goods guaranteed by the state, such as an educated workforce, a clean environment, an efficient infrastructure, etc.

The need to achieve higher levels of equality can be argued from two interrelated perspectives: that of social justice and that of social cohesion.

Social justice requires from society to guarantee that all its members and groups possess substantively equal opportunities to live decent lives, to develop their potential, and to receive a fair reward for their efforts. While this is an ideal situation, society is obliged to work to achieve it as fully as possible. Such an effort is all the more necessary in a country such as Bulgaria, where extreme poverty reaches shocking levels, and where the gap between rich and poor grows every day.

Social cohesion dictates not allowing levels of inequality beyond certain limits, which would make society unstable. When those who have been systematically excluded from society gradually stop being a real part of it, their frustration and anger can erupt in violent ways. This is all the more dangerous, the greater the number of marginalized people and the stronger their feeling that they are systematically wronged by their own society.

Of course, social cohesion is pointless without social justice. There is no reason for a society to continue to exist, if its structure is such that it does not guarantee justice to its members. Except if the rea-

9 Furman, Jason *et al.* Achieving Progressive Tax Reform in an Increasingly Global Economy (Hamilton Project Strategy Paper). Brookings Institution, 2007, p. 10-11.

son is for it to allow better positioned groups to benefit from the labour of the people.

The advantages of greater equality do not stop here. Social justice and social cohesion are also economically beneficial. They guarantee a healthy climate for the development of both worker skills and business growth. Bulgarian economist Dimitar Sabev writes:

> *Progressive taxation brings benefits not only to the state budget, but also to the entire society, because it reduces inequality and thus stimulates the economy. <u>The great gap between rich and poor discourages people from working.</u> Low taxes lead to low public spending, and from there – to low quality education, deskilled workers, low purchasing power, and in the end, an outflow of investments.*

During the 2014 debate over the rejected proposal for abolishing the flat, the chair of the Bulgarian Parliament's budget committee, Menda Stoyanova (GERB), stated:

> *The flat tax is fairer, because it stimulates people to work more and to have their own businesses. Those people will pull the economy up. We must attract investments; people have to develop better skills. If we introduce a progressive tax, people will be taxed more. This boils down to a difference in values.*

The argument is completely topsy-truvy. There is enough evidence that rather than stimulating, the flat tax hampers employment. But Stoyanova is right in one thing: it does boil down to a difference in values. The question is whether the price for economic growth should be paid by mid- and low earners or by high earners and corporations. It also boils down to a value difference about the type of growth. The question is whether we should prefer growth based on low-skilled labour at a high degree of exploitation, or growth based on specialized industries that stimulate the development of other parts of the economy and have also high added value.

In a recent study by the Collective for Social Interventions and Solidary Bulgaria on the topic of social payments, economist Vanya Grigorova (co-author of the present paper) made the following observation:

> *Bulgarian governments continue to implement with full force the following philosophy: "To make the rich work, we have to give them more money and offer them all kinds of exemptions,*

including tax breaks. To make the poor work, we have to leave them without any means of sustenance. The rich need stimuli – the poor need sanctions!"

It is time for working people in Bulgaria to stand up against this philosophy. The change of the tax system is among the most important parts of the struggle against oligarchic privilege.

4. The people against the "experts": the role of taxes in the struggle for democracy

The choice of tax system has to do with more than just the fiscal and social policies implemented within a country. In its broader significance, the tax issue also involves the vary basis of democratic governance. This is the case because taxes are an expression of the values prevalent in a given society. Since it is a vital ingredient of social justice and responsibility, the distribution of goods, and the financing of social systems and institutions, taxation is part of the informal contract that keeps society together and helps it develop.

That is why a tax system has to be democratically introduced, open to democratic debate, and overall democratic in spirit. But we should not imagine this debate to be a polite dialogue among rational speakers, or that the social contract is a free agreement between equal sides. Democratic rights and values are neither naturally given nor something that has been achieved once and for all. They are the result of long struggles and have to be resolutely defended, because they are under constant assault.

The case of the Bulgarian tax system is a glaring example. The adoption of the flat tax in 2007 was so undemocratic that it can be described as a "tax coup". The 2004 open letter to then finance minister Milen Velchev calling for flat taxation was signed by less than 100 experts and NGO activists. In comparison, the *Stop the Machine of Inequality* initiative which in 2017 called for the introduction of non-taxable income and lower VAT rates for some goods, was supported by some 30,000 working Bulgarians, students, and retirees.

Since 2004, the experts supporting flat and low taxes had the opportunity to relay their messages to the public in conditions of full media comfort. The flat tax was adopted in spite of criticisms by the trade unions and other organizations. Later, these so-called "experts" established sole monopoly over the right to discuss the tax system.

For instance, among the main criticisms against the fair taxes initiative was that it did not offer exact calculations how the introduction of the measures it proposed would affect the state budget. This served as a justification for an article in the influential daily *Capital* to call them "populist". On its part, the IME retrospectively described as "populist" the initial opposition against the flat tax in Bulgaria.[10]

Rhetorically opposing "expert" and "populist" politics is typical of present-day political debates. We have all heard how it's better to be governed by "experts" who know what they are doing, than by "populist politicians" who take advantage of the under-informed "people". Yet even as it appears to call for good governance, the opposition poses an undemocratic false dilemma. It takes away from common people the right to discuss and decide common issues that directly and vitally affect them.

The case of the Bulgarian tax system is a manifest example of experts' appropriation of informal power in a vital area of public life. The tax system is being presented to the public as an exclusively technical matter that is not the subject of a value or political choice. But as we have already seen, this thesis is fundamentally wrong. Nevertheless, it creates an opportunity to implement non-transparent decisions to the detriment of society by those who present themselves as the solely competent in these matters.

As we saw above, such "experts" push for ideological policies, if under the cover of an alleged expert neutrality. In contrast, we not only base the present policy paper on solid facts and arguments, but also openly declare the values guiding it.

What is more: even with the best of intentions, it has been impossible to calculate the exact effect a tax reform would have on the state budget, because the Bulgarian National Revenue Agency and National Social Security Institute have not made available to the public the data needed, e.g. data on the structure of income groups and their corresponding revenues. Only recently did the Ministry of Finance publish (in response to an MP question) partial data about income groups in the country, on the basis of which one can make plausible calculations. We will take them into account, when we formulate the two models for tax reforms in chapter 8. Here we can only stress, once again, that the struggle for democratization of the tax system is a struggle against secret, non-transparent expert knowledge.

