

DG TAXUD Consultation paper on the structure and rates of excise duty applied on cigarettes and other manufactured tobacco

Part I - ESTA answers on questions regarding the taxation of other tobacco products

2.1 Should the structure of excise duties on fine-cut tobacco intended for the rolling of cigarettes be brought into line with the structure for cigarettes? If yes, in which way?

ESTA is strongly in favour of Member States continuing to have the freedom to apply their preferred excise structure (specific, ad-valorem or mixed) for fine-cut tobacco. The adoption of prescriptive structural rules on fine-cut tobacco would not lead to the harmonisation of levels of taxes between EU fine-cut markets, but only result in distortions within individual Member States' markets. Moreover, such an approach would not fit in the Commission's objective to come to a simplification of the current EU excise regime for tobacco products.

With regard to structure, it will also be of crucial importance to ESTA that for fine-cut tobacco the "or-clause" as laid down in the current EU legislation is maintained so as to preserve the right of Member States to apply the excise structure that they consider the most suitable for their markets¹.

2.2 How could the minimum rates for fine-cut tobacco be brought gradually into line with the rate for cigarettes, taking account of the specific characteristics of fine-cut tobacco?

In general, ESTA strongly feels that it would be inappropriate to bring the minimum rates for fine-cut tobacco into line with those of cigarettes since fine-cut tobacco has a lower tax bearing capacity than cigarettes, the EU fine-cut tobacco market has remained stable for many years and the internal market for fine-cut tobacco is generally functioning well. Moreover, in such a scenario, fine-cut tobacco would cease to perform a function as a buffer of a legal affordable product to cheap smuggled and increasingly counterfeit cigarettes.

In the Consultation document it is stated that '*...given the different characteristics of the two products, it seems reasonable that the minimum excise for fine-cut tobacco should be fixed at about two thirds of the minimum excise incidence for cigarettes*'. With regard to this statement, ESTA acknowledges the reference to the different product characteristics. ESTA is however of the position that the relationship between the EU minimum excise incidence for fine-cut tobacco and that of cigarettes should be fixed at a maximum of two thirds.

¹ The "or-clause" provides that for fine-cut tobacco, Member States can choose to either comply with the EU minimum excise incidence rate or with the EU minimum specific rate.

When making a comparison on the basis of excise ratios, ESTA strongly favours the use of comparisons based on excise incidence (excise expressed as percentage of the retail selling price - RSP) rather than on tax burden (excise expressed as amount of € per kg) as this makes the use of an arbitrary conversion factor irrelevant. Moreover, in the Consultation document DG TAXUD rightly points out that the setting of minimum rates on an incidence basis has as an advantage that it reflects the purchasing power in the Member States.

ESTA does not oppose an increase of the minimum excise incidence for fine-cut tobacco from 36% of the RSP to maximum 38% of the RSP since this figure represents two thirds of the current 57% minimum excise incidence for cigarettes.

Increasing the minimum incidence to 38% would have an effect on the fine-cut tobacco rates in Luxembourg (pure ad-valorem rate of 36%) and Bulgaria (mixed system, incidence of 36%). Romania, Slovenia and Cyprus would be affected if the minimum excise incidence would also apply to Member States with a specific system². However, ESTA considers it of crucial importance that Member States should remain to have the option to comply with either the minimum excise incidence rate **or** with the minimum specific rate (currently €32,- per kg).

If the Commission would propose to fix the two thirds relationship on the basis of the excise burden as well, it will be indispensable that a comparison is made on the basis that 1 kilogram of fine-cut tobacco equals 1000 fine-cut smoking articles³. Based on this conversion factor, the minimum specific rate on fine-cut tobacco would have to be increased to €43,- per kg, which is two thirds of the €64,- minimum rate that is currently applied for cigarettes. However, such an increase would in the frame of the current review process lead to -often considerable- excise increases in 10 of the 19 Member States with a specific- or mixed system, i.e. Belgium, Bulgaria, Cyprus, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovenia and the Slovak Republic.

