



REPUBLIC OF BULGARIA
MINISTRY OF FINANCE

Tax Expenditure Report

2007-2009

Tax Policy Directorate

TABLE OF CONTENTS

| | |
|---|-----------|
| Introduction | 3 |
| I. Tax Expenditure Report – Essence | 4 |
| II. Why it is Necessary to Report Tax Expenditures in Bulgaria | 4 |
| III. Defining Tax Expenditure | 4 |
| IV. What Is a Benchmark Tax | 5 |
| V. Defining Bulgarian Benchmark Taxes | 6 |
| 5.1. Benchmark Tax in Profit and Income Taxation | 6 |
| 5.2. Benchmark Tax in Consumption Taxation | 7 |
| VI. Methods of Measuring Tax Expenditures | 7 |
| VII. Tax Expenditure Estimates | 8 |
| 7.1. Total Amount of Tax Expenditures | 8 |
| 7.2. Tax Expenditure Estimates by Type of Tax | 9 |
| 7.3. Tax Expenditure Estimates by Type of Tax Measure | 11 |
| 7.4. Tax Expenditure Estimates by Goal | 19 |
| 7.5. Tax Expenditure Estimates by Economic Sector and Subsector | 20 |
| 7.6. Tax Expenditure Estimates by Beneficiary | 23 |
| VIII. Recommendations for Improvements in Tax Expenditure Reporting | 26 |
| Conclusions | 26 |

INTRODUCTION

The main goal in tax policy is to set up the scope of taxation in such a way as to ensure high efficiency and transparency of the tax system. Tax system efficiency refers to ensuring that government fiscal needs are provided for, while maintaining the highest possible economic growth and providing for an adequate standard of living for the public.

Such a compromise between fiscal, economic and social goals is achieved by distinguishing the object of taxation (consumption, income or property) and designing the taxes themselves, including their respective taxable base, tax rates and tax incentives. Such solutions enable higher flexibility in terms of taxation scope and inducing taxpayer behaviours in line with government expectations. On the one hand, those solutions provide incentives for certain specific taxpayer groups, while on the other hand depriving the government of some of its potential tax revenue, or, to put it differently, the government foregoes a portion of its tax revenue in order to achieve a certain economic or social goal.

The Bulgarian tax system provides for a number of tax incentives aimed at inducing taxpayer behaviours enhancing the development of certain regions, selected economic sectors and specific types of activity, or a change in the progressive features of the tax system. From a legal point of view, tax incentives can take various forms: low tax rates for profit tax and withholding tax, reduced tax rates, tax holidays, investment tax credits, accelerated tax depreciation, tax loss carry forward, etc. The common feature shared by the various forms of tax incentives is a reduction in tax liabilities and hence a reduction in potential tax revenues in the public budget.

Any loss of tax revenue resulting from granting tax incentives is considered tax expenditure.

Tax expenditures are *de facto* substitutes for public budget expenditures, and under certain conditions they can be an alternative to direct transfers from the central government or municipal budget.

Unlike public budget expenditures, which are subject to in-depth analysis, monitoring and control, tax expenditures often remain outside the scope of such supervision. One of the main reasons is that budget expenditures are usually dealt with in a single piece of legislation, while tax expenditures tend to be scattered across a number of tax legislation acts, and are often less than explicit, making them hard to analyse and evaluate.

Such a situation is detrimental to the transparency of a country's financial governance and jeopardizes the proper allocation of public funds. That is why measuring tax expenditures is key to national fiscal policy-making. On the one hand, measuring tax expenditures makes it possible to distribute and redistribute public funds; while on the other hand, it serves as a point of reference in measuring the efficiency of each tax expenditure item and the tax system as a whole.

I. TAX EXPENDITURE REPORT – ESSENCE

Tax expenditure reporting has become a long-established practice in most European Union Member States and in member countries of the Organisation for Economic Co-operation and Development.

The first such reports were issued in the late 1960s in Germany and the United States. In the late 1970s, Tax Expenditure Reports were adopted in Austria, Canada, Spain and the United Kingdom.

Annual Tax Expenditure Reports are prepared and published in order to provide transparency concerning provisions regulating tax incentives.

In Austria, Belgium, France, Germany, Portugal, Spain and the United Kingdom, the issuance of Tax Expenditure Reports is regulated by law, and hence those Reports have a direct link to the central government budget and are included in the budget process.

In most countries, a Tax Expenditure Report is issued annually but there are some exceptions as well, with some countries reporting their tax expenditures once every two or three years.

II. WHY IT IS NECESSARY TO REPORT TAX EXPENDITURES IN BULGARIA

In Bulgaria, this is the first time a Tax Expenditure Report has been issued, and the present document is the first attempt at estimating tax expenditures.

Bulgaria's national legislation does not provide the requirement to report tax expenditure, yet this report aims, on the one hand, to increase transparency in public finance, and on the other hand, raise public awareness of the tax preference system and the size of tax incentives.

This Tax Expenditure Report covers a three-year period (2007-2009).

The report includes tax expenditures by type of tax measure (incentives) related to value added tax, excise duties, corporate income taxes and personal income taxes.

Tax expenditures presented in this Report have been estimated on the basis of reporting data stated in tax returns and customs declarations provided by the National Revenue Agency and the Customs Agency, and on the basis of statistics provided by the Bulgarian National Bank and the National Statistical Institute.

III. DEFINING TAX EXPENDITURE

Bulgarian legislation does not provide any legal definition of tax expenditure, or any legal definition of tax incentive.

From a legal point of view, tax incentives can take various forms: low tax rates for profit tax and withholding tax, reduced tax rates, tax holidays, investment tax credits, accelerated tax depreciation, tax deferrals, etc.

The term 'tax incentive' generally refers to a provision in tax legislation resulting in the reduction of the taxable base or the amount of the tax payable. A key feature shared by all forms of tax incentive is that tax liabilities are thus reduced, and hence they all lead to a reduction in potential tax revenues for the public budget. Any loss of tax revenue as a result of the provision of tax incentives is considered tax expenditure.

Although there is a very close link between tax incentives and tax expenditures, the definition of the term 'tax incentive' is not sufficiently exhaustive to enable the identification of tax expenditures.