The members of a society have the right to determine the values and conditions under which that society operates. As one of the most important among those conditions, the tax system, in its broad outlines,

10 Institute for Market Economics. *Flat Tax in Bulgaria*. Sofia: IME, 2016, p. 12-16.

is always an expression of a set of values. The progressive tax is an expression of social responsibility. The flat tax without non-taxable income minimum is an expression of responsibility towards corporations and the rich. That is why the flat tax is a part of the system by means of which the Bulgarian state supports the so-called oligarchy.

Longtime Bulgarian finance minister Vladislav Goranov once coined the following adage:

> *Justice is a class concept and is thus unachievable.*

Let us accept that this is true: that justice as such is not achievable, but is rather a specific policy that can only serve a specific group in society. Then it would not be difficult to answer the question: "Which is the class served by a system in which the rich pay equal direct taxes and a lower percentage of social security and VAT than the middle class and the poor?"[11]

One of the goals of the present policy paper is to revive serious public debate on taxes in Bulgaria. What is more, our goal is to revive it in such a way as to both open it up for all Bulgarian citizens and take it away from the hands of experts.[12]

The experts have the responsibility to develop different scenarios, under which the tax system selected by citizens would be able to successfully function. They also have the responsibility to make their analyses available to ordinary people, so that they are able to make an informed decision. In a democratic society, the experts should not be the ones to have the final word.

Any responsible tax system analysis must take into account ~~of~~ the fact that for the proposed reform to be successful, it must respond to the needs of the people it affects. Such a reform has to be fair, and has to also correspond to people's conceptions of fairness. Stated differently, we must take responsibility for how we interpret people's views and what conclusions we draw on that basis. Should it come as a surprise if working people who do not believe in the fairness of an underfinanced social system might prefer to receive a part of their salary under the

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11 For more on this matter, see: Draganov, Nikolay, "Justice for Goranov", *Baricada*, 2017: and Atanasov, Ivaylo, "For Whom Are Low Taxes Low?", *Baricada*, 2017, as well as the 2018 KOI (CSI) study on the condition of the working class in Bulgaria: Medarov, Georgi, Jana Tsoneva, and Madlen Nikolova. *Exploitation and Resistance: Labour in Three Subcontracting Industries*. Sofia: KOI, 2018.

12 This is why the team of the present policy paper includes not only an economist and trade unionist, Vanya Grigorova, but also an analytic journalist, Ivaylo Atanasov, and a university professor of philosophy, Ognian Kassabov.

table? Or if middle class citizens does not feel the duty to pay more than those above them on the class ladder? Or if social groups that in effect live in different worlds refuse to invest in a shared future? The favourable perception about the fairness of a tax system is a necessary condition for efficient revenue collection, lack of tax avoidance, and the shrinking of the "grey" economy.

A late 2017 study of value attitudes in Bulgaria conducted by the Trend Research Center (commissioned by the Institute of Rightist Politics) produced results that some commentators hastily as expressing political confusion on the part of Bulgarian citizens.[13] According to the Trend analysis:

> *Over 90%of those questioned believe that education and healthcare must fully free, while 86% believe that everyone must be guaranteed a basic income and that the state has the responsibility to guarantee a job for everyone who wants to work*.

The researchers explicitly noted the "fully comparable" results obtained among the youngest age groups, which precludes the possibility of ascribing these attitudes to the so-called legacy of state socialism in Bulgaria. At the same time, however, an impressive 60% said that they wanted the introduction of lower taxes, while only 25% called for higher taxes. This apparent contradiction can easily be resolved if we take into account the facts laid out in chapter 2. It is ordinary Bulgarian citizens who provide the majority of the tax revenue, by both direct and indirect taxes. After the introduction of the flat tax without a non-taxable minimum, the tax burden on their modest incomes has grown. It is therefore perfectly natural that they demand lower taxes. The two progressive tax models that we put forward in chapter 8 actually lower the tax burden for the greater majority of people in Bulgaria while increasing it for the rich and for corporations, thus opening the way for a fairer redistribution.

In turn, the 2013 yearly review book of the Gallup International polling agency notes that while, in contrast to the 1990s, the division between rich and poor has been somewhat normalized in the perceptions of Bulgarians, their attitudes remain strongly in favour of equality. In addition, Bulgarians have maintained their strong support for the welfare state:

> *In August and October 2013, huge majorities – between 80% and 90% – agreed with the statements "The state*

13 The *Capital* title is vivid: "Bulgarian Values are a Mess with a Socialist Aftertaste".

> *must guarantee work to everyone who so desires", "The state must guarantee a certain income to everyone", and "The state must guarantee free education". There was practically no social group in which agreement with those statements was not prevalent.*[14]

Gallup's data show a moderate acceptance of the fact of inequality as "normal", combined with a resolute rejection of levels of inequality even greater than those already present in Bulgaria. In 2013, some 60% of Bulgarians agreed with the statement that "The income of the richest in the country should not exceed more than three times the income of the poorest", with only just over 20% agreeing. The Gallup researchers conclude that Bulgarians accept inequalities "abstractly", but not in practice, in their everyday lives.

These studies show that social and economic equality remains an important value for Bulgarians in spite of decades of neoliberal propaganda – or rather, precisely *because of* those decades, during which neoliberal propaganda was supplemented by neoliberal *reforms*. In this light, a tax reform geared at decreasing income and other types of inequality is likely to enjoy strong public support, granted that it is properly designed and communicated.

The majority of EU member-states and other developed economies around the world demonstrate the successful workings of progressive taxation. And, as we shall see in chapter 6, some East European countries have already left the flat tax behind to return to tax progressivity.

We would like to bring up one final argument in favour of the correlation between democracy and the tax system. In addition to running afoul of the principle of fairness, a flat tax is incompatible with the principles of democratic rule. Broadly speaking, this is so because of the conditions it creates for the concentration of wealth – and therefore also power – in the hands of a small elite. This concentration of wealth is then generationally reproduced and expanded, while working people have less and less influence over how their country is governed. In addition, due to the claim that it is the fairest system possible, flat taxation creates the illusion of lack of alternative, depriving people of democratic choice.

The anti-democratic nature of the flat tax can concretely demonstrated from multiple perspectives. German economist Wolfgang Streeck wrote

14 Gallup International. *Political Process and Public Opinion in Bulgaria, 2013*. Sofia: Ciela, 2013, p. 195-208. We express our special gratitude to executive director Parvan Simeonov for a review he made in the agency's data.

about decreasing tax rates in developed economies since the 1980s.[15] According to Streeck, the policies of tax cuts and shrinking of the welfare state are a "failure of democratic politics", because they benefit corporations and international financial institutions, rather than the citizens of the affected countries. Streeck also argues that their most deleterious effect is that they disempower citizens by limiting their capacities to exercise democratic control over social institutions.

