

Opinion of the European Economic and Social Committee on the Proposal for a Council directive amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC on the structure and rates of excise duty applied on manufactured tobacco

(COM(2008) 459 final — 2008/0150 (CNS))

(2009/C 228/25)

On 11 September 2008 the European Council decided to consult the European Economic and Social Committee, under Article 93 of the Treaty establishing the European Community, on the

'Proposal for a Council directive amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC on the structure and rates of excise duty applied on manufactured tobacco'

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 5 March 2009. The rapporteur was Mr CHREN.

At its 452nd plenary session, held on 24-25 March (meeting of 25 March 2009), the European Economic and Social Committee adopted the following opinion by 32 votes to 2.

1. Conclusions

1.1 While the main objective of the first excise duties on tobacco was solely fiscal, their function is changing in the today's world, and they are becoming more and more a tool of public health and social policies. The European Economic and Social Committee (EESC) endorses the effort of the European Commission to consider other than purely fiscal effects of tobacco products in its excise duties policies. This new policy approach especially focuses on achieving the health policy goals included in the Framework Convention of Tobacco Control, which was formally adopted by the European Union in 2005 and thus became binding for its future policy-making.

1.2 However, it must be noted that other policy objectives of tobacco excise review, including the primary one of a proper functioning of the internal market as mentioned in the Article 4 of the tobacco excise tax directive, should not be forgotten, neither thrown aside. The EESC thus believes that the toughest assignment for policymakers in this area is to find the optimum balance among the interests of different economic, social, security, economic, and fiscal policies. Different aspects and different values have to be taken into account.

1.3 The European Commission's proposal to bring gradually the minimum rates for fine-cut tobacco into line with the rate for cigarettes, and toughen the definition for cigarettes, cigars and pipe-tobacco in order to avoid tobacco product name manipulations aiming to apply the lowest excise duty is commendable.

1.4 The EESC endorses the approach of the European Commission, which gives more freedom to the Member States in adopting decisions in line with their own policy goals, such as wider range for the specific part of the tax burden levied on

cigarettes, or more generous rules for setting minimum tax floor for cigarettes.

1.5 The EESC recommends that the proposed EUR 90 minimum excise should be reduced or the four year period should be extended to 8 years (January 1, 2018). Considering different traditions and social differences among Member States, it has to be noted that in some countries, especially in those that joined the EU just recently, the raising of minimum excise duty from EUR 64 to EUR 90 per 1 000 cigarettes could bring several negative consequences. Some of these countries still did not reach even the level of minimum excise duty as required by the current directives. The EUR 90 minimum excise duty for all retail prices constitutes an increase of 41 % in a period of 4 years and is at least 300 % higher than the expected consumer prices increase in the EU. There is a chance that such a radical step would negligibly reduce consumption, reduce potential budget revenue, reduce consumers' purchasing power, empower smuggling and illegal activities, and increase inflation.

1.6 It has to be noted that few of the proposed actions will lead to a closer harmonisation of tax rates within the European Union. It is very likely that, given the proposed actions, the absolute and relative differences in taxation among Member States will not disappear.

1.7 For example, the historic reason for proportional requirement is harmonisation of excise duty in EU, yet it has not led to any harmonisation in the past and may well bring the opposite results. The proposed increasing of the minimum excise incidence from 57 % to 63 % would lead to further divergence of excise duties in absolute terms and could have serious inflationary impacts, as is shown in the Commission Impact Assessment Report. Given these questionable effects of this proportional minimum requirement, not only its proposed increase, but the reasons for its very existence should be again seriously analyzed and re-considered.

1.8 The replacement of the Most Popular Price Category (MPPC) with weighted price average (WAP) as a benchmark for proportional minimum requirement would hardly lead to more transparency on the market, neither to better predictability of the government revenues, nor to more harmonisation on the cigarettes market. Therefore, the question whether the Commission's proposal could not be further simplified, arises.

1.9 The issue of the best type of tax levied on tobacco products still remains open. The emphasis on the proportional tax rate may have positive effects on eliminating the black market, however, this effect depends on various factors, and thus is not unequivocal. The preference of the purely specific tax rate may help achieving higher tax revenues and lead to a higher minimum tax floor to assist towards health policy goals and tax approximation within the Internal Market.

1.10 The requirement of a mandatory minimum excise tax incidence (of 38 % and 42 % respectively) for all fine-cut tobacco, instead of current minimum tax set either as a percentage of the retail selling price or as a fixed rate per kilogram would result in a mandatory ad valorem excise duty structure and abolish the current freedom of structure for fine-cut tobacco, and thus can't be recommended.

1.11 The linkage between tax and health policy is, to a large extent, conditioned by linking the tobacco excise tax revenues to activities aimed on elimination of the negative consequences of tobacco consumption. However, given the total funding of such activities today, it is quite clear that most of the tobacco excise duty revenues is being spent on activities and policies with no connection to such health policy goals. It is thus quite clear that the fiscal goals are still the primary objectives of the excise duties on tobacco products.

2. Introduction

2.1 Under the Tobacco Excise Directives the European Commission is required to examine every four years, the smooth operation of the single market, the real value of excise-duty rates and the wider objectives of the Treaty. EU rules on tobacco must guarantee the proper functioning of the Internal Market while at the same time be in line with the EU objective to discourage tobacco consumption.

