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TO THE EUROPEAN UNION
- BULGARIA -**

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Subject : Supplementary information to negotiating position
Chapter 10 - Taxation

Document provided by Bulgaria

**SUPPLEMENTARY INFORMATION TO
NEGOTIATING POSITION
ON CHAPTER 10 – TAXATION
(CONF-BG 22/01)**

Bulgaria wishes to refer to its Negotiating Position on Chapter 10 “Taxation” (CONF-BG 22/01) and to the Supplementary information, provided in document Conf BG 69/01.

1. Indirect Taxation

a) Value Added Tax

The Republic of Bulgaria requests a permanent derogation under Art. 28(3)(b) of Council Directive 77/388/EEC regarding the taxation of international transport of passengers.

The request is based on art.28(3)(b) and Annex F17 of the Sixth Directive that allows Member states, exempting passenger transport services, to continue to exempt this activity during a transitional period. The latter shall last until a unanimous Council decision is taken to abolish any of the existing derogations (art.28 (4))

A study of the field shows that most of the Member states did use this possibility and are therefore exempting international passenger transport. International air and sea transport is exempted with a right of deduction in all-fifteen Member States, while road and rail transport is exempted with a right of deduction in nine Member States. Derogations on international passenger transport were granted during the last accession negotiations that took place after the introduction of the internal market. Taken into consideration that such derogations were not considered to pose a significant risk to the functioning of the internal market it should be concluded that such risk will not exist if such a derogation is presented to Bulgaria.

Moreover if the international passenger transport is taxed in Bulgaria, whilst all current Member States currently apply an exemption to this transaction this will have a significant negative impact on this market in Bulgaria.

Therefore the Republic of Bulgaria would request a derogation under Article 28(3)(b) and Annex F17 of the Sixth VAT Directive in order to be allowed to continue to exempt with a right to deduct the input VAT the supply of international passenger transport. This derogation will be applied until the condition of Article 28 (4) of the Sixth VAT Directive is fulfilled.

b) Excises

Alcoholic Beverages

Republic of Bulgaria withdraws the request for a five-year transitional period until December 31, 2011 with regard to the application of the minimum excise rate on alcoholic beverages as per Art. 3 (1) of Council's Directive 92/84/EEC.

Republic of Bulgaria requests a permanent derogation of the provision of Art. 21 of Council's Directive 92/83/EEC for taxation with a uniform rate of ethyl alcohol, in order to be able to apply the special scheme for excise taxation of rakia produced in small-scale distillation facilities.

Republic of Bulgaria requests after the date of accession to tax with reduced rate, but not lower than 50% of the standard excise rate, quantities of alcoholic beverages up to 30 l of alcoholic drink (12 l pure alcohol) per annum per household produced from fruits and grapes, produced by individuals, in specialized small-scale distillation facilities and intended solely to be used by the family.

Motivation

Rakia production in small-scale facilities for alcoholic beverages distillation from fruits and grapes, produced by individuals is a national tradition in the Republic of Bulgaria. It is not intended for marketing but only for consumption by the family of the producer.

The process of the rakia making, i.e. fermented fruits distillation, has been turned into a custom in villages and small towns particularly in the regions where a lot of grapes and fruits are grown.

The population of Bulgaria is around 8,150 million, or 2,4 million households.

The beneficiaries of this derogation will be around 60,000 people or 17,000 households.

The annual consumption of alcoholic beverages for 2000¹ data are shown in Table 1:

Table 1

№	Indicator	Quantity /liters/
1	Alcoholic beverages produced for personal consumption from own fruits and grapes	3 447 828
2	Sales on the distillates and alcoholic beverages market	46 778 129
3	Total consumption of alcoholic beverages (1+2)	50 225 959
4	Percentage of personal consumption of alcoholic beverages from the total consumption of alcoholic beverages	7.37%

Specialized small-scale distillation facilities are legally and economically independent of any other distillation facility and do not perform their activities under license. These facilities are issued registration certificates and public registers are kept with the municipalities of location of the distillation facility, wherein the registration certificates are filed.

