EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
TAX POLICY
Excise duties and transport, environment and energy taxes

Consultation Paper on the structure and rates of excise duty applied on cigarettes and other manufactured tobacco.

Note

This paper is intended as a basis for open consultation of all parties interested in the excise treatment of cigarettes and other tobacco products.

The sole purpose of the consultation exercise is to generate feedback on excise problems in these areas and on options for changing the existing provisions in the Tobacco Excise Directives. Such input from stakeholders can assist the Commission in developing its thinking on the subject.

The contents of this document should not be seen as reflecting the views of the Commission of the European Communities.

Comments are invited on this paper by **1 June 2007** at the latest.

Submissions may be made in writing to
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Directorate-General Taxation and Customs Union
Unit Excise duties and transport, environment and energy taxes

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or by e-mail to taxud-excise-tobacco@ec.europa.eu

If for any reason you wish that your comments remain confidential, please make this clear. Otherwise we will assume that you have no objection to their eventual posting on our website.

Summary

The services of the European Commission have launched a consultation inviting views from, inter alia, businesses involved in the manufacturing and distribution of tobacco products, government administrations, health organisations, non governmental organisations and other organisations representing consumers and other stakeholders on the review and possible changes to the structure and rates of excise duty applied on cigarettes and other manufactured tobacco. The purpose of the consultation is to obtain feedback on excise problems in these areas and on options for changing the existing provisions in the Tobacco Excise Directives.

The main questions are as follows:

1) Cigarette taxation.

1.1 The Commission services question whether the MPPC is still in line with Internal Market objectives and justified as a reference point for setting the minimum requirements. The views of concerned parties are invited on the abolition of the MPPC and on whether EU minimum requirements should either apply to all cigarettes or should be defined in accordance with weighted average prices.

1.2 To what extent should Member States be allowed greater flexibility to determine the structure of the excise duties and to levy minimum excise duties on cigarettes?

1.3 Should the current monetary minimum incidence for cigarettes (€ 64/1000 cigarettes) be increased, given that it only came into force in July 2006 and 10 new Member States have been granted transition periods, some of them until the end of 2009? On the other hand, would an increase in the minimum ad valorem requirement of 57% be in line with internal market and health objectives?

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

2) 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 in to line with the structure for cigarettes? If yes, in which way?

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?

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

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

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

1. INTRODUCTION

1.1. Context

Pursuant to Article 4 of Council Directive 92/79/EEC and of 92/80/EEC the 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. 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. Given the characteristics of manufactured tobacco products, this document pays particular attention to health policy considerations, taking stock of Council Recommendation of 2 December 2002 on the prevention of smoking and on initiatives to improve tobacco control and of the Framework Convention on Tobacco Control, negotiated under the auspices of the World Health Organisation. In addition, priority should also be given to questions of simplification and transparency of the structure of excise duties on tobacco as well as the options to bring the structure of excise duties for fine-cut smoking tobacco into line with the structure of excise duties for cigarettes.

A broad pre-consultation process preceded this reflexion paper. The Commission services requested the taxation authorities of the Member States to give their views on a possible overall review of excise rates and structures for tobacco products on the basis of a questionnaire. The replies were used as a basis for subsequent bilateral discussions between the national administrations and the Commission departments concerned. Associations and other stakeholders (trade, health, etc.) were also invited to submit preliminary position papers and were given the opportunity to discuss the issues in bilateral meetings. Finally, in order to prepare this Consultation paper a study has been undertaken to assess the need to adapt the structure of excise duties[1].

1.2. Objective

This paper lists the main problems identified in the excise treatment of tobacco products, possible solutions, options for change to improve the current system, and health considerations. The views of stakeholders are being sought in order to provide the Commission with informed views on this subject and to help it take forward future work.

1.3. Consultation Target Group

This paper will be of interest to, *inter alia*, government administrations, businesses involved in the manufacturing and distribution of tobacco products, health organisations, non governmental organisations and other organisations representing consumers and other stakeholders.