2.2 The current review is the fourth one and suggests a number of significant amendments to existing Community legislation in order to modernise the existing rules and ensure

a level playing field for the operators. The reform comprises of several proposals:

2.3 Although excise duty is primarily an instrument for generating revenue at national level, policy-making in this area has to take the wider objectives of the Treaty into account⁽¹⁾. In addition, the public health protection is a crucial issue in this review given that the European Community became party, on 30 June 2005, to the World Health Organisation's (WHO) framework convention on tobacco control and that several Member States demand that a higher level of human health protection and consequently higher European minima for excise duties on tobacco.

2.4 The Commission's proposal suggests the setting of a monetary minimum duty and establishing a tax 'floor' for all cigarettes sold in the EU allowing to address health concerns for all categories of cigarettes. It increases the minimum requirements in order to contribute to a reduction in tobacco consumption over the forthcoming five years, notably by preventing that Member States' tobacco control policies be undermined by considerably lower levels in other Member States. In addition the proposal allows Member States greater flexibility to apply specific duties and to levy minimum excise duties on cigarettes in order to achieve health objectives. Finally, it brings the minimum rates and structure for fine-cut tobacco intended for the rolling of cigarettes into line with the rate and structure for cigarettes in order to discourage substitution of cigarettes by fine cut.

3. Summary of the proposed action of the Commission

3.1 To replace MPPC with weighted price average (WAP) as the benchmark for proportional minimum requirement. The Commission argues that the MPPC, as benchmark for minimum rates, is not in line with Internal Market objectives as it entails a partition of the tobacco markets of the Member States.

3.2 To increase minimum excise duty for cigarettes in line with internal market price harmonisation and health considerations. It is proposed to increase minimum excise duty on Jan. 1, 2014 from EUR 64 to EUR 90 per 1 000 cigarettes and the proportional minimum from 57 % to 63 % of weighted price average. However, Member States which levy an excise duty of at least EUR 122 per 1 000 cigarettes on the basis of the weighted average retail selling price would not need comply with the 63 % requirement. Also, countries with transitional periods to achieve the current minimum levels of cigarettes taxation could use a 1 or 2 years long transitional periods to achieve these new higher requirements as well.

⁽¹⁾ Article 152 of the Treaty provides that a high level of human health protection shall be ensured in the definition and implementation of all Community policies and activities.

3.3 To apply the minimum excise duty rate requirement set out in the European Union directive will apply not only to MPPC cigarettes (as is currently provisioned), but to all the cigarettes sold in the country. According to the Commission, this would also establish a 'tax floor' for cigarettes sold in the EU, which should address the Internal Market and health concerns for all categories of cigarettes.

3.4 To allow the Member States to widen the band of specific excise duty share of total tax burden from 5 % – 55 % to 10 % – 75 % in order to make excise duty structure more flexible.

3.5 To bring gradually the minimum rates for fine-cut tobacco intended for the rolling of cigarettes into line with the rate for cigarettes. The chosen taxation relationship between fine-cut tobacco and cigarettes is 2/3. Thus, the minimum excise duty for fine-cut tobacco should be EUR 43 per kilogram, and the proportional minimum requirement should be 38 % of weighted average price. Applying the aforementioned relationship on the proposed excise duty increases for cigarettes from 1 January 2014, excise duty on fine-cut tobacco would be increased to EUR 60 and 42 %. Also with this proposal, the current optional use of either a proportional requirement or a minimum specific tax for fine-cut would be abolished, which would lead to a mandatory ad-valorem tax structure for this type tobacco product.

3.6 To adjust for inflation the minimum requirements for cigars, cigarillos and smoking tobacco. This is needed to take into account inflation for the period 2003 to 2007, which has been 8 % according to Eurostat data on the annual rate of change of the harmonised index of consumer prices. It is proposed to increase minimum requirement to EUR 12 for cigars and cigarillos and EUR 22 for other smoking tobacco.

3.7 To amend and toughen the definition for cigarettes, cigars and pipe-tobacco in order to avoid tobacco product name manipulations aiming for the lowest excise duty.

3.8 The Commission argues that from an internal market, budgetary as well as a health point of view, specific and minimum duties have clear advantages. Due to this, the Commission proposes to provide more flexibility to those Member States that place greater reliance on specific excise duties or on minimum duties.

3.9 European Commission regularly examines the structure and rates of excise duty in Member States and uses information on the quantities and prices of the tobacco products released for

consumption. In order to ensure an efficient and effective collection of this information from all Member States, new rules are proposed regarding the provision of information as well as the definition of the necessary statistical data.

4. Different approaches to the excise duties tax rate

4.1 Over the one and a half century since the first cigarette was introduced to the market in London in 1861, tobacco and tobacco products became a subject to extensive regulations and taxation. Introduction of excise duties was a milestone in this area. While the main objective of the first excise duties on tobacco was solely fiscal, their function is changing in the today's world, and they are becoming more and more a tool of public health and social policies.

4.2 This situation opens a lot of ethical, economic, and other questions. Among them, the issue of the most appropriate forms of taxation, especially in the context of the European single market, is the most common. The questions of how to use the proceeds from tobacco taxation, and whether the health and social objectives can be best achieved through the tax policy, arise.

4.3 Europe has gone through a more than 30 years long way of trying to harmonise tobacco excise duties. The goal of this process was to harmonise the structure of taxation, and then also the tax rates. While the EESC clearly supports harmonisation in this area, it is a regrettable fact that a real convergence has never really happened. National traditions, and long-lasting historical divergences in national tax systems are the main reasons of the persisting differences among particular Member States.