¹ As per General Tax Directorate information

The rakia produced in this way is not sold on the market and is not traded in any other way; it is consumed only by the members of the family and is completely separated from the commercial network.

A number of Bulgarian legislation provisions guarantee that, namely:

- ✓ The Excise Act regulates that bottled alcoholic beverages intended for domestic market shall be sold only with a banderol;
- ✓ Art. 12d, para 1 of the Excise Act prohibits the sale of non-bottled alcoholic beverages;
- ✓ Art. 26 of the Ordinance on the Terms and Procedures for Registration, Licensing, Deletion from the Registers and Withdrawal of Licenses, on Data Subject to Submission for Registration, on Log Entry Processing, on Content and Design of Declarations for the Vintage and Stock Inventory, and on Control of Licensed Persons and Their Activities /promulgated, SG No. 31 of 14.04.2000/ prohibits trade of alcoholic beverages in streets, squares, open markets, in or from light or truck vehicles, on stands, in tents, and other such similar. The establishments wherefrom alcoholic beverages can be traded are explicitly entered into the License for Sale issued;
- ✓ As per Art. 24 of the Ordinance on the Terms and Procedures for Registration, Licensing, Deletion from the Registers and Withdrawal of Licenses, on Data Subject to Submission for Registration, on Log Entry Processing, on Content and Design of Declarations for the Vintage and Stock Inventory, and on Control of Licensed Persons and Their Activities distillation of fermented fruit material for the production of rakia by the citizenry, which is not intended for sale, using their own raw material, shall be conducted in specialized small-scale distillation facilities;
- ✓ As per the Regulations on the Enforcement of the Excise Act individuals shall declare the rakias produced for their own consumption in a Production List, which shall be listed and submitted to the relevant Territorial Tax Directorate by the person responsible for the small-scale distillation facility. The person responsible for the small-scale distillation facility shall collect and pay the excise due for the quantities exceeding the minimum ones exempted under the law;
- ✓ As per the Regulations on the Enforcement of the Excise the relevant Territorial Tax Directorate shall verify through a certificate that the individual is the producer of the materials (fruits and grapes) wherefrom the rakia is being distilled. This regulation guarantees that the quantities of rakias are produced only from own production fruits and grapes.

In cases of violation of the above-mentioned provisions violators are seriously penalised.

In view of the above-stated legal frameworks guaranteeing the control over the production of alcoholic beverages for family consumption in small-scale distillation facilities and the small share of this production compared to the overall production and consumption, the production of rakias for family consumption is not a threat to market fair competition and has no significant effect on excise revenues.

Following the above considerations and having respect for national traditions Republic of Bulgaria is asking for taxation at reduced rate (but not lower than 50% of the standard rate) of alcoholic beverages produced from individuals own fruits and grapes production in specialized small-scale facilities for distillation of alcoholic beverages intended solely for household personal consumption.

Fuels

Republic of Bulgaria withdraws the request for a 5-year transitional period till December 31, 2011 regarding the implementation of minimum excise rates on unleaded petrol and diesel fuel in compliance with Art. 4 and Art. 5 of Council's Directive 92/82/EEC.

Tobacco products

Republic of Bulgaria maintains its request for a 5-year transitional period up to December 31, 2011 regarding the implementation of minimum excise rates on cigarettes in compliance with Council's Directive 92/79/EEC and Directive 2002/10/EEC.

At the moment the excise on cigarettes is determined as an absolute sum in BGL per 1 cigarette piece to which a percent of the sales price is added:

✓ **Filter-tipped cigarettes**

Excise amounts to 40 % of sales /fixed²/ price + BGL 0.002 per piece.

✓ **Non-filter cigarettes**

Excise amounts to 15% of sales /fixed/ price + BGL 0.001 per piece

The most popular brand of cigarettes are filter-tipped cigarettes brand "**Victory**" /box, 85 mm/, with market share of 34.82 and sale **price of BGL 1.20** /Euro 0.61/.

The excise amounts to 43.33% of the most popular brand of cigarettes' price.