[1] Study on the collection and interpretation of data concerning the release for consumption of cigarettes and fine-cut tobacco for the rolling of cigarettes; KPMG December 2005

2. BACKGROUND: THE COMMUNITY EXCISE DUTY ARRANGEMENTS

2.1. General remarks

The current arrangements were introduced on 1 January 1993. They are the outcome of discussions which started in 1985 with the White Paper on completing the internal market, in which the Commission proposed full harmonisation of excise duties on manufactured tobacco. However, the Council chose not to take this approach and harmonisation extended only to taxation structures and to minimum rates[2]. There are separate Community rules for cigarettes and for other manufactured tobacco.

2.2. Excise duty on cigarettes

Under current Community rules, excise duties levied on cigarettes must include a proportional component (calculated on the basis of the maximum retail selling price) and a specific component (levied on each unit of the product). These two components, taken together, must account for at least 57% of the retail selling price, inclusive of all taxes, of cigarettes belonging to the most popular price category (MPPC); this is referred to hereafter as the *"57% rule"*. However the 57% rule has not prevented the perpetuation of wide differences in rates and retail price levels. Since it became clear that application of a minimum percentage alone would not bring about greater approximation, an additional minimum of *€ 64 per 1000 cigarettes of the MPPC* (€ 60 until July 2006) was introduced by Directive 2002/10/EC.

In addition, the specific component of excise duty may not be less than 5% or more than 55% of the amount of the total tax burden resulting from the aggregation of the proportional excise duty, the specific excise duty and the VAT levied on the MPPC. Once these two components have been established based on the MPPC, they are applied to cigarettes of all price categories.

However, there are a number of *exceptions, derogations and transitional periods*:

- First, Member States which levy an excise duty of at least € 101 per 1000 cigarettes for cigarettes of the MPPC need not comply with the 57 % minimum incidence requirement. This escape clause is needed to ensure that the higher-taxing Member States do not have to constantly raise the excise duty to comply with the 57% rule (to date SE and DK).
- Second, under their Acts of Accession, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia were granted derogations to postpone the application of the minimum excise duties on certain tobacco products for periods up to between 31 December 2006 and 31 December 2009.
- Finally, France is authorised until 31 December 2009 to apply lower rates of excise duty to cigarettes released for consumption in Corsica and Portugal is

[2] Council Directive 95/59/EC of 27 November 1995 on taxes other than turnover taxes which affect the consumption of manufactured tobacco (OJ L 291, 6.12.95, p. 40), Council Directive 92/79/EEC of 19 October 1992 on the approximation of taxes on cigarettes (OJ L 316, 31.10.92, p. 8), both as last amended by Directive 2002/10/EC of 12 February 2002, and Council Directive 92/80/EEC of 19 October 1992 on the approximation of taxes on manufactured tobacco other than cigarettes (OJ L 316, 31.10.92, p. 10),),as last amended by Directive 2002/10/EC of 12 February 2002.

authorised to apply lower rates of excise duty to cigarettes made by small-scale manufacturers and released for consumption in the most remote regions, namely the Azores and Madeira.

2.3. Excise duty on manufactured tobacco other than cigarettes

The Community rules currently in force relate to cigars and cigarillos, fine-cut smoking tobacco intended for the rolling of cigarettes, and other smoking tobacco. Article 3 of Directive 92/80/EEC lays down minimum rates of excise duty for these products. Member States can levy a wholly proportional excise duty calculated on the basis of maximum retail selling prices, a wholly specific excise duty or a combination of both.

The *minimum rates* in force since 1 July 2004 are as follows:

- cigars and cigarillos: 5% of the retail selling price inclusive of all taxes or € 11 per 1000 items or per kilogram;
- fine-cut smoking tobacco intended for the rolling of cigarettes: 36% of the retail selling price inclusive of all taxes or € 32 per kilogram;
- other smoking tobacco: 20% of the retail selling price inclusive of all taxes or € 20 per kilogram.

