

MINISTRY OF FINANCE

**TAX EXPENDITURE
REPORTING IN BULGARIA**

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- The focus of this presentation is on the first Tax Expenditure Report in Bulgaria.
- The presentation includes:
 - Main stages in issuing a tax expenditure report;
 - Estimation of the tax expenditures;
 - Main conclusions of the tax expenditure report;
 - Recommendations for improving the process of issuing a tax expenditure report.



INTRODUCTION

- The main objective of the tax policy is to shape the scope of taxation in such a way as to ensure high effectiveness and transparency of the tax system.
- Effectiveness of the tax system, in simplified terms, comes down to securing the fiscal needs of the state while maintaining the highest possible economic growth and providing appropriate living standard to the society.
- This compromise between fiscal, economic and social objectives is achieved mostly by differentiating the object of taxation (consumption, revenues or property) and by structuring the taxes themselves, including tax base, tax rates and tax incentives.
- The implementation of such solutions provides an opportunity to improve the flexibility of the scope of taxation and stimulate taxpayers' behaviors in line with the expectations of the state.



- On one hand, these solutions comprise incentives for specific groups of taxpayers and on the other hand they deprive the state of a part of potential tax revenues or in other words, the state gives up on a portion of tax revenues in order to achieve particular economic or social objective.
- General characteristics of the various forms of tax incentives is the reduction of the tax liability and hence reduction of the potential tax revenues to the state budget.
- The losses from tax revenue occurred as a result of tax incentives are considered as tax expenditures.
- Tax expenditures are *de facto* substitute of budget expenditures and in certain conditions may be an alternative to direct transfers from the state budget or municipal budget.



WHY IT IS NECESSARY TO ISSUE A TAX EXPENDITURE REPORT?

- Unlike the budget expenditures which are subject of comprehensive analysis, monitoring and control, the tax expenditures are very often outside the scope of this monitoring.
- One of the main reasons is that the budget expenditures are usually presented in one single regulation document, while the tax expenditures are 'scattered' in various tax laws, often implicit and hard to be analysed.
- Similar situation violates the transparency of the financial management of the state and creates risk of improper distribution of public funds.
- The estimation of the expenditures is of key importance for the formation of the country's fiscal policy.
- On one hand, the estimation of tax expenditures creates opportunity for the proper distribution and redistribution of the public wealth and, on the other hand, represents a starting point for assessing the efficiency of the various tax expenditures and of the tax system as a whole.



- Preparing tax expenditure reports has a long tradition in OECD countries.
- First reports were prepared in the 1960s in Germany and United States.
- In the late 1970s reports of the tax expenditures start being issued by Austria, Canada, Spain and United Kingdom.
- The annual reports of the tax expenditures are issued and published with the objective of transparency of the regulations stipulating tax incentives.
- In a large number of countries (Austria, Belgium, France, Germany, Portugal, Spain and United Kingdom) the issuing of reports about tax expenditures is regulated by law, whereat in some of them (Belgium, France, etc.) these reports are directly related with the state budget and are included in the budget process.
- In most countries a tax expenditure report is issued each year but there are exceptions, like for example Germany, where the report is issued on biannual basis.



- For the first time, in 2011, in Bulgaria, a tax expenditure report was issued which represents a first trial for assessing the value of tax expenditures.
- In the Bulgarian legislation there is no liability for issuing a tax expenditure report.
- The report was issued with the objective to increase the transparency of the public finance and to acquaint the society with the system of the tax incentives and their value.
- The report covers a three-years period (2007-2009)



MAIN STAGES IN ISSUING A TAX EXPENDITURE REPORT

- Stages in issuing a tax expenditure report:
- Definition of a tax expenditure;
- Determination of the benchmark tax;
- Identification of tax expenditures;
- Selection of an appropriate method for estimating the tax expenditures;
- Analysis of the required information and sources of information in issuing the estimate of the tax expenditures;
- Estimate of the tax expenditures.