In document CONF BG 69/01 Bulgaria presented its assessment on how the increase of excise rates would influence prices, consumption and inflation and stated that it considers that the effect of the increase will be mitigated if this process is carried in several steps.

The following section of this document is a response to the adoption of a new Directive, which introduced a new minimum excise of 64 euro per 1 000 pieces on the restricting condition that it should not be less than 57% of the retail price. The following analysis is based on the assumption that the excise rates in Bulgaria are increased to reach the Community minimal rates as of the beginning of 2002.

Table 2 reviews the impact that the excises' increase (when assessing the effect of the new excise duty) has on inflation and households' consumption for this commodity group.

² The prices of tobacco goods in Bulgaria are fixed with CMD 307/ 27.12.2001 on determining the prices of tobacco goods locally produced and imported into the domestic market /prom. SG 112/ 2001, amend. SG 24/ 2002

✓ **Impact on inflation**

Table 2 shows that the one-time increase of cigarettes' excises would have a significant impact on inflation, generating inflation of about 6.7% within one month other conditions being equal. Increasing the cigarettes' excise, other conditions being equal, would increase their price more than three times.

If we consider a scenario of excises' one-time increase up to the minimum rate, cigarettes' prices will increase by more than 225%. This would reduce their consumption considerably (by about 90%) and practically will freeze the whole domestic market. When increasing these goods' excises the reduced purchasing power of the population as a result of their increased price will not be compensated by the expected increase of persons' income, which could be achieved partially if the excises were increased gradually within a long-term period.

Abrupt increase of cigarettes' prices would lead to considerable increase of the share of illegal trading of these goods and to evading payment of the excises due (and probably evading payment of other taxes and fees, too). Thus if the excises of these goods were increased within a short period of time this would most probably lead to an abrupt increase of the gray share of this economy sector.

Table 2

Indicator	Victory cigarette brand
Current sale price, BGL / a packet	1.20
Current excise duty, BGL / a packet	0.52
VAT, BG LV/ a packet	0.20
Discount (10%), BGL/ a packet	0.12
Producer price, BGL / a packet	0.36
<i>Current tax burden</i>	<i>60.0%</i>
<i>Excise duty / Sale price</i>	<i>43.3%</i>
New sale price, BGL / a packet	3,91
New excise duty, BGL / a packet	2.51
VAT, BGL / a packet	0.65
<i>New tax burden</i>	<i>80,86%</i>
<i>Excise duty / Sale price</i>	<i>64,19%</i>
Sale price change (%)	225,83
Consumption flexibility in relation to price	-0.44
Change in consumption	-99.37
Consumption flexibility in relation to income	0.13
Change in consumption due to income growth by 2007	4.96
Final change in consumption	-94.41
Contribution of one-time increase to the overall inflation of consumer prices – in percentage points	6.69

Given that as of the current moment EC have suggested a three-year transitional period as to achieving minimum excise duty on cigarettes (Directive 92/79/EEC) and in accordance with the new requirement of Directive 2002/10/EEC, Bulgaria requests a five-year transitional period. The schedule for gradual increase of excise duty rates in 5 stages – at the beginning of 2004, 2006, 2008, 2010 and 2012 (*tables 3, 4*).