Hungary, Luxembourg, Spain and Portugal, would face disproportionate rates increases if a minimum specific rate of €43,- would also be applied to Member States with an ad-valorem system⁴. Moreover, the introduction of the “and” clause instead of the current “or clause” would de-facto lead to a mandatory EU minimum excise or a switch to a mixed or specific system in all 8 Member States that currently apply an ad-valorem system. Therefore, as stated above, for ESTA it is essential that the “or clause” is maintained in order to preserve the freedom of structure for fine-cut tobacco as embedded in the acquis.

ESTA considers that a possible increase to €43,- (an increase of 34.4%) would have to be introduced on a gradual basis, spread out over the current- and next review and should only apply to Member States with a specific- or a mixed system. It is ESTA’s position that in the frame of the current review, the minimum specific part for fine-cut tobacco should not be raised above €36,- per kg, reflecting double inflation⁵.

² An overview of the hypothetical increase to 38% is attached as Annex I.

³ See ESTA specific comments (second part of this paper).

⁴ An overview of the hypothetical increase to €43,- is attached as Annex II.

⁵ Taking into account the figure of €34,- as mentioned in paragraph 7 of the Consultation document.

Such an increase would still result in rates increases in 8 of the 19 Member States that apply a specific- or mixed system, i.e. the Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Poland, Slovenia and Bulgaria⁶. Consequently, as recognized in the Consultation document, ESTA considers it indispensable that appropriate transitional periods are granted to these Member States as otherwise the position of fine-cut tobacco as an affordable duty-paid product would be seriously threatened on some of these markets. Furthermore, since for some of the new Member States the transitional periods to reach the current EU minimum rates do not expire until end 2009, ESTA considers that the effectuation of increases of the minimum rates before that time will be highly unfeasible⁷.

2.3 Should the minimum rates for tobacco products other than cigarettes be adjusted for inflation?

As pointed out above, ESTA considers an increase of the specific rate for fine-cut tobacco to €36,- -reflecting double inflation- acceptable if appropriate derogation periods are granted to Member States that would be confronted with national rates increases as a result of the increase of the EU minimum specific rate to €36,-

ESTA acknowledges that the specific minimum rate on pipe tobacco could be adjusted for inflation in order to maintain its real value. However, ESTA is strongly in favour of “freezing” the current minimum rates on pipe tobacco in order to help safeguarding the existence of this declining niche market⁸. In this respect, ESTA acknowledges that it will be important to agree on a definition for pipe tobacco that would as much as possible help in preventing misuse of pipe tobacco for the rolling or tubing of cigarettes.

2.4 How could the existing definitions of cigars and smoking tobacco be amended in order to avoid abuse?

ESTA fully supports the objective of the Commission to amend the current smoking tobacco definition in order to avoid the misuse of pipe tobacco for the rolling or tubing of cigarettes. Without pre-empting any future proposals that it will submit to DG TAXUD, ESTA considers that a differentiation between pipe tobaccos on the basis of the production process could be an important element in this regard. Furthermore, ESTA is considering additional parameters that could be of help in making a better distinction between fine-cut tobacco and pipe tobacco.

If the exploration of the above mentioned routes would not result in a solid proposal for a better definition, ESTA would -as suggested in the Consultation document- opt for strengthening the second paragraph of Article 6 of Directive 95/59/EEC which implies that, regardless of the cut width, pipe tobacco can be taxed as fine-cut if it is sold or intended to be sold for the purpose of rolling or tubing cigarettes.

⁶ An overview of the hypothetical increase to €36,- is attached as Annex III.

⁷ Estonia has been granted a transitional period until 31 December 2009 in order to achieve the application of the minimum excise duties on smoking tobacco.

⁸ An overview of EU pipe tobacco sales is attached as Annex IV.

2.5 How can the current provisions be improved in order to better achieve health objectives?

ESTA acknowledges that in the light of the wider Treaty objectives, the Commission has to take account of Article 152 (health protection) of the Treaty. ESTA however strongly feels that it is primarily the functioning of the internal market that the Commission has to take into account in its review of the acquis on tobacco excise, whilst taking as a basis -as pointed out in the introduction of the Consultation document- that excise duty is primarily an instrument for generating revenue at national level.