Again, there are a number of *derogations and transitional periods*:

- First, under their Act of Accession the Czech Republic was granted a transitional period up to 31 December 2006 to postpone the application of the minimum excise duties on manufactured tobacco other than cigarettes, and Estonia a transitional period up to 31 December 2009 to postpone the application of the minimum excise duties on smoking tobacco.
- Second, the French Republic is authorised to apply lower rates of excise duty to tobacco products other than cigarettes released for consumption in Corsica until 31 December 2009.

2.4. Movement of manufactured tobacco in the Internal Market

Excisable goods move between Member States under duty-suspension arrangements. Businesses wishing to move goods under such arrangements must be authorised in the Member State where they are established and consignments must be accompanied by an administrative document. In accordance with the principles of the single market, private individuals enjoy greater freedom to purchase duty-paid goods for their own use in the Member State of their choice and to transport them to another Member State without having to pay duty again.

As part of the above-mentioned transitional periods contained in the Acts of Accession, Member States were given the possibility to maintain the same quantitative limits which may be brought into their territories from the new Member States in question, as those applied to imports from third countries. Eleven Member States make use of this possibility.

These restrictions do not apply to tobacco products brought in from Corsica or from the most remote regions of the Azores and Madeira.

3. WIDER OBJECTIVES OF THE TREATY

Pursuant to Article 4 of Council Directive 92/79/EEC the report by the Commission and the examination by the Council shall take into account the proper functioning of the internal market as well as the wider objectives of the Treaty. 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. It also provides that Community action shall be directed towards improving public health. Given the characteristics of manufactured tobacco products, particular attention has therefore to be paid to the health aspects and to the relationship between public health and the final price of the products.

Smoking is still the biggest single form of avoidable death in the Community and one of the leading causes of morbidity and mortality in the EU. Despite the considerable progress already made, the number of smokers is still high – around one third of the Community population – and the health effects are equally significant, with about 650,000 smoking-related deaths per year in the Community. Almost half of these deaths are of persons aged between 35 and 69 – well below the average life expectancy. Smoking also affects the health of non-smokers, particularly in vulnerable groups, who are increasingly demanding protection.

Taxation forms part of an overall strategy of prevention and dissuasion which also includes other reduction demand measures such as non-price measures, protection from exposure to tobacco smoke, regulation of the contents, etc. However, according to the World Bank price increases of tobacco products are the most effective single intervention to prevent smoking. A price increase of 10 % decreases consumption on average by about 4% in high income countries among adults. Importantly, the impact of higher prices is likely to be greatest on young people, who are more responsive to price rises than older people. In addition, price increases are an effective policy tool to prevent people from taking up smoking especially among youth, encourage smoking cessation, reduce the number of ex-smokers who resume the habit, and reduce in the long run the average cigarette consumption among continuing smokers.

At national level, in recent years many Member States are developing and implementing comprehensive strategies for tobacco control. A number of Member States has increased taxation of tobacco as a key measure in a comprehensive tobacco control strategy.

At Community level, the Council recommendation of 2 December 2002 on the prevention of smoking and on initiatives to improve tobacco control (2003/54/EC) recommends in Article 7 that Member States adopt and implement appropriate price measures on tobacco products so as to discourage tobacco consumption. Additionally, the Community has widely developed regulation on the manufacture, presentation and sale of tobacco products (directive 2001/37/EC) and to ban any tobacco cross-border advertising (directive 2003/33/EC). Regulatory measures are complemented with other initiatives such as prevention campaigns.

Recently those health policy considerations have become more important. In its Decision of 2 June 2004, the Council approved the World Health Organization's Framework Convention on Tobacco Control (FCTC). Article 6 of the FCTC stipulates that *"The Parties recognize that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons." "…each Party should adopt or maintain, as appropriate, measures which may include: implementing* *tax policies and, where appropriate, price policies, on tobacco products so as to contribute to the health objectives aimed at reducing tobacco consumption;…".*

Tax policies may reduce tobacco consumption either by increasing the overall level of taxation and consequently the retail selling prices, or by imposing minimum taxes or more specific duties in order to tackle cheaper categories of cigarettes. These particular areas are explored in detail in the following chapters.