In their extensive 1999 study, using a completely different methodology, economists Walter Hettich and Stanely Winer reached the following unequivocal conclusion:

> *Barring some sort of extraordinary constraint on political behavior of a type not previously observed in democratic countries – it is possible to have a flat tax, or to have democracy, but not both.*[16]

It is remarkable that the arguments for that conclusion are structural, rather than based on historical analysis or a conception of justice. For Hettich and Winer, a differentiated tax system presents real political alternatives to voters, creating the conditions for a truly competitive political system. In this situation, the different political parties are motivated to offer real choices to working people, who on their part are free to make such choices based on values and interests.

In his turn, Thomas Piketty writes:

> *How can sovereign citizens democratically decide how much of their resources they wish to devote to common goals such as education, health, retirement, inequality reduction, employment, sustainable development, and so on? Precisely what concrete form taxes take is therefore the crux of political conflict in any society. The goal is to reach agreement on who must pay what in the name of what principles – no mean feat, since people differ in many ways.*[17]

The existence of political alternatives is among the hallmarks of democratic governance. The lack of alternatives recalls what liberals call totalitarianism. The broad consensus among different political parties

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15 See Streeck, Wolfgang. *Buying Time. The Delayed Crisis of Democratic Capitalism.* London: Verso, 2014

16 Hettich, Walter and Stanley Winer. *Democratic Choice and Taxation*. Cambridge: Cambridge University Press, 1999, p. 92; also p. 291-292.

17 Piketty, Thomas. *Capital in the Twenty-First Century*. Cambridge: Belknap Press, 2014, p. 494.

and economic experts in Bulgaria regarding the alleged benefits of the flat tax is a self-styled confirmation of the incompatibility between democratic choice and flat taxation.

5. Bulgaria in the global race to the tax bottom (summary)

In light of global trends, we can see that the philosophy "*The rich need stimuli – the poor need sanctions!*" is not a monopoly of Bulgarian politicians. This philosophy has been typical of Western neoliberal capitalism since the last decades of the 20th century. Within its framework, stimuli are reserved chiefly for businesses, while the main fiscal burden is shouldered by ordinary people. In some ways, this trend has been on the rise since the 2008 crisis and the notorious austerity measures imposed as a result.

In the field of taxation, this policy trend materializes in both huge "tax cuts" for corporations as pioneered in the USA, as well as in the textbook fact that the tax burden is globally shifting from direct to indirect taxes. Individual states find it easier to collect revenue from people's consumption than from corporate profits.[18]

This chapter reviews the global trend of lowering taxes. In this context, East European countries and especially Bulgaria have perfected the practical implementation of the principle *Take from the people and give to the corporations!* "Post-communist" countries seem to have no choice but to compete for investments with developed Western economies, which have long applied tax breaks for businesses. It is not surprising that Baltic countries introduced the flat tax in the mid-1990s, in the first years of their transition to a market economy.

The move towards low flat taxes can be viewed from two perspectives. On the one hand, new market economies strive to make up for their not yet fully developed institutional and market infrastructure by gaining a competitive advantage through administrative and tax breaks. On the other hand, increasingly mobile transnational capital flows pressure these comparatively weak governments to implement such policies, in an effort to cut costs and avoid~~ing~~ responsibility towards the societies in which they operate.

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18 An IME author claims, contrary to the fact, that this trend is single-mindedly praised by academic literature. Institute for Market Economics. *Flat Tax in Bulgaria*. Sofia: IME, 2016, p. 53-55.

It is in this light that we should understand the words of Bulgarian minister of finance Vladislav Goranov:

> *Many countries are moving towards alleviating the tax burden and towards flatter taxes. The fact that we are ahead in this modern trend is no problem.*

In a different context, Georgi Ganev (an expert with the Centre for Liberal Strategies) adds the following: "The perception that we are just following an established international trend helps with the theoretical acceptance of [the flat tax] idea."[19] Goranov and Ganev are indeed correct that with its tax system Bulgaria is in the vanguard of an established course of development for other countries. But this fact is in itself highly problematic, especially because the global trend they are referring to is far from inevitable.

Nevertheless, this trend is a fact that we have to take into account. It turns the "avant-garde" countries in self-styled tax havens. Other competing countries are in turn motivated to lower their tax rates. The result is a global race to the bottom in which states compete in offering lower and lower taxes to businesses. As we saw, in this competition it is the working people who suffer. The entire process facilitates the colonization of countries by transnational capital.

In Central Europe, we have an example akin to Bulgaria. In 2016, Hungary reduced its corporate tax rate to 9%. Viktor Orbán's cabinet, famous for allegedly defending national interests, in effect gave a present to corporations operating in the country. *Quartz* wrote:

> *This flat rate will give Hungary the lowest rate in the EU – take that, Bulgaria! – as well as one of the lowest anywhere in the world. Currently, Hungary charges a 10% rate on small businesses – covering corporate income up to 500 million forints ($1.7 million) – and 19% on anything above that. From next year, the only places with lower corporate rates than Hungary will be island tax havens like the Caymans and British Virgin Islands.*

Even though some Hungarian ministers expressed readiness to also decrease the income tax to 9% (from 15%), this is yet to happen. In addition, the country has kept certain tax breaks for families. In other words, even though it is a dedicated participant in the race to the bottom in low taxes, Hungary at least tries to partially compensate for that fact by decreasing the price ordinary citizens are paying.

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19 Institute for Market Economics. *Flat Tax in Bulgaria*. Sofia: IME, 2016, p. 98.

But even though Hungary has chosen this course, the situation in other European countries is different. The debate regarding a possible abolition of the flat tax is taking place in many East and Central European countries where it is currently at work. An analysis published in February 2018 by the Estonian national radio and TV argues that the recent increase of the non-taxable income to EUR 500 is not enough to compensate for inequalities accumulated over 24 years of flat tax:

> *A significant part of the population who has contributed to make economic growth a reality do not get their fair share. ... In absence of bold income support policies and similar means to redistribute wealth, flat-rate tax systems turn out to be intensely regressive. Yes, we all pay the same rate on our incomes, but as basic cost of living and consumption taxes rise, an upward redistribution becomes inevitable. When the GDP grows at a faster pace than households' economic resources, it is that very same growth that hampers people's possibilities to keep up with previous living standards.*

Such debates in other flat tax countries are being largely ignored or belittled by the experts and the press in Bulgaria.

6. Progressive change is possible: the Czech Republic, Slovakia, Latvia, and Albania (summary)

Within the global trend described above, countries still have means for successful opposition at their disposal. Taking up these opportunities means practicing truly democratic politics in the interest of working people, instead of upholding the interests of transnational capital and the local oligarchs. In this chapter, we briefly review four cases of East European countries which have recently given up flat taxation: the Czech Republic, Slovakia (formerly a role model among flat tax countries[20]), Latvia, and Albania.