4.4 Three types of excise tax structures can be used today for tobacco and tobacco products – specific, ad valorem, and mixed. Currently, Member States are obliged to use the mixed structure on cigarettes, and are free to choose which of these three types of tobacco excise duties they use for other tobacco products.

4.4.1 The ad valorem tax rate is set as a percentage of the retail selling price of the particular tobacco product. For the fiscal reasons, in a situation when inflation is high, the ad valorem tax rate is the most efficient for the government, as the tax revenues automatically increase with every increase in the tobacco product's price. However, the ad valorem tax rate may also discourage producers from improving the products' quality if it means higher prices and thus also higher tax payments.

4.4.2 The specific tax rate is set as a fixed amount per kilogram or per piece (in case of cigars and cigarillos). The specific tax rate is the most efficient tool to decrease the consumption of tobacco products. However, it also has its drawbacks. Tobacco producers have no influence over the excise tax based on the specific rate; nor does the quality or the price of tobacco products affect the tax revenues of the government.

4.4.3 The mixed structure is a combination of the specific and the ad valorem tax rate. Member States are obliged to use such a tax rate in case of cigarettes. However, a minimum excise tax can be also set – its importance then increases with the increase of the ad valorem proportion of the total combined tax rate.

4.4.4 Apart from the excise duties, tobacco products in the EU are also taxed by the value added tax. According to the legislation, the basic VAT rate has to be applied to all tobacco products in all Member States.

4.5 All the related factors should be reflected when deciding over the structure of the tobacco excise duty. When choosing between the preference of one or other type of taxation, impacts from the view of consumer, government, and producers should be considered. There is nothing such as a one optimal tax structure for all, as the optimal combination of specific and ad valorem tax rate depends on the policy objectives of each particular country or government.

Table 1: Comparison of Specific and Ad Valorem Taxes on Tobacco Market Participants

Participant/Concern	Impact	Specific Tax	Ad Valorem Tax
Consumer: Quality and Variety	Provide an incentive for higher quality and greater variety of products	Yes (upgrading effect).	No.
	Effect of tax increase on price.	Higher prices (overshifting).	Lower prices (under-shifting).
Government: Revenue and Administration	Maintain revenue value under high inflation.	No (should be adjusted by CPI).	Yes.
	Minimise evasion/avoidance and realise expected revenues.	Manufacturer can manipulate cigarette length or pack size to reduce tax payment.	May need to set minimum price to counter abusive transfer pricing.
	Administration and Enforcement.	Easy.	Must define the base for ad valorem in a way that minimises the industry's ability to avoid taxes.
Domestic Producer: Profits and Marketshare	Protect domestic brands against international brands.	No.	Yes (the higher the price, the higher the absolute amount of tax paid per unit since tax is a percentage of price).

Source: The World Bank, www1.worldbank.org/tobacco/pdf/Taxes.pdf.

5. Different approaches to the excise duties tax base

5.1 In the effort to harmonise the tax policies of EU Member States, the so-called 'Most Popular Price Category' (MPPC) was chosen as a mechanism to calculate the minimum tax requirements for tobacco products.

5.2 However, the efficiency of the MPPC as a tool is questionable. The most common reservations to using the MPPC include:

- There are no consistent or harmonised rules for defining the MPPC, which leads to a large divergence among the Member States (see Picture 1 and Chart 1).

- Since the situation 30 years ago, when the MPPC was introduced, the market situation has change and the diversity of products has increased significantly.
- Dominant producers have the power to increase the tax burden of their competitors by changing the price of their products with the aim of changing the MPPC.
- The prices of MPPC can change year after year, which complicates the estimation of future excise tax revenues, etc.

