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LEGAL, ECONOMIC AND SOCIAL EFFECT OF REDUCED VAT RATE IN BULGARIA. ²²⁰

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***Abstract:** The paper reviews legal, economic and social effect of the reduced VAT rate for certain goods and services in Bulgaria as a measure during COVID-19 pandemic. The VAT rate reduction applies from 01 July 2020 to 31 December 2021. At first glance the reduction of the VAT rate for specific goods / services, seems to be with relatively limited effect, in fact it is a change in the whole philosophy of the tax system in the country. The effect of this reduction on the market, consumption and prices is unclear. The report analyzes how this reduction effects on the tax system, economic and social life.*

***Keywords:** tax, VAT, COVID-19, tax system, social system, economics*

***JEL Codes:** K10, K34*

INTRODUCTION

In March 2020, a state of emergency was declared in the Republic of Bulgaria due to the COVID-19 pandemic. Gradually, there was an idea of tax reform and reduction of the tax rate for certain industries as a tool to deal with the consequences of the spread of coronavirus and the measures taken to stop it. The companies engaged in the service sector suffered a severe consequences and financial losses. These are companies from the fitness industry, hairdressing and beauty services, as well as fast food restaurants. Despite differing opinions on the topic of reducing VAT from 20% to 9%, in May this year was submitted a proposal to the parliament to change the law on value added tax and reduce the amount of VAT due for certain types of activities. This proposal was adopted at first and second reading by the Parliament, and on 19.06.2020 in the State Gazette No. 55 the Law for amendment and supplement of the VAT Act was promulgated. One month later, the perimeter of application of this reduced tax rate was expanded by introducing two new subparagraphs. In the State Gazette, issue 71 of 11.08.2020, in paragraph 6 of the Transitional and Final Provisions of the Law for amendment of the local taxes and fees are placed and reflected the new changes made in the VAT Act. The legislator has provided for these changes to be limited in validity - they will be applicable until 31.12.2021. In this report we will focus on the goods and services for which VAT will be charged at a rate of 9% on sales and consumption and what is the legal, economic and social effect of the reduced tax rate.

EXPOSITION

Overview of changes

The changes in the law (in force from 01.07.2020) are reflected in Article 66 of the VAT Act, as its content has been changed and supplemented with two new paragraphs (in force from 01.08.2020).

With the first changes, the rate of 9% is applicable for:

- accommodation services at hotels and similar establishments (including the provision of

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- vacation accommodation and letting out of places for camping sites or caravan sites) - Art. 66, para 2, item 1;
- supplies of books on physical carriers or carried out electronically or both (including textbooks, cognitive booklets and study sets, children's picture, drawing and colouring books, music printed or in manuscript form), other than publications which are fully or mainly intended for advertising, and other than publications which are fully or mainly composed of video content or audio-music content- Art. 66, para 2, item 2;
 - restaurant and catering services, consisting of supply of prepared or unprepared food; this shall not apply to restaurant and catering services consisting of supply of spirit drinks, including in the cases of [Article 128](#)- Article 66, paragraph 2, item 3;
 - food suitable for babies or for infants in accordance with appendix No. 4 - Art. 66, para 2, item 4;
 - napkins and napkin liners for babies in accordance with appendix No. 4 - Art. 66, para 2, item 5.

The second change concerns the extension of the perimeter of application of the already reduced rate, including the sale and consumption of new goods and services, as well as the inclusion of two completely new supplies of services.

The latest amendments to the VAT Act now include the supply of beer and wine in the scope of application of the reduced rate of 9% VAT. Until the changes made before, Article 66, paragraph 2, item 3 stated that a tax of 9 per 100 was applicable to the supply of "restaurant and catering services, which consist in the supply of prepared or unprepared food; this does not apply to restaurant and catering services, which consist in the supply of beer, wine and spirits, including in the cases under Art. 128".

After the changes, the words "beer" and "wine" have been completely deleted from the law and Article 66, paragraph 2, item 3 has the same content without these two words. The text of this article is as follows: "The tax rate is 9 percent for: restaurant and catering services, consisting of supply of prepared or unprepared food; this shall not apply to restaurant and catering services consisting of supply of spirit drinks, including in the cases of [Article 128](#)". The changes made in para 2, item 3 of art. 66 of the VAT Act as content in the law are not significant, but the consequences for the budget are significantly less VAT revenues.