With regard to Article 152, ESTA stresses that the prime responsibility for health policy and the protection of the health of individual citizens still lies with the Member States. Based on this principle, individual Member States can apply higher taxation than the EU minimum rates, if they conclude that this is the right approach to achieve their health objectives.

ESTA would like to point out that experiences in a number of Member States have learned that an increase of fine-cut tobacco taxes relative to cigarettes does not result in lower consumption of tobacco products as a whole. Instead fine-cut tobacco consumers seem to turn to illegally imported -increasingly counterfeit- cigarettes that often do not comply with EU legislation on ingredients, constituents and labelling. Therefore, ESTA considers that an increase of fine-cut tobacco taxes relative to cigarette taxes would not address public health objectives and might even be counter productive from a public health point of view.

On a general note ESTA would like to make clear that the position of certain cigarette manufacturers that all tobacco products should be taxed equal since they would be equally harmful seems purely driven by the objective to increase their cigarettes market shares.

Part II - ESTA comments on the Consultation document⁹:

6. The structure of excise duties on other manufactured tobacco

6.1 Fine-cut tobacco

Characteristics

- ESTA generally agrees with the wording in paragraphs 1 and 6 on the characteristics of fine-cut tobacco, the industry and its consumers. In this regard, ESTA considers that the following should however also be taken into consideration:
 - There are many small- and medium sized companies, often family owned, that produce fine-cut tobacco. Many of these are located in economically less developed regions with high levels of unemployment.
 - Consumer research in the fine-cut tobacco core markets (Germany, the Netherlands, Belgium, France and the UK) over the years 2002 -2006 shows that approximately two-thirds of fine-cut tobacco consumers are male, that the age profile between fine-cut tobacco and factory made cigarettes is similar and that fine-cut tobacco is not particularly attractive to young adult smokers.

Market developments

- In paragraph 3 it is noted that ‘... *the quantities of fine-cut tobacco released increased from 2002 - 2004, by 20%*’. In the corresponding footnote 5, it is stated that ‘*even without these “sticks” there is a clear upward trend in fine-cut consumption*’.

ESTA does not contest the increase of fine-cut in the period 2002 - 2004 with 20% as this figure is very close to the figure of 19% that results from ESTA’s own figures. However, the sales of fine-cut tobacco over the years 2002 - 2004, without taking into account “sticks”, increased by less than 6%¹⁰. In order to get a more representative figure, ESTA considers it important to note that -according to its own figures- the EU fine-cut market in 2005 decreased slightly compared to 2004 and is almost identical to the market in 2002¹¹. In general it can be concluded that the fine-cut market has remained stable for many years¹². Therefore, ESTA feels that the statement in footnote 5 that ‘...*even without these “sticks” there is a clear upward trend in fine-cut consumption*’ does not reflect the actual development of the fine-cut market in the EU.

Finally ESTA stresses that market comparisons should take into account the fact that fine-cut tobacco represents only a relatively small share of 8% of the total EU duty-paid tobacco product market, while cigarettes account for approximately 90% of the of the EU duty-paid tobacco product market¹³.

⁹ Part II should be read in conjunction with the relevant parts of the Consultation document.

¹⁰ Pursuant to the ECJs judgment in Case-197/04 (10th November 2005) “sticks” cannot longer be taxed as fine-cut tobacco. The figures on the deducted “sticks” sales were verified by the German Ministry of Finance.

¹¹ The ESTA figures are generally based on official data. Data resulting from market research is used where no official data are available.

¹² An overview of EU fine-cut sales is attached as Annex V.

¹³ Ref. first paragraph of Chapter 6 of the Consultation document. The figure of 8% is in line with ESTA’s own calculations.

The conversion factor

- Paragraphs 8 and 9 pay attention to the conversion factor between fine-cut tobacco and cigarettes in order to come to a comparison of the minimum rates on the basis of the excise burden. In this regard, ESTA points out that the amount of tobacco used to prepare a fine-cut smoking article (rolled or tubed) differs widely between countries, within countries and even amongst individual consumers. Market research in the EU fine-cut core markets shows that the amount of tobacco used for rolling and tubing broadly ranges from approx. 400 mg to 1200 mg per fine-cut smoking article¹⁴.