The identification of tax expenditures is a complex process, yet it is a prerequisite for measuring their value. It should be noted that not all tax treatments which represent measures granting tax incentives constitute tax expenditures proper. Some tax measures have been adopted in order to rationalise the tax system or to reduce tax administration costs, or they ensue from international obligations or obligations relating to European Union membership.

An analysis of other countries' Tax Expenditure Reports and the research of a number of publications by international organisations points to the conclusion that there is no single or generally accepted definition of tax expenditure. On the one hand, this is due to the substantial diversity among the various national tax systems, and on the other hand, to their diverging approaches to the function of tax expenditures.

A considerable number of the countries which issue regular Tax Expenditure Reports have adopted the OECD (Organisation for Economic Co-operation and Development) definition of tax expenditure. According to OECD, "Tax expenditure is a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax (i.e. the standard tax system), rather than by a direct expenditure".

According to the above definition, only those tax measures which divert from the adopted benchmark for the respective type of tax would qualify as tax expenditures.

When comparing tax expenditures and benchmark taxes, the accurate formulation of the benchmark is a key to the identification of tax expenditures.

For the purposes of this report, the authors have adopted the definition of tax expenditure of the Organisation for Economic Co-operation and Development.

IV. WHAT IS A BENCHMARK TAX

Defining a benchmark tax is crucial for determining whether a given tax provision constitutes a tax expenditure or it is an inherent feature of the tax system.

Global practice indicates that there is no single generally accepted model for benchmarking taxes due to the diversity of tax systems in the various countries. Each country defines its own benchmark taxes for the purposes of its own research and analysis.

Although every country adopts its own approach in defining its benchmark taxes, every approach can generally be subsumed under one of the following three general frameworks which prevail in tax practices:

- Conceptual approach;

- Legal approach;
- Subsidy-similar approach.

V. DEFINING BULGARIAN BENCHMARK TAXES

In Bulgaria, there is no universal definition of benchmark tax.

It should be pointed out that it is very difficult to define precisely benchmark taxes (the standard tax system), considering that each tax provision ought to be analysed very well in order to determine whether it is an inherent feature of a given tax or an incentive for a certain group of taxpayers, activities, economic sectors, etc.

To define a benchmark tax, it is necessary to indicate the most important principles of taxation, and identify those elements of the tax system which, in legal terms, may be a measure granting tax incentives, but in practice are part of the benchmark tax and should not be considered tax expenditure items. The general principles of a tax system are universality, comprehensiveness and justice of taxation. Other elements which should be recognised as part of the benchmark are the standard tax rates (the respective rates of value added tax, corporate income tax and personal income tax, etc.), the tax depreciation system, the possibility to reduce the annual taxable base (e.g. by deducting the obligatory social security and health insurance contributions), and the principles set up in the EU law, which are binding for all Member States.

It is not possible to define a single benchmark applicable to all taxes. The above principles can be applicable to each tax, but the characteristics of individual taxes require a definition of a benchmark for each type of tax. In value added tax and excise duties, which are harmonised at the EU level and the structure of which ensues from Community Law, there is very little leeway left for Member States in shaping their final design.

For the purposes of this report, in order to identify and estimate tax expenditures, the authors have defined benchmarks in terms of two categories of taxes: taxes on profits and income, and taxes on consumption.

5.1. Benchmark Tax in Profit and Income Taxation

The benchmark in profit and income taxation will be based on the following main principles:

- Universality of taxation: profits and income of legal persons and individuals are subject to taxation, regardless of their economic activity or their region of operation;
- Completeness of taxation: any profit/income is subject to taxation, regardless of their source, the category of payer, or the purpose for which such profit/income is intended;
- Individual taxation: the tax is levied on each legal person or individual which/who receives the proceeds or income;
- Annual assessment of the tax payable;
- Standard tax rates for taxes on profits or income;

- Tax depreciation system.

Tax provisions which correspond to the above principles ought to be considered elements of the benchmark tax and a point of reference in identifying tax expenditures. The benchmark tax will also include all provisions related to avoiding double taxation, i.e. tax exemption or applying the tax exemption methods regulated in bilateral double taxation agreements to which the Republic of Bulgaria is a party signatory.

5.2. Benchmark Tax in Terms of Consumption Taxation – Value Added Tax and Excise Duties

In terms of VAT and excise duties, the benchmark tax will follow the principles which are binding for all EU Member States and are enshrined in EU legislation.

Mandatory exemptions from taxation according to European legislation are a benchmark. All possible tax exemption options which are not binding for Member States and are a matter of national regulation ought to be considered a deviation from the benchmark tax, i.e. tax expenditure items. The same refers to tax rates. The benchmark tax involves a standard (base) rate. Reduced tax rates (for value added tax and excise duties) ought to be treated as tax expenditure items. Any legal provision which narrows the scope of taxation due to administrative or control considerations – for example, exemption from excise duty for alcoholic beverages produced by individuals for their own consumption and not intended for sale, should be considered a benchmark, and not a tax expenditure item.

VI. METHODS OF MEASURING TAX EXPENDITURES

One prerequisite for the proper distribution of public funds is to determine their amount accurately beforehand. Unlike direct transfers (public budget expenditures), the amount of tax incentives is not known ex ante. The possibilities of establishment of their precise amount ex post (after the end of the financial year) are also limited, particularly in cases where there is no requirement for detailed reporting of tax expenditures.

That is why measuring tax expenditures requires estimations arrived at by applying a specific set of methods.

The most common method of measuring tax expenditures is the method of ceding revenue (revenue foregone), which involves estimation of amounts not paid into the budget as a result of the existence of a given tax expenditure item.

Other applicable methods include the method of receiving revenue (revenue gain) and the outlay equivalent method.

The revenue gain method is based on estimating amounts which would have been paid into the budget, had certain tax expenditures been eliminated from the tax system, but factoring in any changes in taxpayer behaviour resulting from eliminating such expenditures.

The outlay equivalent method consists in measuring cash outlays which would be required to finance a given goal outside the tax system (for example, cost of raising the amount of social assistance or subsidies for purchasing new technology).