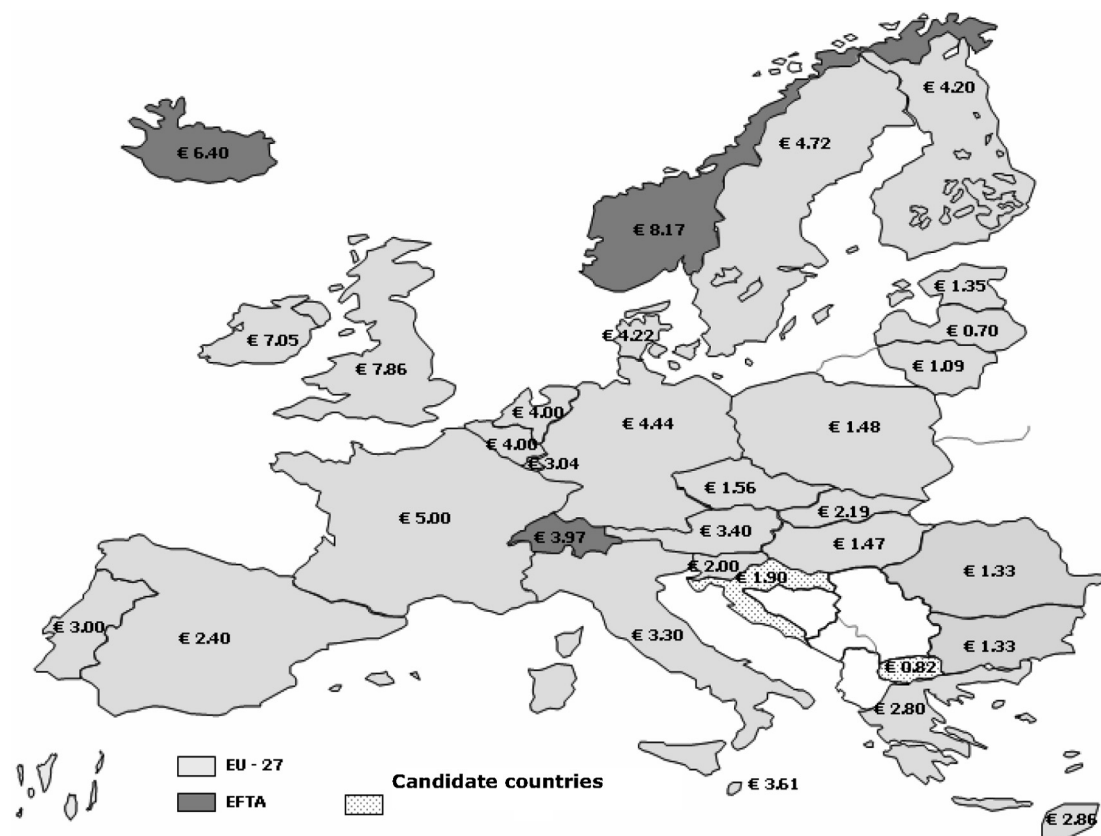
average price is calculated by dividing the product of the number and price of cigarettes sold by the total number of cigarettes sold. Thus, effect on the size of the excise duty may be twofold. If relatively expensive cigarettes are more popular in a certain country, then the minimum excise duty calculated using weighted average price as a benchmark would be smaller than excise duty calculated using MPPC. And vice versa: if relatively cheaper cigarettes are more popular, excise duty calculated based on weighted price average would be larger compared to the one calculated based on MPPC. If the most popular cigarettes are in the middle range price category, excise duty would be the same with either method.

5.3 For all the reasons described above, the European Commission proposes to replace MPPC with weighted price average (WAP) as the benchmark for proportional minimum requirement. Also as a result of this change, minimum excise duty rate requirement set out in the European Union directive will apply not only to MPPC cigarettes (as is currently provisioned), but to all the cigarettes sold in the country. Weighted

5.4 For the government tax planning, both the MPPC and WAP are quite complicated because they change from year to year and cannot be easily predicted. In the absence of a clear and uniform methodology for calculating WAP there is a risk that it becomes another complex non transparent measure. The question whether the Commission proposals could not be further simplified thus arises.

Picture 1

Different prices of the MPPC across Europe (as of January 1, 2008)



Source: <http://europa.eu> - Excise duty tables: Manufactured Tobacco

6. Possible impacts and policies to be considered

6.1 Health policy goals

6.1.1 After the meeting of its member countries in 2003, the World Health Organisation published the Framework Convention of Tobacco Control (FCTC) that describes potential ways of decreasing the consumption of tobacco products. The FCTC was formally adopted by the EU on 30 June 2005, and the European Commission included it to the legislation effective for all Member States.

6.1.2 The EU strategy of fighting tobacco consumption is described in the Commission's document 'Tobacco or Health in the European Union'. This document considers the tobacco excise duty to be the main tool of the fight against tobacco consumption. The document clearly says that the health policy objectives should be superior to the fiscal policy objectives in the case of tobacco excise duty. Among other measures, the Commission also proposes to exclude tobacco from the Index of Consumer Prices.

6.1.3 The European Commission proposes a gradual, but sharp, increase in tobacco excise duty rates, with an emphasis on harmonisation of the excise duty rates among Member States. In case of the fine cut tobacco, the sharp increase in its taxation is proposed, as the hand-rolled cigarettes are currently gaining a significant market share. The Commission underlines that Member States should put stress on the control of smuggling and other illegal activities connected to tobacco products.

6.1.4 The costs of tobacco production in the EU are estimated to some EUR 100 billion. Some 650 000 European

citizens are estimated to die every year as a consequence of tobacco consumption, and some 13 million are estimated to suffer chronic diseases connected to smoking.