In all four countries, the flat tax was not as punishing for low earners as in its Bulgarian version, but they all reintroduced progressive tax-

20 The OECD has published informative studies of the two Slovak reforms: Brook, A. and W. Leibfritz. "Slovakia's Introduction of a Flat Tax as Part of Wider Economic Reforms", *OECD Working Paper* No. 448, 2005; Remeta, J. *et al.* "Moving Beyond the Flat Tax – Tax Policy Reform in the Slovak Republic", *OECD Taxation Working Papers*, No. 22, 2015.

ation to combat inequalities. Subsequently, none of them have experienced negative effects in terms of tax revenue and FDI. Of course, the more countries refuse submitting to capital, the easier would be for others to follow.

We also note the recent interest in introducing a flat tax on the part of the new far-right "populist" cabinet in Italy. The cases of Hungary, Italy, and the ruling coalition in Bulgaria – which features an extreme right-wing formation – provide ample evidence that under the guise of working for the people, the far right actually colludes with capital.

It is also worth noting that the IMF, which intervened in Albania after the 1996-7 financial collapse before advising it a decade later to adopt the flat tax, was instrumental recently in re-introducing progressive taxation in the country. This is in line with the IMF's increasing worries about growing inequalities. Also of note is that Confindustria, one of the largest business associations in Albania, has been pushing for the country to follow its biggest trade partner, Italy,in returning to the flat tax. As we have already seen, tax systems of different countries are interrelated and should not be viewed in isolation.

7. The debate regarding the flat tax in Bulgaria since 2008 (summary)

Unfortunately, since 2008 the debate regarding the flat tax in Bulgaria has been somewhat anaemic. The claim that low flat taxation without a non-taxable minimum income is the best and fairest scenario has achieved hegemonic status for the general public. In this chapter we review attempts to shake up that hegemony.

In 2013, the short-lived BSP-MRF coalition cabinet of Plamen Oresharski (Stanishev's finance minister who implemented the flat tax) attempted to introduce some sort of tax break for Bulgaria's poorest. The measure was instrumental in keeping the fragile coalition together amid vast anti-corruption street protests. But it was also ill-designed, as it gave a tax break only to those earning the minimum wage (then BGN 340), instead of freeing all income up to that amount from tax. This created the conditions for easy fraud. In addition, high administrative hurdles resulted in only 5,384 persons benefiting from the tax break, out of more than 200,000 expected. In addition, PM Oresharski – himself a respected Bulgarian financial expert – stressed that the measure does not involve scrapping the flat tax itself. It is worth noting that (anti-communist) anti-corruption protesters failed to criticize the cabinet for failing to implement a proper social policy combating inequality.

In 2017, the *Stop the Machine of Inequality* campaign called for the introduction of a non-taxable minimum income equal to the minimum wage, as well as lower VAT rates for water, basic foods, medicines, and books. A petition was drafted, stating:

> *A just society is not achievable without an ~~un~~fair taxation system. National welfare is only possible when 'the big' and 'the small' are equally responsible for their tax duties. But today, the tax system in Bulgaria is grossly distorted.*

The petition, which stressed the causal connection between the tax system and the growing inequality in the country, received more than 30,000 signatures. It was tabled to parliament, where it was the discussed by the Committee on Interaction with NGOs and Citizens, which came out with a statement saying that inequality was indeed a problem in Bulgaria, but nothing more specific. The Budget and the Social Affairs Committees declined to consider the petition.

Both the Collective for Social Interventions (New Left Perspectives) and Solidary Bulgaria were central organizations in the *Stop the Machine of Inequality*, which also included other leftist organizations and parties. CSI and SB decided to produce the present paper as a continuation of their efforts in the field of fair taxation.

After the fall of the Oresharski cabinet, in 2014 and 2016 respectively, the Bulgarian Socialist Party tabled two motions to change ~~in~~ Bulgaria's tax legislation and to reintroduce progressive taxation (with brackets ranging 10% to 27%). Both motions were rejected by the rightist majorities and the liberal MRF opposition. Since then, BSP has been inconsistent in its efforts against its own 2007 creation. The 2017 election platform of the party failed to include calls for progressive taxation, in spite of earlier statements to that effect. The 2018 BSP document entitled *Vision for Bulgaria* does not call for progressive taxation either. But during the debates regarding Bulgaria's 2019 state budget, the Socialists once again tabled a motion for the re-introduction of progressive taxation.

The largest trade union confederation in Bulgaria, the Confederation of Independent Trade Unions (CITU / KNSB), has recently followed a similar course. In the summer of 2018, the Confederation came out with a press release calling for progressive taxation. In September, they published a full report entitled *10 Years of Propor-*

tional Taxation in Bulgaria – Time for Recap, in which, albeit criticizing the tax system for raising inequality, low FDI, etc., they only called for the introduction of a non-taxable minimum income and no tax progressivity.

Through the years, the other major trade union confederation in Bulgaria – the Podkrepa Confederation of Labour– has been consistent in its calls for progressive taxation. Podkrepa (with which SB and CSI now have a standing partnership) has included the two models for progressive reform delineated in chapter 8 below in their position on Bulgaria's 2019 budget.

8. Two models for progressive tax reform in Bulgaria

The main criticisms against the 2017 *Stop the Machine of Inequality* campaign for the return of the non-taxable minimum had to do with accounting. "Where would the money come from?", non-governmental and government advocates for the flat tax all asked. Uncharacteristically, they also took the role of defenders of the social systems supposedly threatened by the proposed reduction of the tax burden.

It is worth noting here that in the eyes of experts, these systems become endangered only when taxes on low- and middle-income people are to be reduced; or at least only then are the risks worthy of discussion. It is only in these cases that they require detailed calculations of how exactly to cover the holes in the treasury. If the goal is to reduce the dues of corporations and the rich, these risks seem to disappear into thin air. As we already discussed, the flat tax without a non-taxable minimum was introduced in anon-transparent way and without a detailed estimate~~s~~ of its effects – only on the untenable hope that it would help fight the shadow economy and attract foreign investment.

Especially problematic is the criticism of "insufficient" economic justification voiced by representatives of the government and the parliamentary majority who at the same time withholdfrom the public the very information needed for such detailed analyses.This is by no means typical of the present government alone. Hassan Ademov (social policy minister in the Oresharski cabinet) explained that:

> *A [non-taxable minimum] will decrease the budget revenues with about 600 million BGN. And someone has to*

explain where these 600 million come from in order to continue spending.