For the purposes of this report, the method used is that of revenue foregone.

VII. TAX EXPENDITURE ESTIMATES

Tax expenditures have been estimated over a three-year period (2007-2009).

Tax expenditures presented in this Report have been estimated on the basis of reporting data stated in tax returns and customs declarations, and on the basis of statistics provided by the Bulgarian National Bank and the National Statistical Institute.

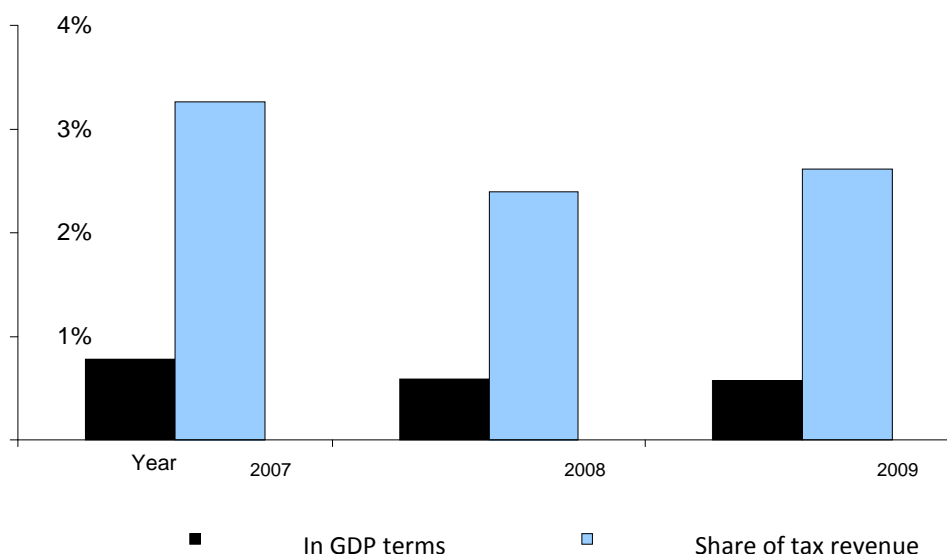
All tax expenditures have been estimated, and their measurement includes:

- Total amount of tax expenditures;
- Tax expenditure estimates by type of tax;
- Tax expenditure estimates by type of tax measure;
- Tax expenditure estimates by goal;
- Tax expenditure estimates by economic sector and subsector;
- Tax expenditure estimates by beneficiary.

7.1. Total Amount of Tax Expenditures

| Year | Total amount of tax expenditures (in levs) | % of GDP | % of tax revenue |
|------|--|----------|------------------|
| 2007 | 470 532 532 | 0.78% | 3.26% |
| 2008 | 402 298 663 | 0.58% | 2.40% |
| 2009 | 388 418 277 | 0.57% | 2.61% |

Total Amount of Tax Expenditure, 2007 -2009



Total for the period 2007-2009

In the period under review, tax expenditures decreased, both in nominal terms and as a percentage of gross domestic product and of tax revenue. In comparison to 2007, 2009 exhibited a reduction in the total amount of tax expenditures by BGN 82 114 255.

The analysis indicates that the estimated loss of revenue resulting from tax expenditures is less than 1% of GDP (0.78% of GDP in 2007, and 0.57% of GDP in 2009).

To compare, that indicator ranges from 0.74% of GDP in Germany, 2% in the Netherlands, 4.9% in Poland, up to 12.79% in the United Kingdom. The wide range of values for the indicator is due, on the one hand, to the existing differences in the tax systems of the various countries, while on the other hand it has to do with the different approaches and methods used for estimation of tax expenditures.

In countries with a broad tax base and low tax rates for profit and income taxation such as Bulgaria, the number of tax expenditure items is low, up to 50. Conversely, in countries with a narrow tax base or high tax rates, the number of tax expenditure items is several times higher and can reach up to 380.

7.2. Tax expenditure Estimates by Type of Tax

Tax expenditures were estimated by type of tax: value added tax, excise duties, corporate income tax and personal income tax.

2007

For 2007, a total of 32 tax expenditure items were identified. On the basis of the information available, 23 tax expenditures were measured (accounting for 72% of all expenditure

items identified). Tax expenditures not measured account for 28 % of all expenditure items.

The largest relative share comes from tax expenditures associated with corporate taxes (53%), followed by tax expenditures associated with excise duties (25%).

| Type of tax | Number of tax expenditure items | Number of tax expenditure items measured | Estimate (in levs) | % of tax revenue |
|-------------------------|---------------------------------|--|--------------------|------------------|
| VAT | 2 | 2 | 72 977 352 | 0.51% |
| Excise duties | 8 | 7 | 113 502 218 | 0.79% |
| Corporate income taxes | 17 | 9 | 261 861 499 | 1.81% |
| Personal income taxes | 5 | 5 | 22 191 463 | 0.15% |
| Total, all taxes | 32 | 23 | 470 532 532 | 3.26% |

2008

For 2008, a total of 32 tax expenditure items were identified. On the basis of the information available, 23 tax expenditures were measured (accounting for 72% of all expenditure items identified). Tax expenditures not measured account for 28 % of all expenditure items.

The largest relative share comes from tax expenditures associated with corporate taxes (53%), followed by tax expenditures associated with excise duties (25%).

| Type of tax | Number of tax expenditure items | Number of tax expenditure items measured | Estimate (in levs) | % of tax revenue |
|-------------------------|---------------------------------|--|--------------------|------------------|
| VAT | 2 | 2 | 78 127 602 | 0.47% |
| Excise duties | 8 | 7 | 133 614 260 | 0.80% |
| Corporate income taxes | 17 | 9 | 159 399 437 | 0.95% |
| Personal income taxes | 5 | 5 | 31 157 364 | 0.19% |
| Total, all taxes | 32 | 23 | 402 298 663 | 2.40% |

2009

For 2009, a total of 35 tax expenditure items were identified. On the basis of the information available, 26 tax expenditures were measured (accounting for 74% of all expenditure items identified). Tax expenditures not measured account for 26 % of all expenditure items.