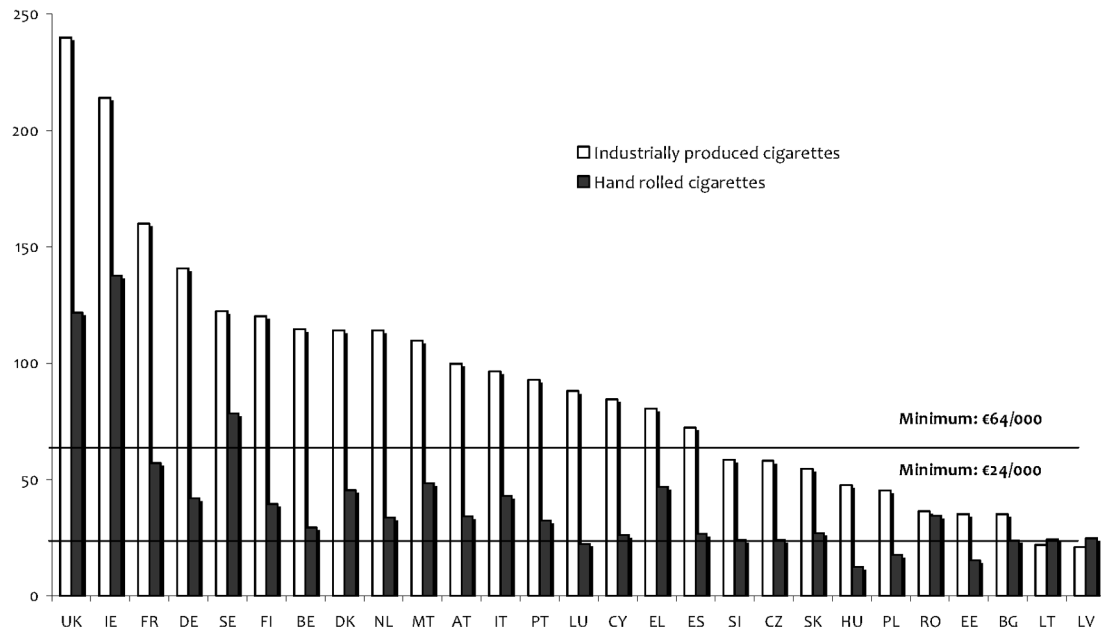
6.1.5 One other aspect should be pointed to in regard to tobacco taxation – the difference in taxation of cigarettes and smoking tobacco, which influences consumer behaviour to a large extent. WHO studies⁽¹⁾ dealing with this issue claim that until all tobacco products will not be taxed the same, smokers will substitute one form of tobacco products for another. Therefore, WHO recommends to tax all tobacco products – cigarettes, tobacco, cigars, and other product by equivalent tax rates.

6.1.6 In addition to increasing taxes, some countries have also introduced minimum prices for cigarettes, as tax increases alone did not always lead to the desired price increases to reduce tobacco consumption. Currently, four countries (Italy, Ireland, Austria and France; moreover, an optionality is offered by the Portuguese law) have introduced such price measures, and all four are being sued for this at the European Court of Justice by the Commission, which views such regulation as violating the freedom of prices guaranteed under EU Tax Directives and Treaty. Another common practice among the EU countries governments is the effort to regulate the number of cigarettes in one cigarette box. As of May 1, 2006, regulations on the minimum number of cigarettes in one box exists in 17 countries of the European Union. In most of them, such regulation was adopted over the course of the last five years. Hence, we observe that Member States are complementing their fiscal framework with price and minimum pack content measures as additional tools to strike the right balance between fiscal and public health policy objectives. This review offers a possibility to regulate such national measures now at EU level in order to drive EU harmonisation.

⁽¹⁾ World Health Organisation, Guidelines for Controlling and Monitoring The Tobacco Epidemic, 1998.

Chart 1:

Comparison of excise duty on cigarettes (min. EUR 64 per 1 000) and hand rolled cigarettes (fine cut, min. EUR 24 per 1 000 hand rolled cigarettes) as of 1 January 2007 ⁽¹⁾



Source: Excise Duty Tables – Part III – Manufactured Tobacco – TIRSP 2007 for fine cut as per the EU Commission Impact Assessment, accompanying document to the Proposal for a Council Directive – SEC(2008) 2266.

6.2 Social Policy goals

6.2.1 The European Commission estimates that a 25 % increase in cigarette tax is needed in order to decrease the consumption of cigarettes by 10 % in the 22 Member States, given the experience from the previous years. However, these effects could differ given the different levels of taxation among Member States; impacts in particular countries may be different, especially in the case of the new member countries.

6.2.2 Cigarette price rises due to higher excise duty would decrease consumers' purchasing power. This effect might be stronger in the poorer countries, especially in some of the new EU Member States. Compared to the older EU Member States, standard of living in some countries of Central and Eastern Europe is still low, people spend a larger part of their income on primary commodities. Although cigarette prices in those countries are much lower than in old EU Member States, when assessed at purchasing power, cigarettes as well as other products are not more affordable. Moreover, it is more common that in countries with lower standard of living a larger part of income is spent on alcohol and tobacco products. Thus higher

prices would have more effect on consumers in the EU newcomer countries compared to consumers in EU Member States with higher standard of living.

6.2.3 Cigarette demand is relatively inelastic. This means that an increase in cigarette prices does not cause a large drop in consumption. For this reason, once cigarette prices rise consumers may respond in two ways. Some may be forced to spend less money on other goods, so their purchasing power would decrease. Others would begin purchasing either lower price cigarettes and tobacco products (a situation called "down-grading") or purchase cigarettes from illegal trade channels.

6.2.4 According to a medical research, although smoking may generally decline as a result of higher cigarette prices, the income-related smoking disparities may not disappear. In fact, the research published in the American Journal of Public Health proves that the gaps in smoking participation among different income groups have widened with the increasing price of a pack of cigarette, when the proportion of lower-income persons smoking increased. The research concludes that increasing

⁽¹⁾ 1 piece of hand rolled cigarette = 0.75 g.

cigarette prices may impose a disproportionate burden on poor smokers ⁽¹⁾.

6.2.5 The proposed EUR 90 minimum excise duty for all retail prices constitutes an increase of 41 % in a period of 4 years and is at least 300 % higher than the expected consumer prices increase in the EU. Such a raising of the excise duty would increase inflation. A sharp increase in excise duty for cigarettes could raise cigarette prices, contributing to a rise in consumer price index. The exclusion of cigarette prices out of the Harmonised Index of Consumer Prices (as proposed in the "Tobacco or Health in the European Union" study) would eliminate this effect *de iure*, however, it could still have social impacts *de facto* as it would imply a wrongly calculated inflation index which could have a negative effect on wage adjustments.