DEFINITION OF A TAX EXPENDITURE

- Tax incentives which are introduced as alternatives to direct government spending so as to achieve given economic and social objectives are generally considered tax expenditures.
- In addition, modifications of the tax system in the form of reliefs, exemptions, deductions from tax due, rate reliefs and tax deferrals may also be viewed as tax expenditures.
- The analysis of the reports on tax expenditures of other states and also the study of a large number of publications of international organisations (OECD, IMF) draw the inference that there is no unified and generally accepted definition of a tax expenditure. This is due, on one hand, to the substantial differences in the tax systems of various states, and on the other hand, to the implemented approach towards the function of the tax expenditures.



- The OECD definition of a tax expenditure – “a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure”.
- In the Bulgarian legislation there is no legal definition of a tax expenditure.
- We used the OECD definition for the purposes of our analysis.
- Due to the juxtaposition of a tax expenditure and a benchmark tax, the key element of a tax expenditure identification process shall be a precise definition of the benchmark tax.



- The definition of a benchmark tax is of substantial significance to the stipulation whether or not a given provision comprises a tax expenditure or is an immanent characteristic of the tax system.
- The world practice shows that there does not exist a generally accepted model for a benchmark tax owing to the differences in the various tax systems of the states. Each state stipulates on its own its benchmark tax for the purposes of its feasibility study and analysis.
- According to the OECD, the benchmark tax incorporating the set of benchmark reliefs and exemptions, may comprise “the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and provisions relating to international fiscal obligations”. (Source OECD, 2010)
- Where the tax system deviates from the benchmark, a tax expenditure is said to exist.



- In Bulgaria there is no legal definition of a benchmark tax.
- It should be stated out that the exact definition of the benchmark tax is very difficult taking into account the fact that every single tax regulation should be analysed in details in order to establish whether or not it represents an immanent characteristic of a particular tax or an incentive for a particular group of taxpayers, activity, economic branches, etc.
- The definition of the benchmark tax requires to point out the most important principles of taxation (universality, completeness and equity) and also the components of the tax system which in their legal sense could be a measure of tax incentives but virtually are part of the benchmark tax and should not be considered as tax expenditure.
- It is not possible to stipulate unified benchmark tax for all taxes.
- The general principles of the tax system could be applied to any tax, however the specific characteristics of the various taxes impose a necessity of differentiating a benchmark tax for each type of tax.



- For the purposes of issuing a tax expenditure report in terms of the identification of the tax expenditures and their estimate, a benchmark tax has been defined concerning two categories of taxes – income taxes and consumption taxes.
- **Benchmark tax for income taxes**
- With regards to the income taxes, the benchmark tax shall include the following main principles - universality of taxation, completeness of taxation, taxation of actual income, individual taxation, annual tax cycle, standard tax rates, tax depreciation system, etc.
- The benchmark tax shall also include all the solutions preventing double taxation – application of methods resulting from agreements on double taxation .



- Benchmark tax for consumption taxes
- In terms of VAT and excise duty which are harmonised at EU level, the benchmark tax shall follow the principles that are provided for in EU law and are compulsory for all EU Member States.
- All optional tax solutions adopted in the field of VAT and excise duty (solutions which the state may, but does not have to apply) should be considered as a deviation from the benchmark tax.
- In regard to the tax rates, the benchmark tax includes the standard tax rates. The reduced tax rates of VAT and excise duty shall be treated as tax expenditure.
- Benchmark tax also includes such solutions as the limitation of the scope of taxation for administrative or control purposes – for example excise duty exemption for homemade wine and alcoholic beverages manufactured by individuals for their own use and not intended for sale.



- A necessary condition for the proper allocation of budgetary funds is to know their amounts.
- As opposed to direct transfers (budget expenditures) value of tax expenditures is not known ex ante.
- Possibilities of determining their exact value ex post (after the end of fiscal year) are also limited as tax expenditures usually do not carry detailed reporting requirements.
- The determining value of tax expenditures requires estimations performed by application of specific methodology.
- **Applicable methods of estimating tax expenditures:**
 - Revenue forgone method;
 - Revenue gain method;
 - Outlay equivalence method.