The largest relative share comes from tax expenditures associated with corporate taxes (49%), followed by tax expenditures associated with excise duties (29%).

| Type of tax | Number of tax expenditure items | Number of tax expenditure items measured | Estimate (in levs) | % of tax revenue |
|-------------------------|---------------------------------|--|--------------------|------------------|
| VAT | 2 | 2 | 69 564 028 | 0.47% |
| Excise duties | 10 | 9 | 145 255 110 | 0.97% |
| Corporate income taxes | 17 | 9 | 140 347 615 | 0.94% |
| Personal income taxes | 6 | 6 | 33 251 524 | 0.22% |
| Total, all taxes | 35 | 26 | 388 418 277 | 2.61% |

Total for the period 2007-2009

The analysis revealed that a considerable part of tax expenditures have not been estimated. The absence of an estimate is due to the fact that tax returns do not contain the relevant data, or contain aggregated information which cannot be used to measure the respective tax expenditure item reliably.

For example, the annual tax return filed under Article 92 of the Corporate Income Tax Act contains aggregated information concerning the tax deductible cost of depreciation/amortisation for all tax depreciable tangible and intangible assets.

The information provided by means of the tax return is not sufficiently broken down to enable the estimation of tax expenditures under tax measures "Accelerated tax depreciation of up to 50% for machines and equipment" and "Accelerated tax depreciation (100% per annum) for assets generated as a result of R&D".

On the one hand, it is necessary to simplify administrative procedures, including the procedure of filling in and filing tax returns, in order to reduce the administrative burden and the cost of compliance for taxpayers. On the other hand, the unavailability of certain information concerning tax incentives under corporate and personal income taxation prevents the measuring of the actual size of tax expenditures and the production of a realistic Tax Expenditure Report.

Information filed through the annual tax returns should be carefully examined and the possible elimination of some items and their replacement by other items should be considered, with a view of striking an efficient balance in order to achieve the set goals.

7.3. Tax Expenditure Estimates by Type of Tax Measure

Tax expenditures have been estimated by type of tax measure for the following types of taxes: value added tax, excise duties, corporate and personal income taxation.

1. Tax Measures Associated with Value Added Tax

In tax expenditures associated with value added tax, the highest relative share is that of the tax expenditure under tax measure "Reduced tax rate for accommodation provided by a hotel operator".

2007-2009 Tax Expenditure Report

| Tax measure type | As a percentage of tax revenue from VAT | | | Amount (in levs) | | |
|--|---|--------------|--------------|-------------------|-------------------|-------------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Special regime for charging VAT on imports and a 30-day deadline for VAT refunds | 0.002% | 0.003% | 0% | 158 221 | 242 711 | 0 |
| Reduced tax rate (7 %) for accommodation provided by a hotel operator | 1.1% | 1.04% | 1.08% | 72 819 131 | 77 884 891 | 69 564 028 |
| Total | 1.1% | 1.04% | 1.08% | 72,977,352 | 78,127,602 | 69,564,028 |

2. Tax Measures Associated with Excise Duties

| Tax measure type | As a percentage of revenue from excise duties | | | Amount (in levs) | | |
|--|---|--------|--------|--|------------|------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Refund of excise duty paid on alcohol and alcoholic beverages when used for medical purposes | | | | The tax expenditure has not been measured. | | |
| Refund of excise duty paid on electric power for licensed railway carriers and railway infrastructure managers | 0.004% | 0.004% | 0.004% | 130 000 | 155 000 | 148 674 |
| Zero-rate excise duty on electric power for household consumption | 0.34% | 0.28% | 0.33% | 11 245 680 | 11 358 137 | 12 726 361 |
| Zero-rate excise duty on sales of coal and coke to individuals | 0.12% | 0.11% | 0.10% | 4 044 449 | 4 496 623 | 3 768 120 |

2007-2009 Tax Expenditure Report

| Tax measure type | As a percentage of revenue from excise duties | | | Amount (in levs) | | |
|---|---|--------------|--------------|--------------------|--------------------|--------------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Zero-rate excise duty on natural gas used as motor fuel and heating fuel | 0.79% | 0.78% | 0.76% | 26 061 782 | 31 802 549 | 29 200 471 |
| Reduced excise rate on ethyl alcohol (rakiya) produced in specialised small distilleries, amounting to BGN 550 per hectolitre of pure alcohol | 0.02% | 0.02% | 0.02% | 825 169 | 931 430 | 952 000 |
| Reduced excise rate on beer produced by small independent breweries | x | x | 0.05% | x | x | 1 881 606 |
| Reduced excise rates on mixtures of biofuel and liquid fuel derived from crude oil | 0.24% | 0.10% | 0.28% | 8 068 851 | 4 023 997 | 10 730 012 |
| Zero-rate excise duties on biofuels in pure form (repealed) | x | x | 0% | x | x | 0 |
| Refund of excise duty on diesel fuel used by registered agricultural producers (repealed) | 1.90% | 2.0% | 2.23% | 63 126 287 | 80 846 524 | 85 847 866 |
| Total | 3.42% | 3.30% | 3.78% | 113,502,218 | 133,614,260 | 145,255,110 |

Total for the period 2007-2009

The analysis revealed a significant increase in tax expenditures associated with excise duties. In comparison to 2007, 2009 exhibited a nominal increase of BGN 31 752 892, or 27.98%.

The largest increase was observed for two tax measures: “Refund of excise duty on diesel fuel used by registered agricultural producers” and “Zero-rate excise duty on electric power for household consumption”.

For the period under review, in tax expenditures associated with excise duties, the highest

relative shares are those of tax expenditures associated with three tax measures:

- “Refund of excise duty on diesel fuel used by registered agricultural producers” (55.6% in 2007, 60.5% in 2008 and 59.1% in 2009);
- “Zero-rate excise duty on natural gas used as motor fuel and heating fuel” (22.9% in 2007, 23.8% in 2008 and 20.1% in 2009);
- “Zero-rate excise duty on electric power for household consumption” (9.91% in 2007, 8.51% in 2008 and 8.76% in 2009).