4. THE STRUCTURE OF EXCISE DUTIES ON CIGARETTES

4.1. The MPPC as a benchmark for the minimum requirements

Member States' excise duties have to meet two requirements: the 57% rule and a minimum of € 64 per 1000 cigarettes of the MPPC, according to the data established at 1 January of each year in the Member State. If at 1 January of a certain year the category changes, Member States have to check continuing compliance with the 57 % and the € 64 excise incidence requirements. In other words, the MPPC is the basis upon which these minimum requirements are determined.

During the consultation process, the MPPC received an amount of criticism:

- The MPPC fluctuates due to changes in tax components, price structure, external components, etc. Consequently, government tax revenues are volatile as changes in the MPPC can trigger tax rate changes. As the MPPC is outside the control of governments, it makes tax planning difficult.
- The link between the excise duty rates and the MPPC also distorts price competition between tobacco manufacturers. Dominant tobacco manufacturers can increase the tax burden of their competitors by strategically shifting the prices of their brands so as to create a different MPPC.
- The MPPC concept was introduced 30 years ago. At that time, the national cigarette markets were typically dominated by one brand that was clearly 'most popular'. However, currently the average market share of the MPPC is circa 35%. In addition, the current international market environment is very dynamic, with many different brands at different price points. Price changes are a regular feature.
- In certain Member States the MPPC falls within a low price category while in other Member States it falls within a high price category. Consequently, the MPPC cannot ensure a uniform minimum level in all Member States.
- The Excise directive provides no rules for calculating the MPPC. This leads to Member States calculating the MPPC in different ways, which makes the current rules even more complex and unclear.

Consequently, the Commission services question whether the MPPC is still in line with Internal Market objectives as it entails a partition of the tobacco markets of the Member States and whether it is still justified as a reference point for setting the minimum requirements. In addition, abolishing the MPPC would significantly simplify the arrangements and provide greater transparency. . As an alternative , EU minimum requirements could either apply to all cigarettes (see below 4.2) or the EU minimum duties could be defined in accordance with weighted average prices(see below 4.3).

The views of concerned parties are invited on the abolition of the MPPC.

4.2. EU minimum requirements on all cigarettes

Applying EU minimum duties on all cigarettes would have as a consequence that the excise duties on all brands would have to meet two requirements: the 57% rule and the minimum of € 64 per 1000 cigarettes.

4.2.1. The minimum duty of € 64 per 1000 cigarettes

If the current minimum incidence of € 64 were maintained, the impact on market prices would be minor. Today, in the majority of Member States the excise duties on all brands already exceed € 64 per 1000 cigarettes. In the other Member States where this is not the case increases of excise duties for brands which are cheaper than the MPPC would be required but only to the extent that there is no minimum excise tax in force equal to the tax due on the MPPC.

4.2.2. The 57% minimum requirement

The 57% rule has some advantages. Given that pre-tax-prices are mainly related to the purchasing power in the Member States, it ensures a minimum tax incidence in function of the purchasing power in all Member States. During the consultation process most Member States appeared to be in favour of the 57% incidence rule for cigarettes. However, other Member States were concerned that this requirement could widen tax differences within the EU if high-excise Member States have to raise their taxes further to reach the 57% incidence. Consequently, since one of the aims is to bring about greater approximation of the excise burden on cigarettes, an escape clause is needed to ensure that the higher-taxing Member States do not have to constantly raise excise duty to comply with the 57% rule. Therefore, the exception in Article 2(2) of Directive 92/79/EEC could be maintained (but without reference to MPPC), namely:

"Member States which levy an overall minimum excise duty of at least EUR 101 per 1000 cigarettes for cigarettes … need not comply with the 57 % minimum incidence requirement."

If the current minimum incidence of 57% were maintained, the impact on market prices would be minor. The most affected Member States currently qualify for the exception foreseen in Article 2(2) of Directive 92/79/EEC. Other Member States that would need to make minor changes could be granted a transition period.

Nevertheless, there are arguments for abolishing the 57 % rule. For example, if it is retained it would effectively be transforming an EU tax level requirement into a national requirement introducing a de-facto minimum ad valorem rate..