- **Revenue forgone method** – the most frequently used method of estimation of tax expenditures. The revenue forgone method comprises an estimate of the amounts that are not paid to the budget as a result of the existence of a given tax expenditure.
- **Revenue gain method** – the method is based on the estimate of the amounts that would have been paid to the budget if particular tax expenditures have been eliminated from the tax system after taking in consideration the change in the behaviour of the taxpayers, which is due to the elimination of the expenditures.
- **Outlay equivalence method** – the method comprises an estimate of the value of the cash expenditures which are required for funding of a particular objective outside the tax system (like for example expenditures for increase of the social aid or subsidies for purchase of new technologies).
- **For the purposes of issuing a tax expenditure report in Bulgaria the revenue forgone method has been used.**



ESTIMATION OF THE TAX EXPENDITURES

- The tax expenditures have been estimated for a three-years period (2007-2009)
- The tax expenditures presented in the report are estimated on the basis of accounted data, contained in the tax returns and the customs declarations, and also on the basis of statistic information of the Bulgarian National Bank and the National Statistics Institute.
- Overall estimate of the tax expenditures has been made which includes:
 - total value of the tax expenditures;
 - estimate of the tax expenditures by type of taxes;
 - estimate of the tax expenditures by type of tax measures;
 - estimate of the tax expenditures by objectives;
 - estimate of the tax expenditures by economic branches;
 - estimate of the tax expenditures by beneficiaries.



IDENTIFIED TAX EXPENDITURES

- In the analysed period, 35 types of tax expenditures have been identified. An assessment of 26 types of tax expenditures (comprising 74% of all expenditures) has been made.
- The analysis shows that considerable part of the tax expenditures (26%) is not estimated. The lack of estimate is due to the fact that tax returns do not contain the required data or the data are generalised and could not be used to make a reliable estimate of the corresponding tax expenditure.
- **Example:** The annual corporate tax return contains generalised information about the costs of depreciation recognised for tax purposes of all types of depreciated tangible and intangible assets. The information in the tax return is not sufficiently specialised as a result of which the issuing of an estimate of the tax expenditures in terms of tax measures “Accelerated tax depreciation up to 50% for machinery and equipment” and “Accelerated tax depreciation (100%) for assets, formed as a result of research and development activities” is not possible.



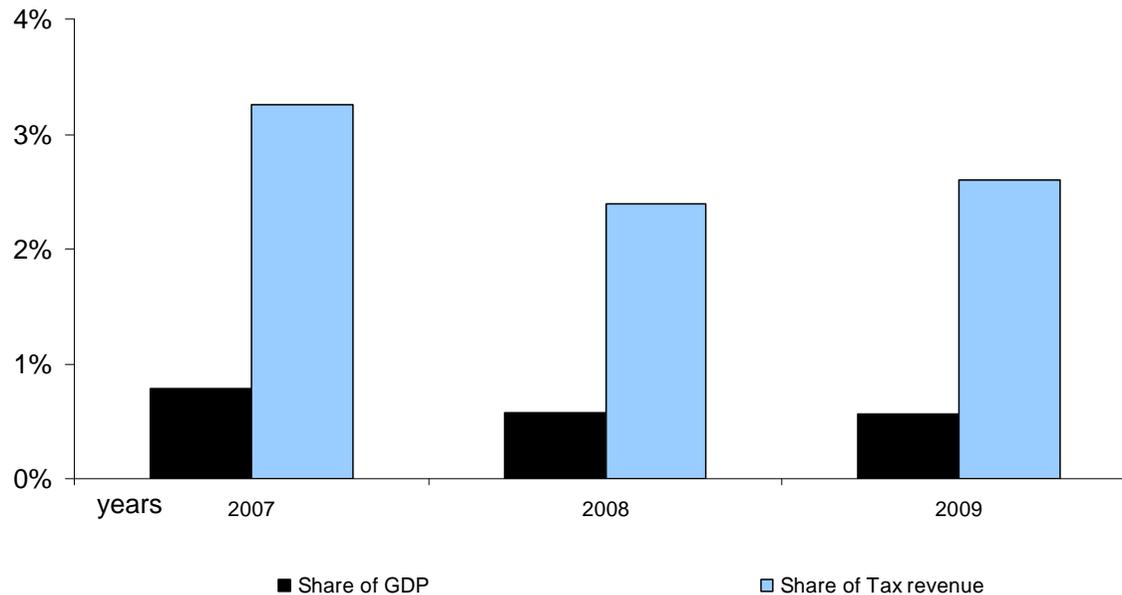
TOTAL VALUE OF THE TAX EXPENDITURES

Year of estimate	Total value of the tax expenditures (BGN)	Share of GDP (%)	Share 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%