6.3 Fiscal Policy Goals

6.3.1 Considering the revenues of the tobacco excise duty and the ways of how these revenues are spent, it is clear that in reality, the main goal of the excise duty is to raise funding for the general spending of national governments.

6.3.2 The linkage between tax and health policy is, to a large extent, conditioned by linking the tobacco excise tax revenues to activities aimed on elimination of the negative consequences of tobacco consumption. However, given the total funding of such activities today, it is quite clear that most of the tobacco excise duty revenues is being spent on activities and policies with no connection to such health policy goals.

6.3.3 It is thus quite clear that the fiscal goals are still the primary objectives of the excise duties on tobacco products. However, achieving the fiscal goals in this case is complicated by the existence of public health insurance. Would the health insurance schemes, and especially the health insurance premiums, reflect the risks connected to smoking, smokers would be forced to bear the costs of their habit. This would basically fulfil most of the anti-tobacco and anti-smoking strategies of international organisations and national governments.

6.3.4 It should be noted, when considering the fiscal aspects of tobacco taxation, that raising excise duty might, but does not

necessarily increase budget revenue. Due to a possible rise in smuggling and illegal trade, and also due to the possible popularity of cheaper cigarettes, it is possible that instead of increasing budget revenue, raising excise duty would have an opposite effect. Once excise duty taxation grows, followed by growth of the illegal market, a decrease in budget revenue due to the growing illegal market may actually be larger than the increase due to higher excise duty.

6.4 Security policy goals (illicit trade)

6.4.1 Tax collectors do always have to cope with tax avoidance. Two main illegal activities are linked to tobacco products: counterfeiting and smuggling.

6.4.2 From an economist's perspective, raising excise duty increases incentives for cigarette smuggling and for the illegal market. Smuggling is an economic activity to which laws of supply and demand apply. Raising excise duty increases the price difference between legal and smuggled cigarettes and as a result, demand for smuggled cigarettes rises. When their demand rises, the prices of smuggled cigarettes increase, making smuggling more profitable and leading to a rise in smuggling. This is true for the intra-EU illicit trade with cigarettes, as well as for the smuggling coming from other countries. Especially in the new Member States price and other factors are favourable to the expansion of smuggling from outside of the common market: prices in neighbouring countries to the East are becoming relatively cheaper, new Member States have few border patrol resources, and sometime the amount of shadow economic activities is considerable. For example, according to an opinion poll carried out in Lithuania in 2008 ⁽²⁾, as many as 38.9 % of surveyed people justify or tend to justify smuggling. Also, when investigating the conditions for the development of an illegal market it is important to consider the amount of shadow economy not only in the EU, but also in the potential sources of smuggling – the neighbouring states.

6.4.3 The above-mentioned situation could be described by the case of Lithuania. Seeking to harmonise the tax system with the EU, tobacco excise duty has been sharply increased between 2002 – 2004 in Lithuania (between 2001 and 2004, excise duty burden increased by 121 %). This has led to a sharp increase in cigarette prices. Raising excise duties reshaped the tobacco market. Sales of legal cigarettes decreased, while smuggling and the illegal market grew in size. The amount of smuggled products detained rose almost 13 times between 2001 and 2004. In 2004 market share of legal and illegal market (counting units sold) almost equalled.

⁽¹⁾ Franks et al.: Cigarette Prices, Smoking, and the Poor: Implications of Recent Trends, published in the American Journal of Public Health, October 2007, Vol. 97, No. 10.

⁽²⁾ http://www.freema.org/index.php/research/opinion_poll_public_perceptions_of_smuggling/4656.

6.4.4 When evaluating excise duty effectiveness it is crucial to consider changes in total consumption of cigarettes (that is both legal and illegal consumption). International experience shows that aggressive tax and subsequently price rises tend to decrease legal sales rather than change total consumption, and this effect is due to expansion of the illegal market. This is what happened in Lithuania as well: when excise duty was increased in 2002 – 2004, gross consumption decreased but this change was not as vivid as the decrease in legal cigarette sales.

6.4.5 The fact that the high price and tax differentials are indeed one of the main reasons behind the substantial amounts of smuggling, in particular of cigarettes, from certain neighbouring countries into the European Union, was admitted by the European Commissioner Laszlo Kovacs in the European Parliament in September 2008. It would thus be ill-advised to adopt decisions and increases of the EU minimum excise requirements that would further deepen this problem.

6.5 Internal Market Goals (Harmonisation)

6.5.1 In spite of the thirty years of harmonisation of the tobacco excise duty in the European Union, the differences in tobacco products taxation within the EU – given both the structure of tax and the total tax burden – still remain high.

6.5.2 While some countries chose the health policy as their first priority, traditions and social situation still cause deep divergence in the total tobacco taxation. The difference in excise tax yields across the EU is from EUR 242 per 1 000 cigarettes in the UK to EUR 19 per 1 000 cigarettes in Latvia (data as of 1 January 2007). This might actually be the main reason for the fact that the illicit trade within the European community (in terms of volume of cigarettes) is estimated to be double that smuggling coming from other countries.

6.5.3 It has to be noted that few of the proposed actions will lead to a closer harmonisation of tax rates within the European Union. It is very likely that, given the proposed actions, the absolute and relative differences in taxation among Member States will not disappear.