Applying the above-mentioned EU minimum duties of 57 % and € 64 on all cigarettes would simplify the existing situation, make it more transparent, establish a tax "floor" for all cigarettes sold in the EU and promote long term approximation. Apart from resolving the fiscal instability that is created by the MPPC concept, it would provide a fair and neutral competitive environment for tobacco manufacturers and would allow for the setting of minimum duties at a level that are effective in addressing health concerns for all categories of cigarettes. (Annex F contains a simulation of the impact of this option on the level of taxation in the Member States)

The views of concerned parties are invited on the analysis above.

4.3. EU minimum duties on weighted average prices

An alternative is to set EU minimum duties on weighted average prices. The average weighted price could be calculated on the basis of historical data or on the basis of the prices in force on 1 January (as is currently the case for calculation of the MPPC). Subsequently the adjusted excise rates would apply to all categories of cigarettes. It should be noted that in most cases the MPPC and the weighted average TIRSP (Tax Inclusive Retail Selling Price) fall within the same price range. However, substantial differences occasionally exist.

If the average excise yield were set at € 64 for all price categories, the impact would be very minor. Only a few countries would be affected slightly. So far as applying the 57% rule on weighted average prices, only 2 Member States would be affected. (Denmark and Sweden who are prima facie affected would benefit from the exception in Article 2(2) of Directive 92/79/EEC as their average excise yields are € 106 and € 102 respectively.) However, the situation would be different if the 57% would be increased to 60%, in order to achieve health objectives as suggested above.

Weighted average prices would have the advantage of providing a comparable benchmark for minimum requirements as well as a level playing field for manufacturers. However, the disadvantage of weighted average prices is that they are more complex and less stable as applying simple minimum requirements for all cigarettes. (Annex G contains a simulation of the impact of this option on the level of taxation in the Member States)

The views of interested parties are therefore invited.

4.4. Minimum incidence including VAT

At present, a minimum excise duty of 57% and € 64 has to be charged on the cigarettes of the MPPC. The amount obtained by applying the 57% and the minimum requirement of € 64 do not include VAT. An alternative would be to include in the minimum VAT and excise. As stated in the previous Commission report[3], such an approach has its limitations and would not solve all the problems. On the one hand, the introduction of a VAT inclusive ad valorem tax incidence would have some peculiar effects. It would oblige some Member States which already have high rates of taxation to increase their excise duties still further, while other Member States with low excise duties could keep their taxation level unchanged. On the other hand the introduction of a VAT inclusive specific tax incidence would oblige those Member States with low pre-tax prices and relatively high excise duties to increase their excise duties still further, while other Member States with high pre-tax prices and relatively low excise duties could keep their taxation level unchanged. The Commission services are therefore not convinced that including VAT in the minimum incidence would enhance tax approximation within the EU.

The views of concerned parties are invited on the analysis above.

[3] COM (2001) 133-1 final of 14 March 2001

4.5. The maximum level of the specific element of the excise duty and specific versus ad valorem duties

At present, the specific component of the excise duty may not be less than 5% or more than 55% of the amount of the total tax burden resulting from the aggregation of the proportional excise duty, the specific excise duty and the turnover tax levied on these cigarettes. This ratio was laid down by Directive EEC/72/464 and sought to reduce the diversity of tax structures. Recently a number of Member States have requested more flexibility to determine freely the relative importance of both excise elements, taking into account the characteristics of their national market for cigarettes.

The choice between ad valorem and specific duties depends on the policy objective pursued. Ad valorem duties increase absolute price differences and consequently promote cheaper brands of cigarettes. Specific duties reduce the relative price differences and consequently promote the premium brands. Historically, the tobacco producing Member States favoured ad valorem duties in order the give a tax advantage to the cheaper national brands as compared to international premium brands. However, to date, most European markets are dominated almost exclusively by international brands.