3. Tax Measures Associated with Corporate Income Taxes

| Tax measure type | As a percentage of tax revenue from corporate taxes | | | Amount (in levs) | | |
|---|---|-------|-------|--|------------|------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Tax exemption of equity transactions performed on a stock exchange | 3.87% | 0.97% | 0.75% | 78 000 000 | 23 500 000 | 14 400 000 |
| Tax exemption from corporate income tax for collective investment schemes, licensed investment companies and special purpose vehicles | | | | The tax expenditure has not been measured. | | |
| Tax exemption from corporate income tax for the Bulgarian Red Cross | | | | The tax expenditure has not been measured. | | |
| Tax exemption from corporate income tax and income tax for institutions of higher education | | | | The tax expenditure has not been measured. | | |

2007-2009 Tax Expenditure Report

| Tax measure type | As a percentage of tax revenue from corporate taxes | | | Amount (in levs) | | |
|--|---|---------|---------|--|------------|------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Tax exemption from corporate income tax and income tax for the Bulgarian Academy of Sciences, the Academy of Agriculture, etc. | | | | The tax expenditure has not been measured. | | |
| Remission of 100 per cent of the corporate income tax for undertakings engaging in manufacturing activities in municipalities with high unemployment rates | 1.63% | 0.28% | 0.35% | 32 889 000 | 6 817 000 | 6 815 000 |
| Remission of 60 per cent of the corporate income tax for registered agricultural producers | 1.07% | 0.70% | 0.73% | 21 510 000 | 16 960 000 | 14 129 000 |
| Remission of corporate income tax for undertakings employing people with disabilities | 0.21% | 0.04% | 0.05% | 4 326 000 | 966 000 | 880 000 |
| Remission of 50 per cent of the corporate income tax for social security and health insurance funds | 0.01% | 0.0002% | 0.0005% | 223 000 | 5 000 | 10 000 |
| Accelerated tax depreciation | | | | The tax expenditure has not been measured. | | |

2007-2009 Tax Expenditure Report

| Tax measure type | As a percentage of tax revenue from corporate taxes | | | Amount (in levs) | | |
|---|---|--------------|--------------|--|--------------------|--------------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Accelerated tax depreciation (100 % per annum) for assets generated as a result of R&D | | | | The tax expenditure has not been measured. | | |
| Tax losses carry forward | 5.76% | 3.97% | 4.49% | 116 038 000 | 95 929 600 | 86 394 800 |
| Tax deductible expense for donations | 0.29% | 0.25% | 0.23% | 5 883 655 | 5 989 837 | 4 328 465 |
| Tax exemption of social benefit expenses for food vouchers | 0.14% | 0.38% | 0.69% | 2 907 844 | 9 150 000 | 13 311 350 |
| Tax exemption of social benefit expenses for contributions and premiums for additional social security and life insurance | | | | The tax expenditure has not been measured. | | |
| Tax exemption of social benefit expenses for employee transport | | | | The tax expenditure has not been measured. | | |
| Tax deduction for hiring unemployed persons | 0.004% | 0.003% | 0.004% | 84 000 | 82 000 | 79 000 |
| Total | 12.99% | 6.60% | 7.30% | 261,861,499 | 159,399,437 | 140,347,615 |

Note: Tax measures under corporate taxes include “Tax losses carry forward” as a tax expenditure item. Tax loss carry forward is a tax incentive, but an in-depth analysis of the nature of that tax incentive indicates that it ought to be deemed part of the benchmark tax and should not be included and measured as a tax expenditure item. For the purposes of the present analysis, that tax incentive has been measured as a tax expenditure item, due to its high value.

Total for the period 2007-2009

The analysis revealed a significant reduction in tax expenditures associated with corporate income taxes. In comparison to 2007, 2009 exhibited a reduction of BGN 121 513 884 in nominal terms, or 46.41%. The reduction is the result of the lower amount of declared tax profits and

corporate income taxes, which directly affects the size of tax expenditures.

The largest reduction was observed in the following tax measures: “Tax exemption of equity transactions performed on a stock exchange”, “Remission of 100 per cent of the corporate tax for undertakings engaging in manufacturing activities in municipalities with high unemployment rates”, and “Tax losses carry forward”.

A considerable increase was observed under tax measure “Tax exemption of social benefit expenses for food vouchers”. The 2009 increase in the tax expenditure under that measure from its 2007 value amounted to BGN 10 403 506 in nominal terms, or a factor of 3.5.

It should be noted that the tax measure relating to food vouchers has not been fully measured. Due to the unavailability of information to allow identification, the tax expenditure relating to tax exemption benefiting the employee in terms of their imputed personal income tax and social security and health insurance contributions due on the amount provided in the form of food vouchers.

For the period under review, within tax expenditures associated with corporate taxes, tax expenditures under three tax measures accounted for the highest relative shares. Those are:

- “Tax losses carry forward” (44.31% in 2007, 60.18% in 2008 and 61.55% in 2009);
- “Tax exemption of equity transactions performed on a stock exchange” (29.79% in 2007, 14.74% in 2008 and 10.26% in 2009);
- “Remission of 60 per cent of the corporate tax for registered agricultural producers” (8.21% in 2007, 10.64% in 2008 and 10.07% in 2009).

4. Tax Measures Associated with Personal Income Taxes

| Tax measure type | As a percentage of tax revenue from personal income taxation | | | Amount (in levs) | | |
|---|--|-------|-------|---|-----------|-----------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Tax incentives for sole proprietors (incentives under CITA which can be used by sole proprietors) | 0.18% | 0.21% | 0.19% | 3 290 898 | 4 182 759 | 3 901 983 |
| Tax exemption of certain types of personal income | | | | A portion of this tax incentive is not a tax expenditure item. The tax expenditure has not been measured. | | |
| Tax exemption of certain types of income under employment contracts governed by the Labour Code | | | | A portion of this tax incentive is not a tax expenditure item. The tax expenditure has not been measured. | | |