- During the analysed period it is observed a decrease in the value of the tax expenditures as absolute amount and as percentage of the Gross Domestic Product (GDP) and of the tax revenue.
- In year 2009, in comparison with 2007, the decrease in the total value of the tax expenditures is BGN 82 114 255 or by 17.45%.



TOTAL VALUE OF THE TAX EXPENDITURES (2)



- Throughout the analysed period a decrease both in the tax expenditures as % of the GDP (0.78% - 2007; 0.57% - 2009) and as % of the tax revenue (3.26% - 2007; 2.61% - 2009) is observed.



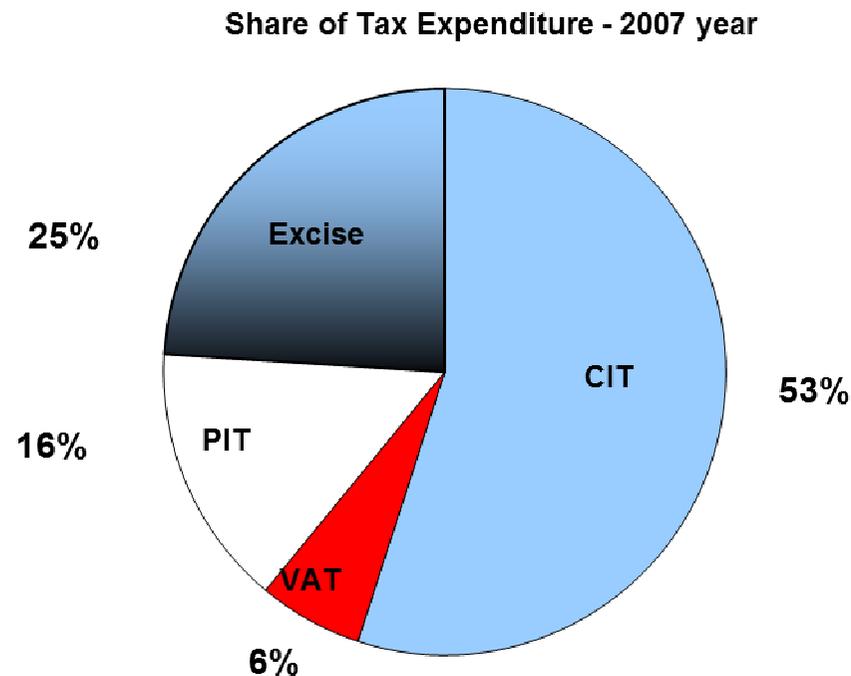
TOTAL VALUE OF THE TAX EXPENDITURES (3)

- The analysis shows that the estimated loss of revenue as a result of the tax expenditures represents less than 1% of the GDP (0.78% of the GDP in 2007 and 0.57% of the GDP in 2009).
- For comparison, this indicator varies from 0.74% of the GDP for Germany, 2% - The Netherlands, 4.9% - Poland to 12.79% for United Kingdom.
- The wide range of the values of these indicators is due, on one hand, to the existing differences in the tax systems of the various states, and on the other hand, to the different approaches and methods used in assessing the tax expenditures.
- In states such as Bulgaria that have adopted wide tax base and low tax rates for the income taxes tax expenditures are fewer number - up to 50.
- Respectively in countries with narrow tax base or with high tax rates the number of tax expenditures is much times greater and reaches 380.