From a health point of view cheaper and more expensive cigarettes are considered to be equally harmful Ad valorem duties do lead to greater price diversity and thus greater availability of relatively cheap cigarettes, which can undermine price policy objectives. While the specific component contributes to minimise the variability of pre-tax prices, the ad-valorem component maintains those differences. Ad-valorem would favour the partitioning of markets by the manufacturers in order to offer different products addressed to specific targets, as for example young people. As a consequence, smokers can change to cheaper brands when taxes are increased. Without a high specific component, manufacturers can continue to market cheap cigarettes just by producing low cost products. A strong Public Health oriented taxation policy would favour a high specific component to avoid cheap cigarettes entering or remaining in the market, which could be the most attractive to young people.

Specific duties do have a number of other advantages. A scenario that sets all duties to specific duties would entail a narrowing of price differences at EU level by 50%. Consequently, greater reliance on specific duties can lead to further approximation of retail selling prices. Furthermore, as they are based on consumption volumes rather than on prices, they are more stable, easier to forecast and increase the stability of tax revenues. Finally, specific duties on quantities are easier to administer than ad valorem duties, since the latter demands the monitoring of retail prices.

In conclusion, from an internal market, budgetary as well as a health point of view, specific duties have clear advantages and more flexibility could be provided to those Member States that place greater reliance on specific excise duties. Given that EU minima are set by way of overall minimum requirements the question could be raised whether the 55% restriction should not be abolished and Member States should be given the freedom to levy either an ad valorem or a specific duty or a combination of both as long as they respect the EU minimum requirements? From a health perspective a sufficient specific duty could be guaranteed either by means of minimum excise duties or by means of an increase of the 5% minimum rule.

The views of concerned parties are invited on the analysis above.

4.6. Minimum excise duties on discount and low price cigarette brands

The market share of cheap cigarettes soared in a majority of Member States during the period 2002-2004 resulting in reduced revenue receipts and/or mitigating the downward effect of tax increases on the consumption of cigarettes. They have also undermined Member States' health policy objectives. Tobacco control measures, such as the EU comprehensive ban on tobacco advertising, have led tobacco manufacturers to use price competition as a way to differentiate their products. Diversifying and introducing cheap cigarettes is just one of those marketing strategies. Some Member States reported that they would welcome greater flexibility in tackling cheap cigarettes and, in particular, coping with price wars between the manufacturers.

At present, Article 16(5) of Directive 95/59/EC allows Member States to levy a minimum excise duty on cigarettes provided that this does not have the effect of raising the total excise duty to more than 100% of the total excise on the most popular price category. This means that each packet of cigarettes offered for sale to consumers must bear at least a certain minimum amount of excise duty. This provision is intended to provide Member States with a certain level of revenue and ensure that cigarettes are not sold at prices far below normal market levels. To date, 18 Member States apply a minimum excise tax. The current EU requirements limit the minimum excise tax to 100% of the excise duty on the MPPC. This means that in countries where the MPPC is based on low priced cigarettes, the tool of minimum excise duty has limitations. In this situation health objectives can mainly be achieved by a general increase of the excise duties. . Consequently greater flexibility could be provided in the current EU requirements in order to enable Member States to better address simultaneously budgetary and health objectives, e.g. by allowing the setting of minimum taxes at any level deemed appropriate or by defining minimum taxes in accordance with weighted average prices.

Recently, some Member States have introduced minimum prices on grounds of health protection. In line with the jurisprudence of the ECJ, the Commission services take the view that minimum prices are disproportionate since the health objectives may be adequately attained by increased taxation or a change of the taxation structure, which would safeguard the principle of free formation of prices.

The Commission services are inviting the views of interested parties on what measures need to be considered.

5. MINIMUM RATES OF EXCISE DUTIES ON CIGARETTES.

5.1. General remarks

An analysis of the prices and excise rates for cigarettes in the EU shows that there are still considerable differences between the Member States. In 1992, the EU introduced a minimum excise incidence of 57% of the retail selling price of the MPPC. In 2002, it introduced an additional minimum excise tax level of € 64 per 1000 cigarettes of the MPPC. Despite all these efforts, the harmonization of tobacco excise rates is today no closer. Indeed, with the recent enlargement of the EU, the tax and retail selling price differentials between Member States has actually widened. For example, cigarettes belonging to the MPPC are nearly seven times as expensive (all taxes included) in the United Kingdom as in Latvia.