During the 2016 debates on progressive taxation proposed by the BSP, Ivailo Kalfin (social minister in the second Borisov cabinet) in effect used the opacity of government – of which he himself was part – as an argument against the reforms:

In the motives for the bill, there is no assessment of what effect the introduction of the progressive income tax would have on the state budget. It is important to bear in mind that any change in taxation policy should be assessed against the backdrop of the general context of measures directed at specific sectoral policies and be accompanied by the relevant estimates of the expected direct and indirect effects on the budget and policy implementation.

For more than five years now, the debate on tax reform has been stuck on the question of obtaining the public data needed for "the relevant estimates". As we shall see below, ministers have every reason to keep this information secret. However, no legitimate technical or moral reasons exist for not making public the data needed to analyze the tax revenues in the treasury. What is more, keeping these figures secret is a blow to democratic governance. Thomas Piketty argues that:

Economic and financial transparency are important for tax purposes, to be sure, but also for much more general reasons. They are essential for democratic governance and participation.[21]

More transparency would have made it impossible for finance minister Vladislav Goranov to declare in 2016 that the introduction of a progressive tax would starve the budget of BGN 1.236 billion – because someone immediately would have detected that he was saying only half of the truth. The minister did not reveal any methodological details about this calculation but after the Ministry of Finance disclosed partial data on tax revenues for 2016 in response to an MP question, we can make some reasonable assumptions.

The ministry must have calculated this amount by multiplying the number of people living on a minimum and above-minimum salary

21 Piketty, Thomas. *Capital in the Twenty-First Century*. Cambridge: Belknap Press, 2014, p. 569-570.

(about 2.2 M people) by the annual non-taxable minimum of BGN 504 (the minimum salary in 2016 was BGN 420), adding to the result all taxes levied on people whoseaverage incomefalls below the minimum wage (about BGN 110 M). But in practice this means that the calculated "losses" in practice are just those incurred from introducing a non-taxable minimum. And that's a whopping 40% of personal income tax revenue for 2016.

The above calculation is approximate, but nevertheless correct overall. The other half of the truth that minister Goranov omitted is the automatic increase in revenue in the event of the introduction of progressive taxation. Our calculations on the basis of the incomplete data for 2016 published by the Ministry show that the reintroduction of the non-taxable minimum and progressive taxation would decrease the tax burden for 97% of working people in Bulgaria (those receiving up to BGN 2600) – without having a negative impact on tax revenue. Progessive taxation could even exercise a positive effect on this revenue as a result of anticipated boosts of aggregate demand.

But before we zoom on in the details, it is worth dwelling more on minister Goranov's words intended to show that a tax-free minimum is inconceivable. Goranov in effect put the government in a contradictory position – both lauding its huge successes with respect to so-called macroeconomic stability and economic growth and at the same time firmly asserting that Bulgaria could not possibly afford to implement policies that functioned well ten years ago in the same (then much poorer) country.

Shortly before its EU-accession, Bulgaria could afford to reduce the taxes of the rich and of corporations by eliminating the taxable minimum and progressivity and thereby increasing taxes for poor and middle-income people. Today's significantly richer economy (with a 55% GDP growth between 2007 and 2017) could not afford to reverse this process, as we hear from the pundits. The ideology behind such claims often masquerades as expert economic knowledge.

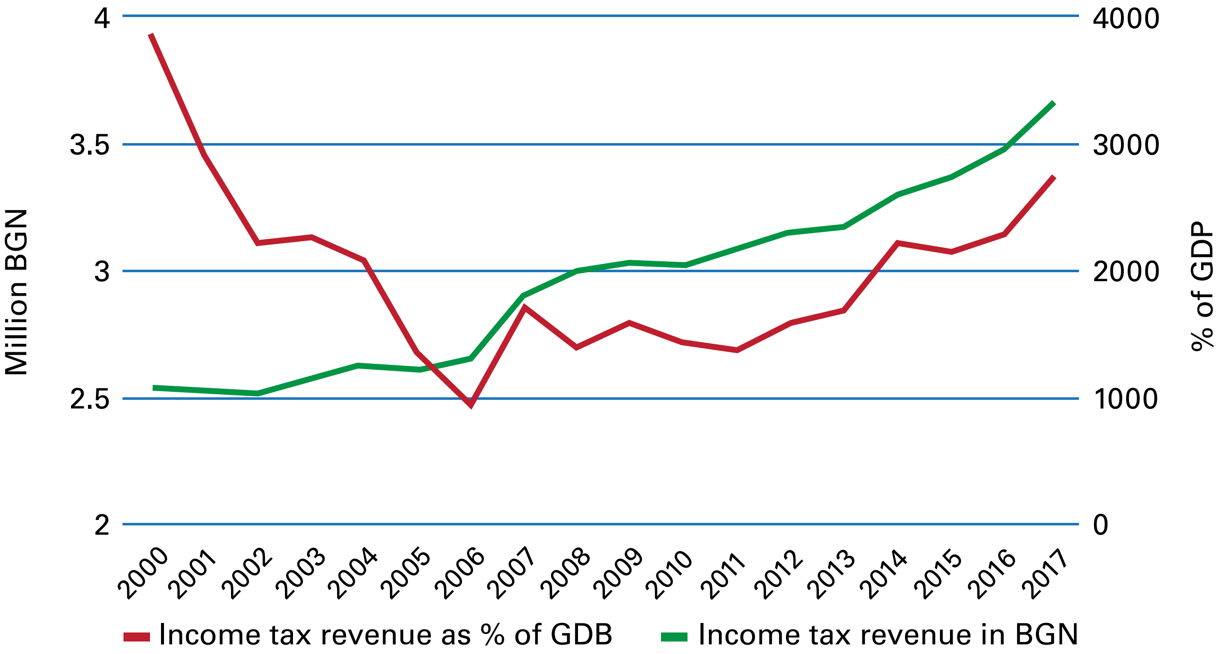
But the even more important revelation by the Bulgarian finance minister is that over 40% of the flat income tax revenues in 2016 were due to the absence of a tax-exempt minimum. This demonstrates that the modest growth in income tax revenue since 2008 is not a result of the flat tax, as the experts loudly proclaim, but rather of the abolition of the non-taxable minimum.[22]

Income tax revenues in 2007 (the last year with a non-taxable minimum) were 2.85% of GDP. In 2016 they stood at 3.15% of GDP. How-

22 See chapter 2 of this paper.

ever, with a non-taxable minimum they would have been 1.83%. In short: since 2017, the state's bills have been footed by low- and middle-income people, with the shift of a higher tax burden onto them precipitated by the flat tax. The following graph shows that with the elimination of the non-taxable minimum and before the 2008 credit crunch hit Bulgaria, flat tax revenues fell as a share of GDP and began to recover only after 2013 because of employment growth.