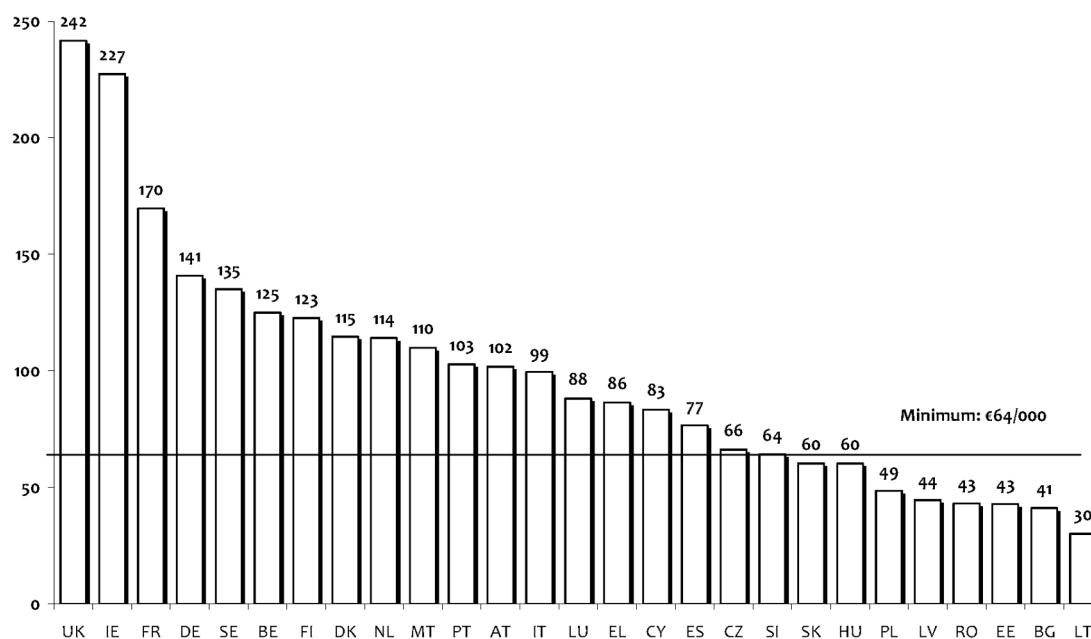
6.5.4 For example, the historic reason for proportional requirement is harmonisation of excise duty in EU, yet it has not led to any harmonisation in the past and may well bring the opposite results. For example, Slovenia and Italy have similar excise tax incidence on MPPC of about 58 %, but the excise tax yield on MPPC for Italy is 80 % higher than for Slovenia, EUR 102.38 to EUR 57.6 per 1 000 cigarettes. The proposed increasing of the excise tax incidence from 57 % to 63 % would lead to further divergence of excise duties in absolute terms and could have serious inflationary impacts, as is shown in the Commission Impact Assessment Report. Given these questionable effects of this proportional minimum requirement, not only its proposed increase, but the reasons for its very existence should be again seriously analyzed and re-considered.

6.5.5 Even the proposed increase of the minimum excise tax on cigarettes from EUR 64 to EUR 90 per 1 000 pieces would lead to harmonisation only if the higher-tax countries do not further raise taxes. From this point of view, it might be interesting to consider a maximum tax level to supplement the existing minimum tax rate.

6.5.6 In the view of the fact that several member states until now have not been able to adjust the minimum rate of EUR 64 per thousand of cigarettes even for the MPPC, the proposed increase to EUR 90 should be re-examined and for many reasons either reduced, or a longer period to comply with the increase should be provided, by January 1, 2018.

Chart 2:

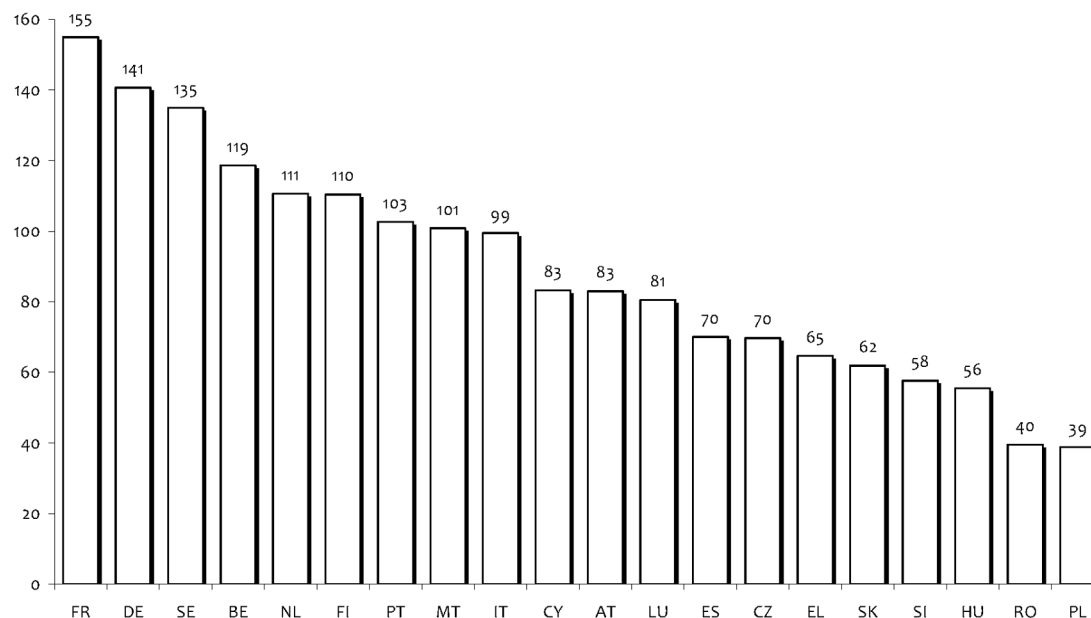
Excise tax yield in EU countries as of January 1, 2008 (EUR per 1 000 cigarettes)