It is essential to make a distinction between the weight of fine-cut tobacco that is purchased and which is actually used for consumption, since smokers of fine-cut do not consume all the tobacco. A substantial part of the fine-cut smoking article functions as a hand piece -that is generally also used as a filter- and is not smoked but discarded as butt. Moreover, some of the tobacco is left in the pouch or thrown away because it is impossible to roll a fine-cut smoking article with since the tobacco normally contains stems, crumbs, is too short or has dried out.

On the basis of the different product characteristics between semi-finished fine-cut tobacco and ready made cigarettes and in the absence of any meaningful average tobacco weight used for a fine-cut smoking article, the taxation of fine-cut tobacco is based on a per kilogram basis, while factory made cigarettes are based on a per stick basis.

If nonetheless a comparison should be made for tax purposes, Member States and the smoking tobacco industry generally apply a figure of 1000 fine-cut smoking articles per kilogram of fine-cut tobacco (1 gram per fine-cut smoking article). ESTA is therefore strongly opposed to the option of applying a weight of 0,75 gram per fine-cut smoking article as brought forward in the Consultation document that refers to ISO standard 15592-3 as a justification for the 0,75 gram. In this respect, ESTA stresses that ISO standard 15592-3 concerns the scientific method for measuring the tar and nicotine yields from fine-cut tobacco in burnt form. It has not been developed to serve as a basis for comparing taxation levels between fine-cut tobacco and cigarettes, and should thus not be used for that purpose.

When considering the issue from a cigarette point of view, ESTA considers that the statement in paragraph 7 that 1000 cigarettes weigh about 750 gram is biased since cigarettes across the EU exist in many different sizes, containing different amounts of tobacco. In this regard it is important to note that Article 4 of Directive 95/59/EEC indicates that tobacco rods up to 9 cm (excluding the filter) are taxed as one cigarette. Also from this perspective, ESTA considers it inappropriate to compare fine-cut smoking articles and cigarettes on the basis of any conversion factor less than the established 1 gram per fine-cut smoking article.

¹⁴* H.F. Dymond 'A survey of roll-your-own tobacco use and practise and considerations for the analysis of smoking articles made from it' – Tobacco Science 1996;

* H.F. Dymond 'Making habits of roll-your-own smokers in the Netherlands and tar and nicotine yields from the resultants products – Tobacco Science 1996;

* H.F. Dymond 'Physical dimensions and tar and nicotine yields of fine-cut smoking articles rolled by German consumers' – Beiträge zur Tabakforschung International, Vol.18 N°4 April 1999.

Minimum excise incidence

- ESTA points at an incorrect statement in paragraph 7 where a figure of 30% is mentioned as the minimum excise incidence for fine-cut. In the next sentence the document rightly puts the figure at 36%. It is stated that ‘A two thirds minimum would result in the minimum incidence for fine-cut tobacco rising from 36% to 40%’. ESTA assumes that that the 40% is based on a minimum excise incidence of 60% for cigarettes as mentioned in the consultation document (5.4.2) since two thirds of the current 57% for cigarettes would amount to a minimum excise incidence of 38% for fine-cut tobacco.

Excise incidence versus burden

- ESTA believes that the wording in the 2nd paragraph that ‘..there are situations in several member states today where the tax level on hand-rolled cigarettes is less than 30% of the tax level on cigarettes’ is not correct. The difference in tax levels in absolute terms (based on the excise burden) between fine-cut tobacco and cigarettes lies between 30,3% (only in Belgium) and 169,4% in Latvia. In Lithuania and Romania the taxation level in absolute terms is also higher for fine-cut tobacco than for cigarettes¹⁵. The average total excise burden of fine-cut tobacco in the EU 27 is €58,7 per kg, which is 58,3 % of the average total cigarette excise burden of €100,7 per kg¹⁶.

A comparison based on excise incidence shows that fine-cut tobacco is highly taxed, with an average total excise incidence in the EU 27 of 51,6% of the retail selling price, which represents 82,4% of the average total cigarette excise incidence of 62,6%. In 5 Member States (Poland, Greece, Latvia, Slovakia and Sweden), the excise incidence on fine-cut tobacco is higher than that for cigarettes¹⁷.