In Art. 66, para 2 two new points have been added, concerning the application of a 9% rate for:

- the supply of single service to tourists in the cases of Article 136, as well as excursions organised by tour operators and tourist agents with occasional bus transport of passengers - art. 66, para 2, item 6;
- the supply of sport facility use services- art. 66, para 2, item 7.

The changes made in Art. 66 of the VAT Act and the introduction of a lower tax rate for the above supplies of goods and services should undoubtedly be considered as a tool to address the consequences of the introduction of anti-epidemic measures to combat COVID-19 for the most severely affected branches in business. But what is the legal, economic and social effect of the introduction of the reduced rate? Are the changes made effective and do they work in the interest of society and the end user? The lower tax rate brings less VAT revenue to the national budget, and does this not further aggravate the situation with regard to indirect tax revenues?

The establishment of public goods and the achievement of management priorities are pursued by the expenditure policy of the budget. The quality of public services, whether we are talking about upholding the rule of law and guaranteeing personal freedoms, property and contracts, access to education, safe food and social support for disadvantaged people, etc., is mostly a matter of creating effective models for their financing. For their part, taxes are the tool for achieving these priorities - they provide the necessary funds to finance spending programs. A good tax system - anywhere in the world, but especially in an open and catching-up economy like Bulgaria's - is one that manages to collect certain taxes effectively, while at the same time distorting incentives for saving, innovation, investment and labor to the least extent.

The tax system must, generally, be designed in such a way that, on the one hand, it allows for the efficient collection of public revenues, while at the same time distorting competition on the market

to a minimum and limiting incentives for productive economic behavior. Each tax has a different impact on economic choices and actions - saving, investing, entrepreneurship, hiring and supplying labor, etc. The decision to change the relative weight of one tax at the expense of another affects business and household incentives, changes behavior, encourages some life and economic choices, and discourages others. A country's tax system should take into account the medium- and long-term challenges of the factors for increasing the productivity and quality of human capital, the specifics and structure of its economy, as well as the tax policies of countries that are regional or international competitors to attract investment.²²¹ Bulgaria and the countries of Central and Eastern Europe, which join the EU common market with significantly lower GDP per capita and seek to catch up with the richer economies in the union, generally choose a tax policy that encourages savings, entrepreneurship, investment, labor, and to a lesser extent - current consumption. In addition, it should be noted that such a tax structure is more adequate for small open economies in which the international exchange of goods and services plays a significant role. The structure of taxation must also take into account the possibility of efficient collection of public revenues. On the one hand, this is related to the resources and costs (efficiency) that the revenue administration must invest in order to administer revenue collection. From another, with the increasing complexity and introduction of various tax exemptions and special regimes, the possibility for tax agents to avoid taxation (loss of efficiency) also increases. The reduction of the VAT rate for specific goods / services, although at first glance it seems to have a relatively limited effect, represents a change in the whole philosophy of the tax system in the country. So far, tax policy relies on two main pillars - a broad tax base and a minimum number of exemptions that allow low rates to be maintained, on the one hand, and stimulating employment and investment through lower direct taxes at the expense of consumption taxes. The introduction of ill-considered tax privileges will quickly lead to a deterioration in the budget balance, as seen in the previous crisis and as it has become clear from statements by several ministries that there will be no spending cuts. This is in addition to declining revenues and rising costs as a result of the effects of the pandemic.

Therefore, the tax system must be considered in its entirety and dynamics. Similar preferences for a range of business activities are already creating pressure to introduce new taxes or increase current rates, including VAT. This is shown by the quick review of the structure and tax rates of VAT in other countries - in all countries with a reduced rate for food in restaurants, the standard VAT rate is higher than in Bulgaria (except for France). In some of the countries that are often cited as an example and in support of the arguments in favor of such a privilege, the difference is significant - for example in Greece the standard rate is 24%, in Poland - 23%, in Hungary - 27%, in Sweden - 25%, etc.

The effect of a reduced rate, or in other words, determining how market participants distribute the benefits of lower taxation, depends on many characteristics specific to the market for the various goods and services. In general, with such differentiation, "support" can be either through the mechanism of increasing consumption by lowering the final price for the customer, or by increasing the trader's profit while maintaining prices.