Income tax revenue



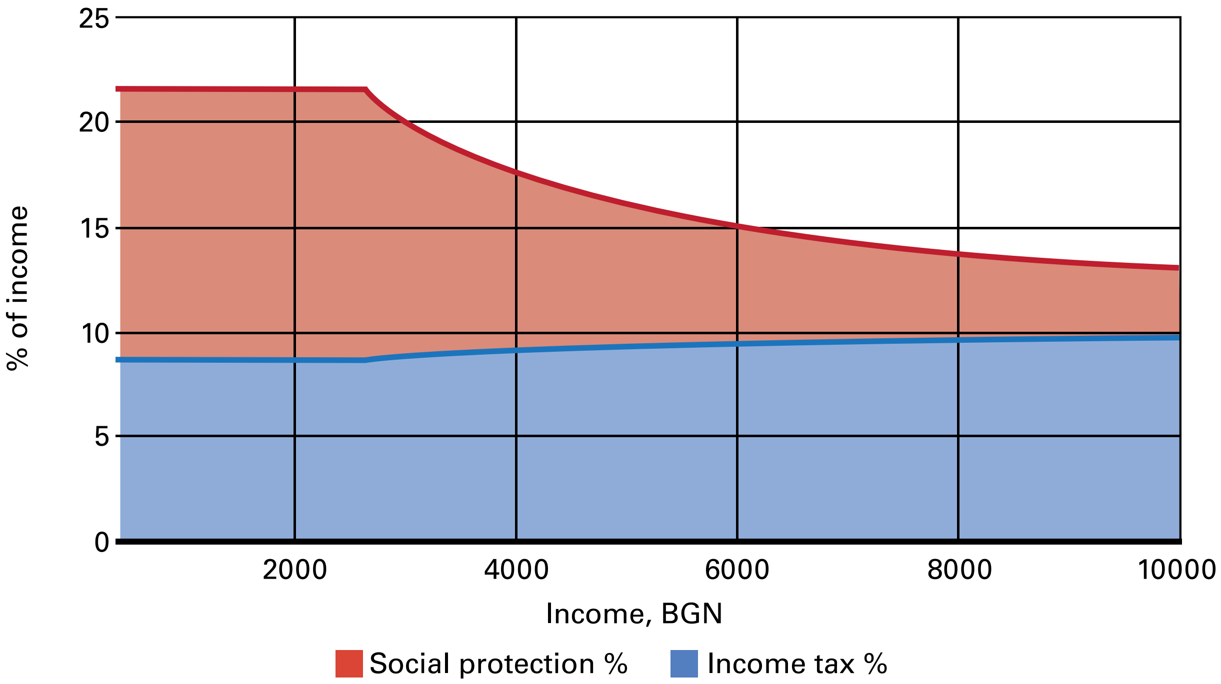
It is clear that in 2017-18 the cost of a possible non-taxable threshold equal to the minimum wage has increased by approximately 21%. But given that the share of those at risk of poverty and social exclusion remains significantly above the average European level, and the Gini coefficient broke the psychological limit of 40 points, tax relief for people of low and middle income is more urgent than ever. Moreover, the present modest levels of public redistribution can be maintained even with moderate tax reforms that would help align Bulgaria with most other European countries. Even without increasing state redistribution, such reforms could shift the tax burden away from people with minimum and medium incomes toward the rich.

The proposals that follow are far from ideal. Their goal is to rekindle the possibility of progressive taxation and to show how we can finance a universal non-taxable minimum income. To this end, we propose removing the regressivity of certain taxes and introducing a moderate progressive rate. All calculations below refer to 2016, the last year for which reasonably detailed data is available to the public.

8.2 Two models for fair taxation

The first important prerequisite for a reasonable and fair division of the wealth created within an economy is the just distribution of the tax burden. The current regressive distribution in Bulgaria undermines one of the major engines of economic development – aggregate demand. The graph below illustrates the distribution of the direct contributions to the budget (those stemming from income tax and social security contributions) from income brackets of BGN 420 to BGN 20,000 per month.

Income tax revenue



The sharp decline marks the ceiling of the social security cap, after which the social security burden decreases. Again, the table reflects only the regressivity of indirect taxation, but not of indirect taxation (which is also practically regressive, since people with lower wages spend their entire disposable income on dailyand household consumption). A VAT reduction for daily goods of first necessity – a measure also encouraged by the European Commission – would reduce the negative effect of this tax on most consumers.

The highest rate on the left side of the table affects about 2.96 million people who declare a monthly tax base of up to BGN 2600. They represent over 96% of all workers in Bulgaria. Persons with a monthly tax base of over BGN 5000 (right ¾ on the ride side of the graph) pay between 5.5 and 11.5% less in direct income tax and social security.

They are 1.1% of workers, but earn as much as the poorest 50% while shouldering a significantly lower tax burden.

Here we formulate two sets of measures to restore progressive taxation in Bulgaria. We cannot stress enough that these measures are not ideal. We do not wish to cause fiscal havoc; rather, we want to pave the way for a smooth transition towards progressivity. The measures, of course, include a non-taxable minimum income for all. Their common goal is to enforce a sharp reduction of poverty and stop the machine of inequality. But they are also in essence measures that would bring our distorted tax system closer to the fairer structure of taxation adopted by the vast majority of European countries.

I. A model without a social security cap

1. Social security contributions become a 'flat tax'. The regression in social security will be automatically abolished with the cancellation of the social security cap. No such caps exist in 40% of countries in the EU, and in several others they apply only to a fraction of the employed or to a part of their income.[23] For example, Romania has a social security ceiling only for pension contributions but not on unemployment or health benefits. Other countries with a cap on social security contributions offset them with high progressive taxes levied on the rich who tend to contribute less to social security systems (see Model II). The absence of a ceiling partly explains the lower level of income inequality in Hungary, which otherwise sports a flat tax regime. The removal of the taxable social security cap in Bulgaria would free some **BGN 710 million** (as per 2016 data) or 57.4% of the funds necessary to finance a tax-free minimum.[24] Bulgarian law dictates that social security proceeds only finance the relevant social systems. But at present money for pensions is not enough, and therefore more money from social contributions would allow for a bigger spending on pensions from the budget. Removing the social security cap could be accompanied by raising the limits on pensions and benefits (in healthcare they do not exist anyway). However, this needs to be calibrated in such a way as to prevent transporting grotesque levels of inequality into the social security systems.

23 "Comparative Social Security Benefits Study", Deloitte, 2017,

24 All calculations are based on the tax bases of the relevant income brackets which the Bulgarian ministry of finance revealed after an MP question.