Filter-tipped cigarettes

Table 3

<i>Victory</i>	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Sale price	0,86	1,20	1,20	1,41	1,41	1,72	1,72	2,22	2,22	2,88	2,88	4,05
Sale price change	0,0%	39,5%	0,0%	17,5%	0,0%	22,0%	0,0%	29,1%	0,0%	29,7%	0,0%	40,6%
Excise duty	0,30	0,52	0,52	0,65	0,65	0,86	0,86	1,20	1,20	1,66	1,66	2,51
- ad valorem, BGL	0,258	0,48	0,48	0,59	0,59	0,76	0,76	1,02	1,02	1,38	1,38	2,03
- ad valorem, % of the total	87%	92%	92%	91%	91%	88%	88%	85%	85%	83%	83%	81%
Excise duty - EUR/1000 pieces	7,62	13,29	13,29	16,67	16,67	21,90	21,90	30,71	30,71	42,50	42,50	64,04
VAT	0,14	0,20	0,20	0,235	0,235	0,287	0,287	0,37	0,37	0,48	0,48	0,675
Discount (up to 10%)	0,086	0,10	0,10	0,118	0,118	0,143	0,143	0,185	0,185	0,24	0,24	0,338
Producer price	0,347	0,38	0,38	0,405	0,405	0,433	0,433	0,464	0,464	0,498	0,498	0,533
Producer price change	0,0%	9,5%	0,0%	6,7%	0,0%	6,9%	0,0%	7,1%	0,0%	7,3%	0,0%	7,0%
Tax burden	49,7%	60,0%	60,0%	62,9%	62,9%	66,5%	66,5%	70,8%	70,8%	74,4%	74,4%	78,5%
Excise duty / Sale price	34,7%	43,3%	43,3%	46,3%	46,3%	49,8%	49,8%	54,1%	54,1%	57,7%	57,7%	61,9%

The proposed schedule is based on an average annual producer price change of about 3.4%³ and on a need for more gradual sale price increase. In the analysis the current restriction of trade discount of no more than 10 per cent of sale price has been retained. It should be therefore taken into consideration that in the event of price liberalisation the discount as a sale price element can undergo changes.

As a result of excise duty increase, the opportunities for demand reorientation to cheaper brands of cigarettes shall be limited, due to the much more significant price increase of lower class cigarettes (their sale price is expected to increase approximately 8.5 times). The possibility exists for some of them to disappear from the market, being replaced by medium class brands. During the period of excise rates increase, the contribution of cigarette price change to annual inflation (at the end of the respective year) is projected to be about 1.0 – 1.7 per cent.

³ Producer price will most probably increase by more than 3,4% with reference to the commitment to improvement of technological methods for hazardous substance level decrease in tobacco products

Even in the case of gradual excise increase till the beginning of 2012, the decreased purchasing power of the population as a consequence of their increased price amounting to 238 %, would not be compensated by the expected increase of the real income of the population. The rate of cigarette prices increase will outpace at least twice the rate of income increase.

The minimum excise duty rate of 57% of retail price alone, is estimated to lead to increase of retail price of the most popular brand of cigarettes by 85%. The introduction of the new requirement for minimum excise duty rate will result in an increase in retail prices of more than three times more than the introduction of the 57% requirement.

Other effects

- ✓ adverse impact on tobacco production.
- ✓ adverse social impact. Tobacco production is an economic sector of considerable economic, social and demographic significance for Bulgaria. It is concentrated in mountain and semi-mountainous regions of soil of low fertility, where the cultivation of other crops is impossible; there are no conditions for alternative employment of the population. The level of unemployment in these regions is higher than the average for the country. A gradual harmonization would allow for a restriction of possible adverse impact on employment in the tobacco industry, enabling enterprises to adapt to the consequences of cigarette excise rate increase.
- ✓ Difficulty in ensuring tax collection. The abrupt excise rate increase would lead to an overtly economic incentive for illegal cigarette trade /smuggling/, which would force the authorities to concentrate more resources on the control of this activity. The gradual tax rate increase within a 5-year transitional period, would ensure gradual and smooth tax revenue increase, thus ensuring their stability.

Bulgaria would like to call for the consideration of the following factors, specific to Bulgaria:

- ✓ the implementation of the new excise duty would result in one of the highest price rates of cigarettes as compared with member states and other candidate countries;
- ✓ the differences in the amount of VAT, as a significant price dispersion factor. Bulgaria implements one of the highest VAT rates;
- ✓ the need for investment in the technologies for hazardous substances level decrease in tobacco products, which would result in a considerable production cost increase (which has not been accounted for in the analysis) and consequently, in a further retail price increase.

The proposed schedule for gradual excise duty rate increase of cigarettes takes into consideration the fact that the Republic of Bulgaria is withdrawing its request for transitional periods for alcoholic beverages and fuels and that the increase of excises for those groups of commodities will take place before accession.