2007-2009 Tax Expenditure Report

| Tax measure type | As a percentage of tax revenue from personal income taxation | | | Amount (in levs) | | |
|---|--|--------------|--------------|-------------------|-------------------|-------------------|
| | 2007 | 2008 | 2009 | 2007 | 2008 | 2009 |
| Reducing the sum of annual tax bases by deducting any pension contributions made during the year at the expense of the individual | 0.01% | 0.004% | 0.003% | 97 880 | 85 114 | 56 689 |
| Tax deduction on donations | 0.26% | 0.02% | 0.02% | 4 786 202 | 467 711 | 341 100 |
| Reducing the sum of annual tax bases for persons with 50 per cent or more reduced work capability | 0.49% | 1.18% | 1.19% | 8 780 665 | 23 350 914 | 24 487 724 |
| Reducing the sum of annual tax bases by deducting any personal voluntary pension contributions and insurance premiums | 0.29% | 0.16% | 0.12% | 5 235 818 | 3 070 866 | 2 480 761 |
| Tax deduction for young families | x | x | 0.10% | x | x | 1 983 267 |
| Total | 1.23% | 1.58% | 1.62% | 22,191,463 | 31,157,364 | 33,251,524 |

Total for the period 2007-2009

The analysis revealed a significant increase in tax expenditures associated with personal income taxation. In comparison to 2007, 2009 exhibited a nominal increase of BGN 11 060 061, or 49.83%.

The largest increase was observed under tax measure "Reducing the sum of annual tax bases for persons with 50 per cent or more reduced work capability".

For the period under review, in tax expenditures associated with personal income taxation, the highest relative shares are those of tax expenditures under three tax measures:

- "Reducing the sum of annual tax bases for persons with 50 per cent or more reduced work capability" (39.57% in 2007, 74.95% in 2008 and 73.64% in 2009);
- "Tax incentives for sole proprietors" (14.83% in 2007, 13.42% in 2008 and 11.73% in 2009);
- "Reducing the sum of annual tax bases by deducting any personal voluntary pension

contributions and insurance premiums” (23.59% in 2007, 9.86% in 2008 and 7.46% in 2009).

7.4. Tax Expenditure Estimates by Goal

Tax expenditures have been estimated in terms of two main goals: an economic goal and a social goal.

Tax expenditures with an economic goal refer to tax measures aimed at promoting foreign direct investment and innovation, stimulating higher employment and the development of certain regions and sectors in the national economy.

Tax expenditures with a social goal refer to tax measures targeted at certain categories of individuals.

2007

In 2007, the relative share of tax expenditures with an economic goal was 91.72%, and tax expenditures with a social goal accounted for 8.28%, respectively.

| Goal | Amount (in levs) | As a percentage of tax revenue |
|---------------------|---------------------|-----------------------------------|
| Economic goal | 431 594 787 | 2.99% |
| Social goal | 38 937 745 | 0.27% |
| Total, goals | 470 532 532 | 3.26% |

2008

In 2008, the relative share of tax expenditures with an economic goal was 86.71%, and tax expenditures with a social goal accounted for 13.29%, respectively.

| Goal | Amount (in levs) | As a percentage of tax revenue |
|---------------------|---------------------|-----------------------------------|
| Economic goal | 348 826 084 | 2.08% |
| Social goal | 53 472 579 | 0.32% |
| Total, goals | 402 298 663 | 2.40% |

2009

In 2009, the percentage of tax expenditures with an economic goal was 84.63%, and tax expenditures with a social goal accounted for 15.37%, respectively.

| Goal | Amount (in levs) | As a percentage of tax revenue |
|---------------|---------------------|-----------------------------------|
| Economic goal | 328 702 559 | 2.21% |
| Social goal | 59 715 716 | 0.40% |

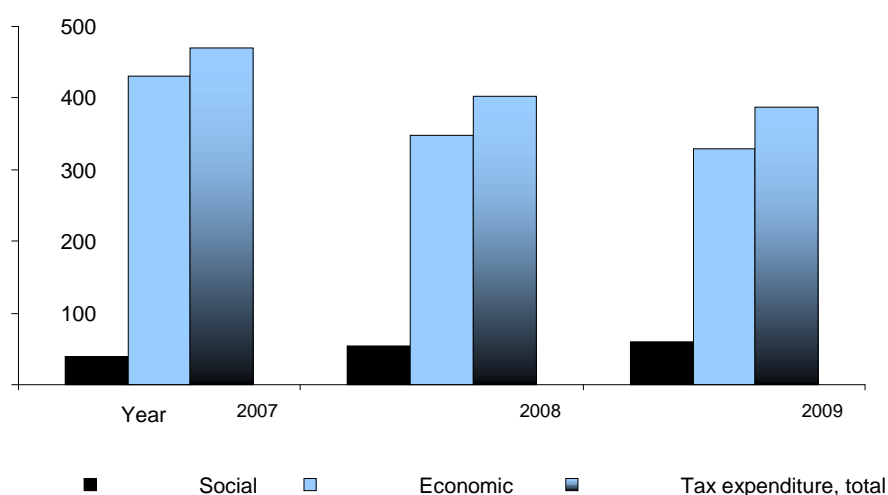
| | | |
|---------------------|--------------------|--------------|
| Total, goals | 388 418 275 | 2.61% |
|---------------------|--------------------|--------------|

Total for the period 2007-2009

The analysis revealed an increase in the relative share of tax expenditures with a social goal. In comparison to 2007, 2009 exhibited a nominal increase of BGN 20 777 971, or 53.36%.

In the period under review, there is a considerable reduction in tax expenditures with an economic goal. In comparison to 2007, 2009 exhibited a reduction of BGN 102,892,228 in nominal terms, or 23.85%. The reduction is largely due to the lower amount of declared tax profits and corporate taxes, which directly affects the size of tax expenditures with an economic goal.