2. Solidarity tax. Time and again we must reiterate that wealth is created only within a society and its accumulation is made possible only socially. We propose **a modest progressiveness: 20% of income tax levied on incomes over BGN 5,000**. A non-taxable minimum would apply to all earnings up to this amount and everything above that minimum would be taxed by 10%. As a result, **BGN 267 M** (2016 data) would flow to the budget which would cover 22.7% of the cost of the non-taxable minimum. Raising the tax on earnings above BGN 5,000 would not impact the economy negatively, the way high taxes on the poor currently do, because the reform would not hurt the consumption of high-income people (especially of goods produced in country).

3. Corporate Tax. Bulgaria has one of the lowest corporate tax rates in the EU but this has not attracted foreign investors as promised by the flat tax punditry. That is why a tax increase would not repel them. Investors are not so concerned with a percentage point or two of tax on their profit, which they could anyhow avoid to pay by declaring it as reinvested capital. Access to strong local markets is more important for them than that – as are a good infrastructure and skilled workers who would not emigrate in the foreseeable future. Investors desire social stability, something hardly secured by high inequality combined with widespread poverty. Sooner or later such conditions lead to political instability and riots, as we saw in 2013. A **12% rate** on the profits of corporations would result in **BGN 415** million or 33.6% of the cost of the non-taxable minimum (2016, and BGN 462 M for 2017). A sizable portion of this money would return to businesses in the form of increased consumption. Of course, with an intelligent reform of the corporate tax base, this amount could increase significantly.

4. Budget surpluses. So far we have shown how we can raise 113.7% of the necessary money, to finance the non-taxable minimum income through measures that would not affect investment negatively, but would rather have a positive impact on demand and thus accelerate economic growth. If the government cannot muster enough courage to implement our proposals either partially or in their entirety, it could instead provide a significant portion of the funds needed by putting an end to hidden budget surpluses that underestimate revenues in the budget. Such surpluses are a practical tool for cabinets to spend money without approval from parliament and ultimately – without a democratic debate. A hidden surplus allows year-round generous uncontrolled spending to pre-empt protests or to meet unforeseen costs, and governments often avail themselves of this opportunity. According to National Statistics Institute data, the budget surplus in 2016 was BGN 209 M, in 2017 it reached BGN 920 M, and the government went on an unapproved spending spree (directing additional funds to ministries, and another BGN 1 B to the housing stock insulation program).

II. Model with insurance income ceiling offset by a more progressive tax

Social security contributions are differentiated from income tax only for the sake of clarity and as a warranty that the pension and health care systems (as well as the systems for unemployment compensation) do not depend on the whims of any government. Unfortunately, this approach does not work well in Bulgaria, where the social systems are systematically underfunded. Not to mention that during his term, finance minister Simeon Djankov (2009-13) even breached the principle of spending health insurance contributions only on healthcare.

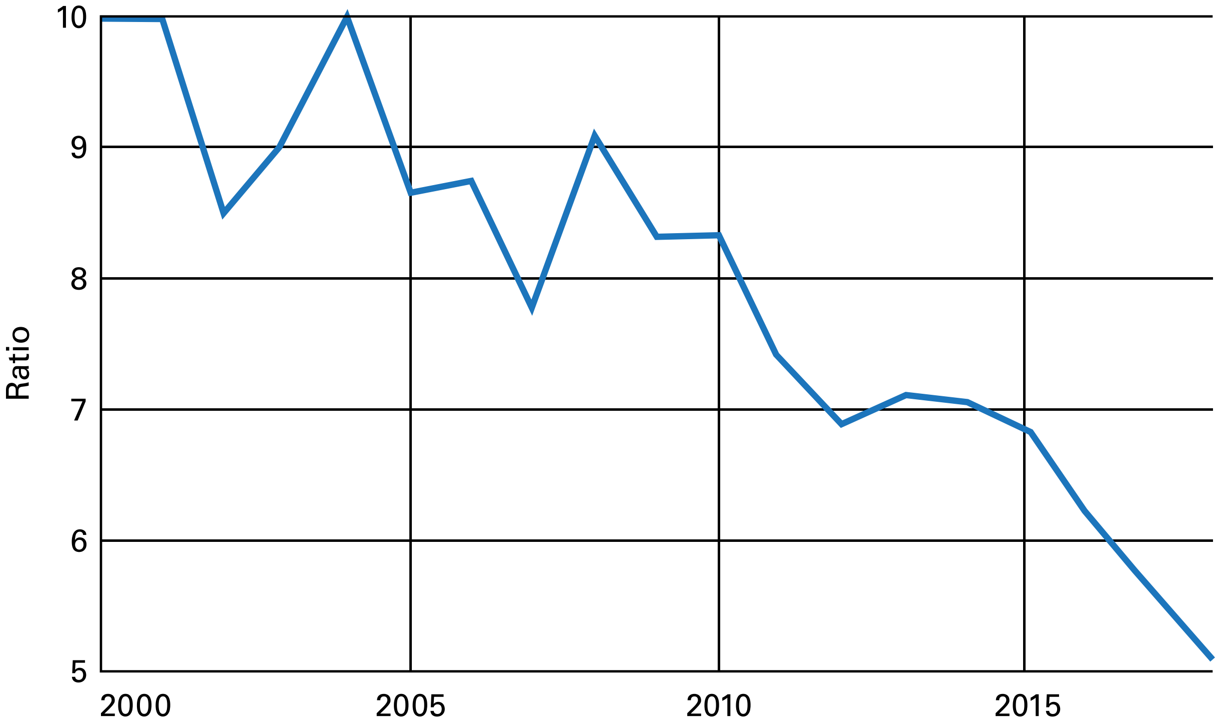
A negative side effect of the separation of the income tax from social security payments is the individualization of public systems that are solidarity-based to begin with. The cap on social security contributions exists on the grounds that people who earn more shouldn't pay the same share of their income as the poor, as they do not benefit from these services to the same extent that they would be paying if there were no cap. In essence, this argument states that since the solidary social systems have been designed so as not to reproduce inequalities beyond certain limits, we should finance them regressively and thus increase this inequality. This way they are transformed from a central obligation for the members of a developed society to an individual service.

If we choose to uphold this model, we have to counter the regression of social contributions with a more progressive income tax.