The expected change in the price of a commodity with a reduction in the tax rate generally depends on two factors: the elasticity of demand, on one hand, and the market structure, the presence of competition and the elasticity of supply, on the other. Goods have different characteristics in terms of consumer sensitivity to price - for some a small change in price leads to a significant increase in consumption, for others the change in consumption is much weaker, and there are goods with virtually fixed consumption, which does not depend from the price.

The argument that lower prices (assuming such an effect will have) will be encouraged visits to restaurants and other establishments should be considered in view of the specific circumstances that led to the problems of the industry. As a result of the continuation of some anti-epidemic distance measures, the capacity of the establishments will be reduced. Many Bulgarian households will voluntarily give up visiting public places in the coming months, even if the measures are further relaxed or even abolished. Restrictions on international travel are likely to be maintained in some

form, regardless of the measures discussed by the European Commission, which applies to both Bulgarians traveling abroad and foreign tourists coming to Bulgaria. But even without restrictions, at least next year, the flow of short-term tourists in Bulgarian cities is unlikely to recover, possibly increasing their consumption in restaurants attracted by lower prices. In the short and medium term, it is difficult to assume that even lower prices will have a large effect on increasing visitors and turnover.

This leads to the conclusion that the expectations for the effect of the reduced rate are direct aid to the companies in the branch by increasing the profits. Reducing the tax rate for a certain group of companies is not a guarantee for their stabilization and for dealing with the consequences of the spread of the coronavirus. There is no guarantee that lower prices as a result of the reduction of the VAT rate for restaurants and fast food restaurants will increase their attendance. However, there is no serious argument for entrepreneurs who have suffered adverse effects from the pandemic and anti-epidemic measures not to take advantage of the various financial measures to support business. They can participate in the measure for maintaining employment (the so-called 60/40), to use loans guaranteed by Bulgarian Development Bank, as well as to receive a grant of up to BGN 30,000. The introduction of a third measure for certain activities creates tension among the owners and managers of companies, for which the introduced "preferences" in the law do not apply. At the same time, VAT revenues in the budget after the changes will decrease, which is a prerequisite for increasing other types of taxes to compensate for the difference of 11% VAT revenue in the national budget.

Next, the possibility of tax fraud and manipulation by traders, to which the reduced tax rate of 9% and the standard rate of 20% apply at the same time, should not be ruled out. It is very likely that a large part of the income will be taxed only at a tax rate of 9%. In practice, it is difficult to prove in a commercial site for which type of goods which tax rate is applied, there is no subsequent control by the revenue administration for the proper implementation of the changes.

CONCLUSION

The latest changes in the VAT Act are hasty, ill-considered and not effective enough to deal with the consequences of COVID-19. They were proposed and accepted because of the mass dissatisfaction of owners and companies from certain industries in the country, and not because of the real need for business support. The changes, which came into force on 01.07.2020, affected certain sectors of the economy, followed by loud dissatisfaction of others. And to make everyone happy in the end, the next change in the law was made, the one that is the subject of analysis in this publication. The pros and cons of the changes were not well considered by the legislator. The introduction of the reduced tax rate from 01.08.2020 did not change the prices of goods and services in the offered retail outlets. We can safely say that the prices of most of the offered goods and services remain unchanged after 01.08.2020. In practice, this means that there is an increase in the prices of goods and services for which a reduced tax rate of 20% to 9%. Which is in complete contradiction with the adopted changes - on the one hand the government is trying to relieve citizens in the consumption of certain goods, and business on the other hand is trying to profit from it in a crisis. Which circumstance again gives us reason to believe that the changes made are ineffective, do not work in the public interest, but on the contrary - allow certain industries to increase the value of goods and services in an epidemic.

The lower tax rate brings less VAT revenue to the national budget. According to the latest data from economic analyzes, VAT revenues at the end of the first half of 2020 amount to 48.9% of the amount planned for the same period. The increase in the sectors of the economy for which the reduction of the reduced tax rate of 9% is introduced further aggravates the situation with regard to revenues from indirect taxes.

In view of the arguments presented, we believe that the differentiation will have rather negative socio-economic and fiscal effects.

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