Tax Expenditure Amounts, 2007 – 2009, by Goal



7.5. Tax Expenditure Estimates by Economic Sector and Subsector

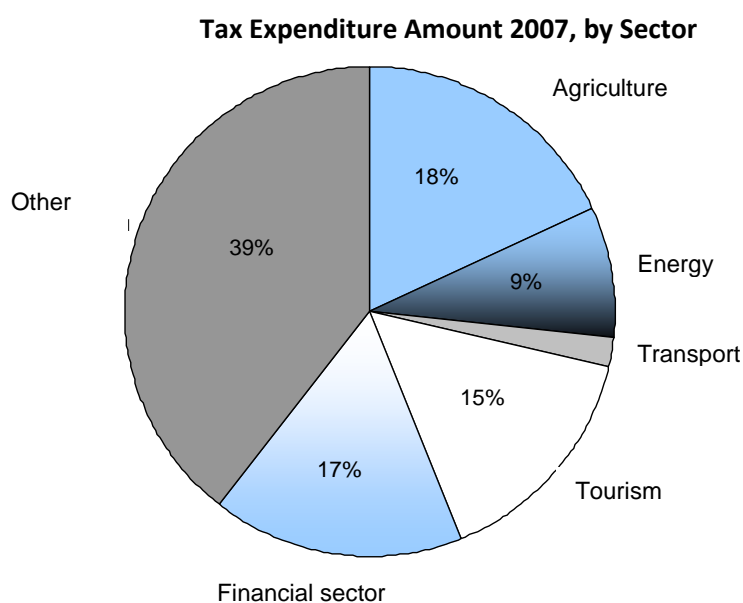
Tax expenditures have been estimated by economic sectors and subsectors.

2007

| Economic sector | Amount (in levs) | As a percentage of tax revenue |
|-----------------|---------------------|-----------------------------------|
| Agriculture | 84 636 287 | 0.59% |
| Energy | 41 351 911 | 0.29% |
| Transport | 8 198 851 | 0.06% |
| Tourism | 72 819 131 | 0.50% |

2007-2009 Tax Expenditure Report

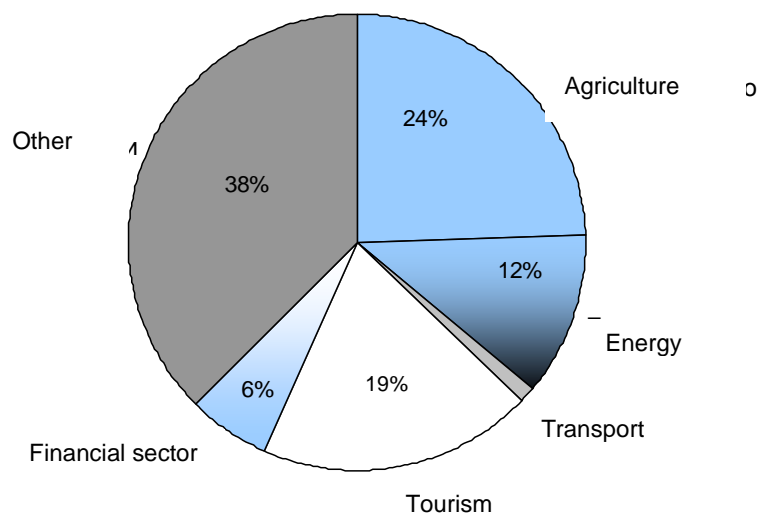
| | | |
|-----------------------|--------------------|--------------|
| Financial sector | 78 223 000 | 0.54% |
| Other | 185 303 352 | 1.28% |
| Total, sectors | 470 532 532 | 3.26% |



2008

| Economic sector | Amount (in levs) | As a percentage of tax revenue |
|-----------------------|---------------------|-----------------------------------|
| Agriculture | 97 806 524 | 0.58% |
| Energy | 47 657 309 | 0.28% |
| Transport | 4 178 997 | 0.02% |
| Tourism | 77 884 891 | 0.46% |
| Financial sector | 23 505 000 | 0.14% |
| Other | 151 265 942 | 0.90% |
| Total, sectors | 402 298 663 | 2.40% |

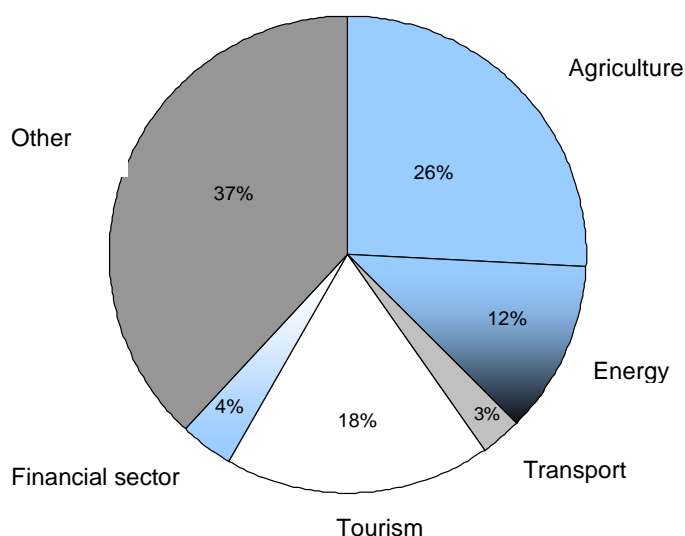
Tax Expenditure Amount 2008, by Sector



2009

| Economic sector | Amount (in levs) | As a percentage of tax revenue |
|-----------------------|---------------------|-----------------------------------|
| Agriculture | 99 876 866 | 0.67% |
| Energy | 45 694 952 | 0.31% |
| Transport | 10 878 686 | 0.07% |
| Tourism | 69 564 028 | 0.47% |
| Financial sector | 14 410 000 | 0.10% |
| Other | 147 893 744 | 0.99% |
| Total, sectors | 388 418 275 | 2.61% |

Tax Expenditure Amount 2009, by Sector



Note: For the purposes of estimating tax expenditures, the category of „Other” includes several economic sectors (food and beverages, pharmaceuticals, etc.) and tax expenditures associated with general tax measures (for example, „Tax deferrals”) or tax measures for promoting regional development and employment which, on the one hand, cover a considerable number of sectors and, on the other hand, are hard to differentiate by economic sector (for example, „Cession of 100 per cent of the corporate tax for undertakings engaging in manufacturing activities in municipalities with high unemployment rates”).

Total for the period 2007-2009

The analysis revealed that the largest increase in tax expenditures was in the sector of agriculture. In comparison to 2007, 2009 exhibited a nominal increase of BGN 15 240 579, or 18.01%.

In the period under review, there is a considerable reduction in tax expenditures in the financial sector. In comparison to 2007, 2009 exhibited a reduction of BGN 63 813 000 in nominal terms, or 81.58%.