The functioning of the internal market

- ESTA considers that the statement in the 3rd paragraph that ‘The substantial differences in tax levels among Member States on fine-cut tobacco, combined with major differences in pre-tax prices, encourage smuggling between neighbouring countries and give rise to distortions in the internal market’ does not do justice to the actual internal market situation regarding fine-cut tobacco as the internal market for fine-cut tobacco is generally functioning well. Such problems as have occurred have been caused by the unilateral actions of a few individual Member States, rather than by a malfunctioning of the internal market as a whole. According to the best of our knowledge only 2 Member States (i.e. the UK and to a lesser extent France - that both apply excise rates on fine-cut tobacco that are generally much higher than those in neighbouring Member States) are being confronted with the inflow of considerable amounts of non-duty paid fine-cut tobacco. In this context ESTA stresses that anomalies within the internal market should be addressed by closer convergence of Member States’ rates within product groups and not between different products groups such as fine-cut tobacco and cigarettes.

¹⁵ These figures are based on a conversion factor of 1 gram per fine-cut smoking article (i.e. 1 kg of fine-cut tobacco equals 1000 fine-cut smoking articles).

¹⁶ An overview of the excise burden for fine-cut tobacco and for cigarettes in the EU 27 is attached as Annex VI.

¹⁷ An overview of the excise incidence for fine-cut tobacco and for cigarettes in the EU 27 is attached as Annex VII.

The wider Treaty objectives

- ESTA recognizes that in the light of the wider Treaty objectives, the Commission has to take account of Article 152 (health protection) of the Treaty. The same however applies for Article 127 (employment)¹⁸. In this regard, ESTA considers that a disproportionate increase of fine-cut taxes relative to those of cigarettes will have a negative impact on the competitiveness of the predominantly small and medium enterprises in the smoking tobacco industry and will thus have negative effects on employment¹⁹.

The buffer function

- The share of contraband and counterfeit cigarettes is growing significantly in new Member States as they are in the process of moving towards higher rates to meet the EU minimum requirements as well as in a number of EU 15 Member States that have faced considerable excise increases in recent years.

ESTA points at the fact that the availability of fine-cut tobacco as a legal alternative to cheap illegal cigarettes limits the emergence of a disorderly market and assists the authorities to fight criminal organizations and to protect their tax revenue.

The Hungarian market developments between 2000 and 2006 demonstrate that fine-cut tobacco (forming the major part of smoking tobacco sales) has a role as an alternative for cheap smuggled cigarettes: In the period 2002 - 2005, the black market for cigarettes increased, the legal market for cigarettes decreased, while the smoking tobacco market first increased and then remained stable. In 2006, the legal cigarette market recovered significantly, while the black market for cigarettes decreased by almost 38%. The smoking tobacco market grew slightly. There seems to be no market for smuggled smoking tobacco products²⁰.

The development of the German market also demonstrates the role that an affordable legal duty-paid product can have as a buffer to cheap smuggled cigarettes: As a result of significant excise increases for both cigarettes and fine-cut tobacco within a short period, consumers switched partly to “sticks” instead of non-German duty-paid cigarettes²¹. After the phasing out of the “sticks” from April 2006, the inflow of non-domestic duty-paid cigarettes is estimated to have increased in Germany from 16.9% (figures for January - March 2006) to 22.6% (figures for January - March 2007)²².

6.2.4. Smokeless tobacco products

Taxation

- Taking into account the negligible market share of nasal snuff- and chewing tobacco, ESTA is of the opinion that there is no need for the Commission to propose EU tax rules on nasal snuff and chewing tobacco.

¹⁸ Article 127 states that ‘The objective of a high level of employment shall be taken into consideration in the formulation and implementation of Community policies and activities’.

¹⁹ Based on a survey carried out in 2006 amongst the ESTA member companies, it is estimated that the smoking tobacco sector in the EU generates approximately 7500 full-time jobs (direct employment).

²⁰ An overview of the Hungarian tobacco market over the year 1998 – 2005 is given in Annex VIII. The legal sales are based on official data.

²¹ An overview of the German market developments is given in Annex IX.

²² These are German Cigarette Association (VdC) figures, based on pack collection studies.