5.2. The reasons for TIRSP differentials.

The retail selling price differentials are due to differences in wholesale prices and retail margins, the excise duty rates, the structure of the excise duties and in VAT rates on tobacco products.

5.2.1. Differences in wholesale prices and retail margins

Average pre-tax prices between Member States range from € 15 to € 75 per 1000 cigarettes – a fivefold difference. The differences in pre-tax prices are mainly a result of differences in wholesale profit margins and retail margins. Several approaches have been chosen to assess the relationship between the pre-tax prices and the excise duty structures and rates. There seems to be no direct relationship between the specific or ad-valorem component and the pre-tax price. On the other hand, it is clear that the pre-tax price of cigarettes is to a large extent related to the purchasing power in the respective Member States.

5.2.2. Differences in the excise duty rates

The minimum excise incidence of 57% of the MPPC has sustained the existing price differences between Member States. The application of a minimum incidence of 57% on pre-tax prices (which, as stated, already vary between Member States in differences of up to fivefold) results in differences in tax inclusive prices between Member States varying up to sevenfold. In addition, the minimum duty of € 64 per 1000 cigarettes is insufficient to approximate retail selling prices between high and low taxing Member States. However, when all the new Member States comply with the minimum duty of € 64 per 1000 cigarettes, the tax exclusive prices between Member States will probably reduce to a fourfold difference.

The great variability in the excise duty rates among different Member States also partly reflects the existing differences in national tobacco control policies. While some Member States are committed to tobacco taxation policies to increase significantly prices to promote healthy behaviour, others are either in the process of doing so or are reluctant to do so.

5.2.3. Differences in the structure of the excise duties

The mere fact that there is no fixed relationship between the specific and the ad valorem elements results in retail selling price differences between Member States, regardless of differences in rates or in wholesale prices. The more ad valorem duties are applied the more the differences in pre-tax prices and excise rates are magnified.

5.2.4. Differences in the VAT on tobacco products

Since excise duties are included in the VAT base, excise rates and VAT interact with each other. The differences in VAT rates across the EU range from between 15% and 25% which compounds further the differences in tax inclusive retail selling prices (TIRSP).

Consequently, differentials in pre-tax prices and in excise duties are the primary reason for the differentials in tax inclusive prices of cigarettes between Member States. In addition, these differentials are compounded by differences in VAT rates and in the structure of the excise duties.

5.3. Impact of differences in TIRSP for Member States and the internal market

The significant differences in TIRSP between Member States has created an environment for purely tax induced cross-border shopping and for smuggling and fraud. Indeed, the tobacco sector is particularly susceptible to these activities, especially smuggling and fraud. Based on an in-depth analysis of the data collected, the Commission study[4] estimated that total market penetration in 2004 represented approximately 13% of the EU-25 tobacco market whereby 4% to 5% consists of legitimate cross-border shopping and 8% to 9% of illicit trade.

5.3.1. Cross border shopping

Cross-border shopping is entirely legitimate and, indeed, one of the benefits of the internal market provided the products are purchased by individuals for their own personal use. However, this can cause a problem for higher taxing Member States who see erosion of their revenues, and undermining of their health policies. Cross-border shopping for cigarettes increased sharply (over 10 %) in certain Member States as a result of large increases in their excise duty rates mainly driven by health objectives.

In addition, under their Acts of Accession most new Member States were granted derogations to postpone the application of the minimum excise duties. As part of these derogations, the EU-15 Member States were given the possibility to maintain limits on the quantity of tobacco products that individuals could bring into their territories from these new Member States. However, notwithstanding these restrictions, there is a clear in-flow of cheap cigarettes from certain new Member States into, particularly, neighbouring EU-15 Member States.