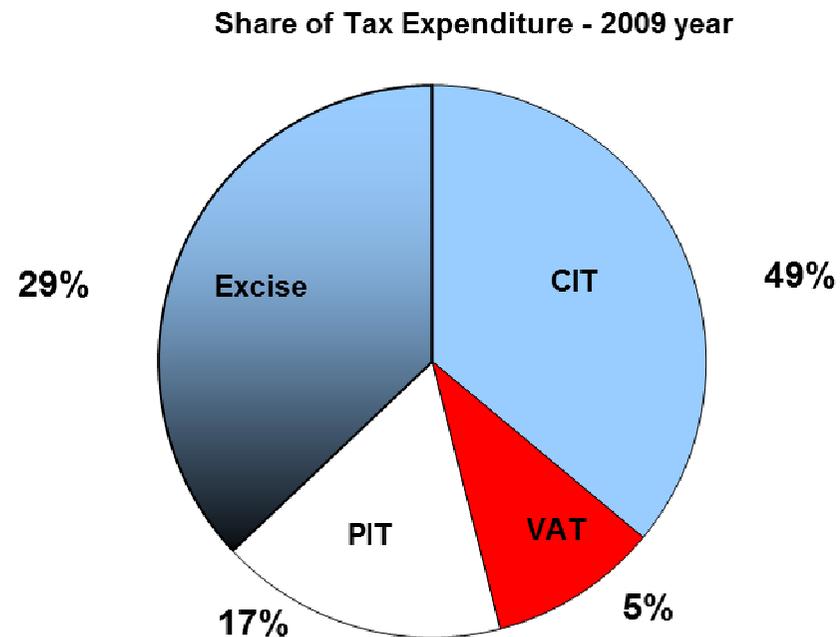
ESTIMATE OF TAX EXPENDITURES BY TYPES OF TAXES AND BY TAX MEASURES

- During the analysed period, expenditures are estimated in terms of types of tax. They are measured by the following taxes: value added tax, excise duties, corporate income tax and personal income tax.
- In 2007, tax measures related to corporate income tax and excise duties account for the greatest relative shares of tax expenditures: 53% and 25%, respectively.



ESTIMATE OF THE TAX EXPENDITURES BY TYPES OF TAXES AND BY TAX MEASURES (2)

- During the analysed period, significant decrease in the relative share of the tax expenditures by corporate income tax is observed, as well as increase in the relative share of tax expenditures by excise duties.



ESTIMATE OF THE TAX EXPENDITURES BY TYPES OF TAXES AND BY TAX MEASURES (3)

- In 2009, with comparison to 2007, the decrease in absolute amount is BGN 121 513 884 or by 46.40%. The decrease is as a result of the declaration in smaller amount of tax profit and corporate income tax, having direct impact on the value of the tax expenditures.
- In the analysed period significant, increase is observed in the tax expenditures attributable to excise duties. In 2009, with comparison to 2007, the increase in absolute amount is BGN 31 752 892 or by 27.98%. The greatest increase is observed in the tax measure “Reduced excise duty rate for gas oil, used by registered agricultural producers”.