1. **Increasing the social security cap from BGN 2,600 to 5,000** would bring an additional **BGN 257 M** to the treasury (calculations for 2016). Raising the social security ceiling is not only feasible, but also mandatory for making up for the years of freezing it. As a result, the insurance contributions have become an increasingly

regressive tax affecting people with income up to BGN 2,600.[25] The steep decrease of the ratio between the social security cap and the minimum salary can be seen in the following graph:

Social security cap to minimum wage



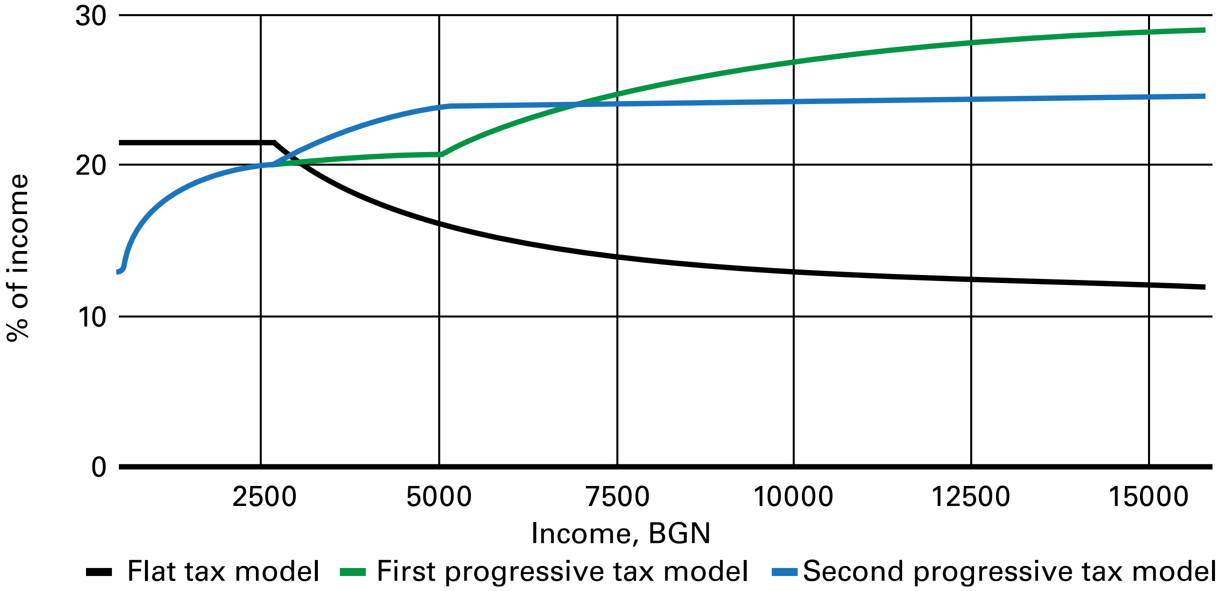
2. The lower social security burden for persons with income exceeding the social security ceiling should be offset by more a progressive income tax. For incomes up to BGN 2,600, the current rate of 10% shall be retained. The BGN 2,600-5,000 income bracket would be taxed with a **15%** tax while a Solidarity Tax of **25%** on incomes over 5,000 BGN would contribute **BGN 554 M** to the treasury. The remaining funds needed to pay for the non-taxable minimum could come from a minimal increase of the **corporate tax** and from a **contraction of the hidden budget surpluses** and of the government spending unapproved by parliament.

In both models, people with a monthly income up to BGN 3,000 would pay less in income tax than they currently do with the 10% rate, combined with no tax-free minimum income. In the first model, people in the over BGN 5,000 bracket would be taxed pronouncedly more progressively due to the operations of the Solidarity Tax. Even so, they would continue to pay significantly less than their counterparts in Western Europe. Because of the taxable social se-

25 The initial intention for the social security cap was for it to be 10 times the minimum salary. Retaining the ceiling amid increases of the minimum salary over the years, however, violates this ratio.

curity ceiling, the second model is slightly less progressive and brings less money to the treasury. Thus, the remaining funds for the financing of the non-taxable minimum income would have to be raised at the expense of larger budget deficits and a higher corporate tax. The following graph illustrates how the proposed models would shift the tax burden across social classes, compared to the current taxation regime:

Social security cap to minimum wage



The suggested models prove that there are no objective obstacles to the return of the non-taxable minimum income and of a moderately progressive tax system of Bulgaria. This can happen without any sharp shocks, by means of some modest measures requiring only a little political will. Not only are such measures not going to repress economic growth – they will actually boost it through increases in aggregate demand.

At the very least, the poorest EU member state should make it so that its tax system does not fuel inequality and poverty. Moderate progressivity would provide breathing room for 97% of Bulgarian working population. It would also economically and politically stabilize the country and would ensure that the state does not implode with the occurrence of a harsh winter, sale of a utility company, or increase of the price of water.

In addition, there also is something strange about committed Bulgarian Euro-Atlantic liberals' ready to chastise every hypothetical deviation from the country's so-called 'civilization choice,' while at the same time jealously guarding a tax model similar to that in Putin's Russia and Orbán's Hungary and including a tax rate equal to that in

Abkhazia and Transnistria. Aligning our tax system to fairer models found elsewhere in Europe, as well as democratizing it, is also a 'civilization choice'.

We reiterate that both models will necessarily involve increases in the corporate tax. That rate is informally linked to the income tax on individuals due to perceptions about relative proportionality, as well as in order to facilitate tax collection. An adequate reform of the tax base needs must also be implemented, so that corporations stop taking advantage of loopholes and start paying their fair share to the society that makes it possible for them to generate their profits.

Other changes in the tax system we need to think about include increasing taxes on property (e.g. property taxes on secondary residences, large deposits, dividends and inheritance) and making their collection more efficient. Recently the Ministry of Finance came up with some limited proposals in this direction, on the grounds that rich landlords need no tax benefits. This argument is correct. It should become the basis for a thorough rethinking of our tax system.

Fairer and more progressive options can also be tabled. They can be introduced after the eventual successful transition to progressive taxation. They will open the possibility for restructuring other budget revenues. Countries like Denmark and to some extent Sweden fund their generous social systems without deducting social security contributions from workers, the money coming from direct and indirect taxes instead. Such a tax system makes a lot of sense, as it avoids individualizing welfare and strongly emphasizes their solidary nature. In the end, it could be introduced in Bulgaria – if Bulgarian society is to grow mature enough to embrace the ideas of social justice and solidarity.

Conclusion

Contrary to the received wisdom of the majority of experts and politicians in Bulgaria, the introduction of progressive taxation is possible without shocks to the treasury, and could even increase its revenues. A progressive tax is necessary if we want adequate remuneration for workers, good education for children and the youth, and decent pensions for the retired. Of course, to accomplish these ends, changes in the tax system are insufficient, in and of themselves. But they remain fundamental if we are serious about upholding justice, solidarity and democratic governance in our country.

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