Source: Excise Duty Tables – Part III – Manufactured Tobacco

Chart 3:

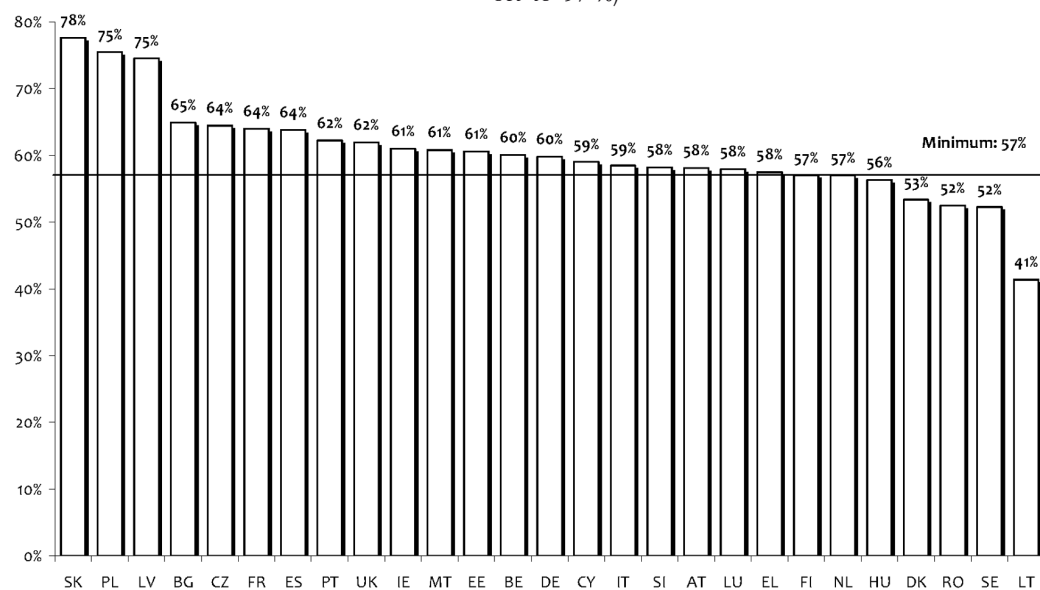
Minimum Excise Tax in EU countries as of January 1, 2008 (EUR per 1 000 cigarettes)



Source: Excise Duty Tables – Part III – Manufactured Tobacco

Chart 4:

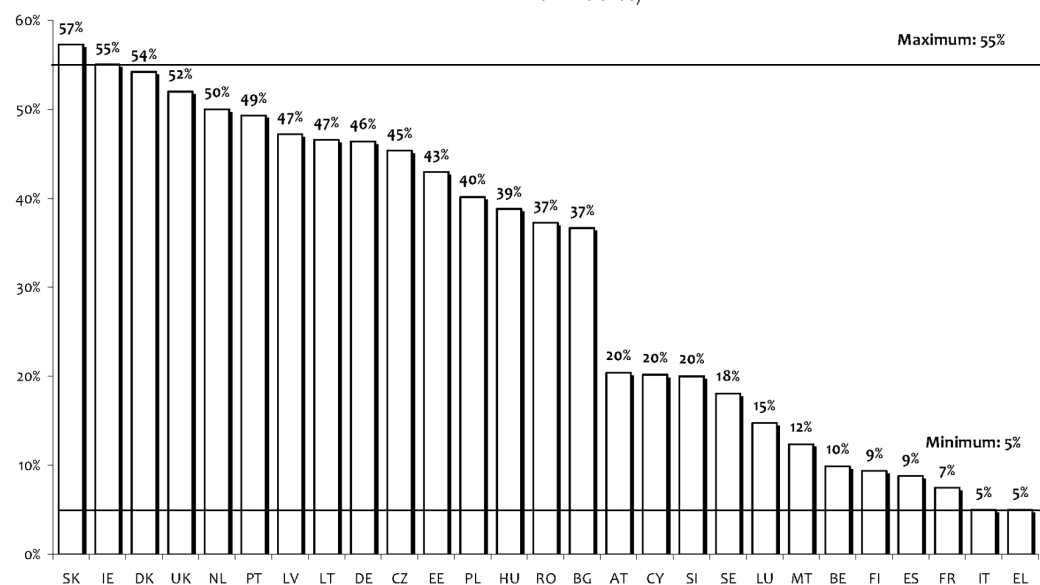
Total excise tax in EU countries as of January 1, 2008 (percentage of the MPPC, minimum set to 57 %)



Source: Excise Duty Tables – Part III – Manufactured Tobacco

Chart 5:

Specific ratio in EU countries as of January 1, 2008 (percentage specific to total tax on MPPC; set to 5 – 55 %)



Source: Excise Duty Tables – Part III – Manufactured Tobacco

Brussels, 25 March 2009.

The President
of the European Economic and Social Committee
Mario SEPI