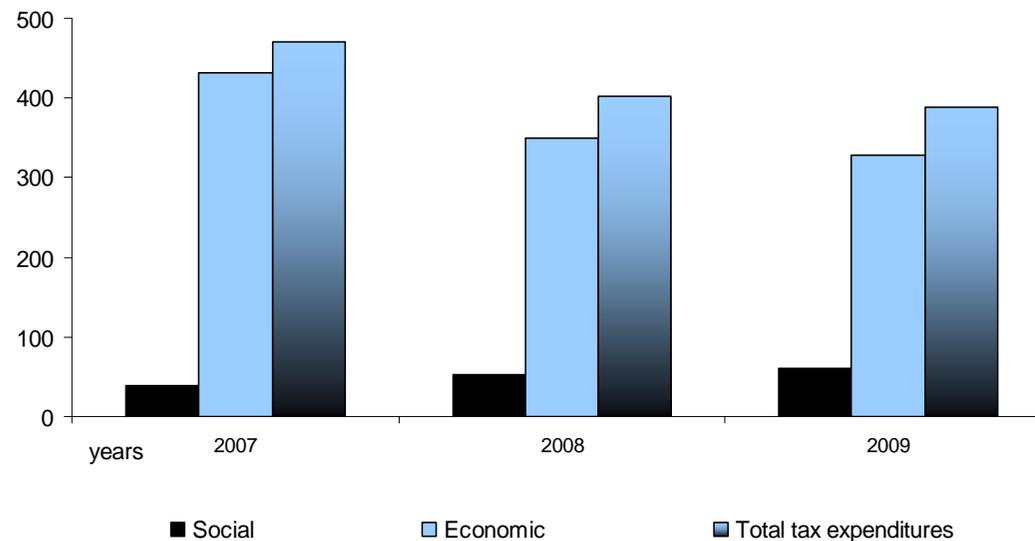
ESTIMATE OF THE TAX EXPENDITURES BY OBJECTIVES

- Tax expenditures are estimated in terms of two main objectives – economic and social.
- Tax expenditures with economic objective concern the tax measures oriented towards stimulating the investments and innovations, the development of particular regions and economic branches in the country, etc.
- The relative share of the tax expenditures with economic objective is 91.72% in 2007 and 84.63% in 2009.
- The analysis shows significant decrease in the tax expenditures with economic objective. In 2009, with comparison to 2007, the decrease in absolute amount is BGN 102 892 228 or by 23.84%.



ESTIMATE OF THE TAX EXPENDITURES BY OBJECTIVES (2)

- Throughout the analysed period neither new tax expenditures were implemented, nor existing ones were repealed. The decrease is due mainly to the declaration of smaller amount of tax profits and corporate income tax by companies having direct impact on the value of the tax expenditures with economic objective.



- The tax expenditures are estimated by economic branches.
- Throughout the whole three-years period the greatest relative share in the tax expenditures is attributable to the tax expenditures of the following branches: “Agriculture”, “Tourism” and “Energy”.
- The analysis shows that the greatest increase of the tax expenditures is in the branch of “Agriculture”. In 2009, with comparison to 2007, the increase in absolute amount is BGN 15 240 579 or by 18.01%.
- During the analysed period significant decrease is observed in the tax expenditures attributable to the the financial sector. In 2009, with comparison to 2007, the decrease in absolute value is BGN 63 813 000 or by 81.58%.



MAIN CONCLUSIONS OF THE TAX EXPENDITURE REPORT

- The Bulgarian tax system proposes few tax expenditures. The tax expenditures are directed mainly towards stimulation of the economic development and growth through stimulating the investment, innovation and employment.
- During the analysed period decrease is observed in the tax expenditures as a whole. The decrease is due mainly to the declaration of smaller amounts of tax profits and corporate income tax, having direct impact on the value of the tax expenditures.
- Considerable part of the tax expenditures is not estimated due to the lack of information related to tax incentives in the tax returns. In this connection, in the future it will be necessary to undertake actions to decrease the share of non-estimated expenditures towards issuing of more realistic tax expenditure reports.



- Part of the tax expenditures implemented years ago have lost their impact on taxpayers and are ineffective so that, at this stage, they may cause only decrease in the budget income without any benefit to the economy and society.
- In terms of ineffective tax expenditures, a more comprehensive feasibility study has to be performed to provide answers as to what extend their implementation, in their current form, is justified.



RECOMMENDATIONS FOR IMPROVING THE PROCESS OF ISSUING A TAX EXPENDITURE REPORT

- **Recommendation 1** – Periodic feasibility study and estimation of the tax expenditures – issuing a tax expenditure report on annual or biannual basis;
- **Recommendation 2** – Publishing the tax expenditure report on the website of the Ministry of Finance with the objective to improve the transparency of the public finance and the awareness of society;
- **Recommendation 3** – National definition of tax expenditure;
- **Recommendation 4** – Defining a benchmark tax – in terms of categories of taxes or by taxes;
- **Recommendation 5** – Decreasing the share of non-estimated tax expenditures;
- **Recommendation 6** – Working out an assessment for the efficiency of the tax expenditures;
- **Recommendation 7** – Repealing the ineffective tax expenditures;
- **Recommendation 8** – Issuing a preliminary “cost-benefit” analysis, when implementing new tax expenditures in the future.
- **Recommendation 9** – Working out of medium-term forecast estimates of the tax expenditures, for a period of three-years.



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