Over the entire three-year period, the highest relative share in tax expenditures is that of tax expenditures in the Agriculture, Tourism and Energy sectors.

7.6. Tax Expenditure Estimates by Beneficiary

Tax expenditures have been estimated for two main categories of beneficiaries: legal persons and individuals.

2007

In 2007, the relative share of tax expenditures where the beneficiaries are legal persons was 73.08%, and that of tax expenditures where the beneficiaries are individuals was 26.92%.

| Beneficiary | Amount (in levs) | As a percentage of tax revenue |
|-----------------------------|-----------------------------|---|
| Legal persons | 343 862 871 | 2.38% |
| Individuals | 126 669 661 | 0.88% |
| Total, beneficiaries | 470 532 532 | 3.26% |

2008

In 2008, the relative share of tax expenditures where the beneficiaries are legal persons was 60.31%, and that of tax expenditures where the beneficiaries are individuals was 39.69%.

| Beneficiary | Amount (in levs) | As a percentage of tax revenue |
|-----------------------------|-----------------------------|---|
| Legal persons | 242 637 465 | 1.45% |
| Individuals | 159 661 197 | 0.95% |
| Total, beneficiaries | 402 298 663 | 2.40% |

2009

In 2009, the percentage of tax expenditures where the beneficiaries are legal persons was 57.57%, and that of tax expenditures where the beneficiaries are individuals was 42.43%.

| Beneficiary | Amount (in levs) | As a percentage of tax revenue |
|-----------------------------|-----------------------------|---|
| Legal persons | 223 623 934 | 1.50% |
| Individuals | 164 794 341 | 1.11% |
| Total, beneficiaries | 388 418 275 | 2.61% |

Note: For the purposes of estimating tax expenditures, the “Legal persons” category includes resident legal persons, including non-personified entities and permanent establishments of non-resident persons in Bulgaria.

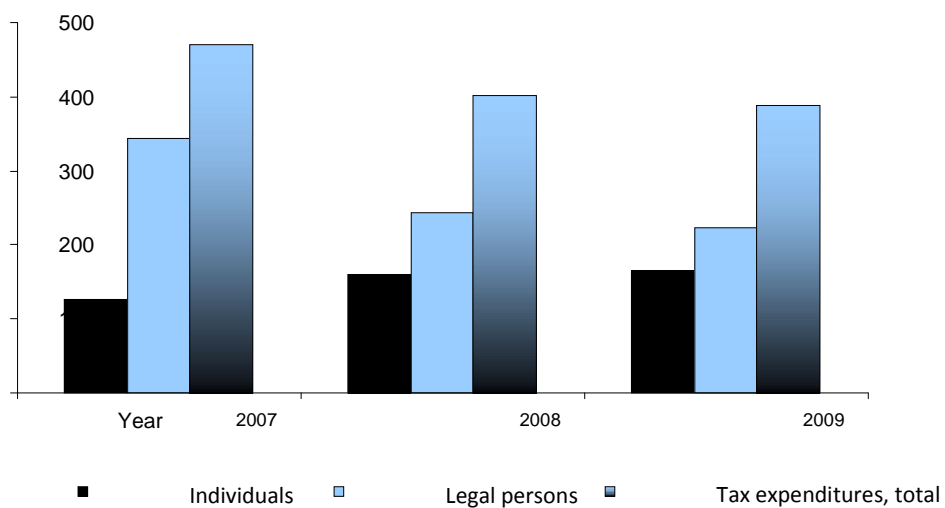
Total for the period 2007-2009

The analysis revealed an increase in the relative share of tax expenditures where the beneficiaries are individuals. In comparison to 2007, 2009 exhibited a nominal increase of BGN 38 124 680, or 30.09%.

In the period under review, there is a considerable reduction in tax expenditures where the beneficiaries are legal persons. In comparison to 2007, 2009 exhibited a reduction

of BGN 120 238 937 in nominal terms, or 34.97%. The reduction is largely due to the lower amount of declared tax profits and corporate income taxes, which directly affects the size of tax expenditures where the beneficiaries are legal persons.

Tax Expenditure Amount, 2007 – 2009, by Beneficiary



VIII. RECOMMENDATIONS FOR IMPROVEMENTS IN TAX EXPENDITURE REPORTING

Recommendation 1: Review and measure tax expenditures regularly, issuing a Tax Expenditures Report annually or once every two years.

Recommendation 2: Publish the Tax Expenditure Report on the website of the Ministry of Finance in order to increase transparency in public finance and raise public awareness.

Recommendation 3: Develop methods of tax expenditure reporting.

Recommendation 4: Adopt a national definition of “tax expenditure” for the purposes of analysing and measuring tax expenditures.

Recommendation 5: Define benchmark taxes for the purposes of tax expenditure reporting, for each taxation category or type of tax.

Recommendation 6: Analyse information requirements and information sources for the purposes of tax expenditure measurement.

Recommendation 7: Reduce the share of unmeasured tax expenditures.

Recommendation 8: Assess tax expenditure efficiency.

Recommendation 9: Conduct a cost-benefit analysis before introducing any future tax expenditures.

Recommendation 10: Develop short- and mid-term forecasts for tax expenditure estimates.

CONCLUSIONS

The Bulgarian tax system provides a small number of tax expenditure items. Generally, tax expenditures are aimed at stimulating economic development and growth by promoting investment, innovation and employment.

In the period under review, there is an overall reduction in tax expenditures. The reduction is largely due to the lower amount of declared tax profits and corporate income taxes, which directly affects the size of tax expenditures.

The Report shows that a considerable part of tax expenditures have not been measured, due to the unavailability of information about tax incentives associated with corporate and personal income taxation. In that regard, it is necessary to undertake appropriate action to reduce the share of unmeasured expenditure and ensure more realistic tax expenditure reporting in the future.

Last but not least, it should be noted that part of the tax expenditures introduced several years ago have now lost their ability to influence taxpayers and are inefficient, and at this point their only effect is to reduce budget revenue, without adding any real value for the economy and

the society. Such inefficient tax expenditures should be subject to an in-depth review to explore the question of how justified it is to retain them in their present form.

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