5.3.2. Cross-border smuggling

The significant differences in TIRSP not only provoke cross-border shopping but partly also fraud within the Community. Cross-border smuggling is where individuals purchase tobacco in other Member States ostensibly for their use but instead sell it without paying excise duty in the Member State of consumption. In addition, abuse of the distance selling arrangements via the internet has also emerged where duty should be paid in the Member State of destination (consumption) but is not.

Avenues to explore

Almost all Member States' taxation authorities in their replies to the questionnaire stated that closer approximation of rates would at least contribute to a reduction in cross-border shopping and partly also to a reduction of fraud within the Community. However, several Member States expressed the view that the question of approximation cannot be addressed without taking into account aspects such as the pre-tax-prices set by the manufacturers and the price level of tobacco products in neighbouring third countries.

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4 Study on the collection and interpretation of data concerning the release for consumption of cigarettes and fine-cut tobacco for the rolling of cigarettes; KPMG December 2005

5.4. Closer approximation of rates

The Commission services are of the opinion that more convergence between the taxation levels of the different Member States, aimed at restricting fraud and smuggling and to ensure health protection objectives, should be reached. However, any proposal for further approximation must take into account that several Member States still have transitional periods for the current minimum rates, some of them up to 31 December 2009.

5.4.1. The minimum duty of € 64 per 1000 cigarettes

The current EU minimum duty of € 64 per 1000 cigarettes is insufficient to achieve approximation of retail selling prices between high and low taxing Member States. For example, in FR the excise duty per 1000 cigarettes has been increased for reasons of health protection to € 160. However, in neighbouring countries such as ES, IT and LUX the excise duty is € 72, € 82 and € 90 respectively. Consequently, the attraction for individuals in high taxing countries to make their purchases in lower taxing countries undermines health protection objectives. Therefore, to counter this threat, EU minimum rates would need to be increased substantially. However, this would pose a problem given that 10 Member States still have derogations to the current minima. Consequently, any further increase in the minimum requirement of € 64 at this time will probably entail additional transitional periods. Only from 2010 onwards, when all derogations expire, could an increase be considered. However, even an increase to € 90 would make cigarettes extremely expensive in terms of purchasing power in certain new Member States, while it would be insufficient to achieve health objectives in other Member States. On the other hand, at a certain point, the minimum requirement of € 64 per 1000 cigarettes will have to be adjusted for inflation. However, this minimum incidence only came into force in July 2006 and therefore an adjustment for inflation appears to be at this point premature.

5.4.2. The 57% minimum requirement

The 57% minimum requirement has not been modified since it was introduced in 1992. However, to date in countries with a health driven taxation policy excise duties account for more than 60% of the TIRSP. When all new Member States comply with the minimum of € 64, the excise yield will probably also be more than 60% in most of those Member States. Since the pre-tax price of cigarettes is to a large extent related to the purchasing power, an increase of the minimum requirement to e.g. 60% would align the level of taxation to a large extent with the purchasing power. Combined with the escape clause for high-taxing Member States, this would in practice entail an increase in the excise duties in a limited number of Member States where prices of cigarettes are relatively low as compared to the purchasing power -. It should be noted that this 60% requirement could be applied to all cigarettes or as a weighted average. An increase of the 57% requirement fits best with internal market objectives. It would lead to further approximation and ensure a sufficient price level of tobacco products in all Member States in function of the purchasing power and consequently also serve health objectives. It has the advantage that it would not entail an increase in the excise duties in those Member States where cigarettes are already expensive in terms of purchasing power (inter alia most of the new Member States) or where taxes are already high. In order to avoid a distortion of the markets the minimum rates could be increased by stages.

The views of concerned parties are invited on the analysis above.

5.5. The pre-tax price differentials

As mentioned, average pre-tax prices between Member States range from € 15 to € 75 per 1000 cigarettes – a fivefold difference. For certain international brands, threefold pre tax price differences have been noted for the same quantity of the same brand in different Member States. The current tobacco legislation facilitates partitioning of markets (price fixing) by tobacco manufactures, for the following reasons. The ad valorem excise duties are calculated on the basis of maximum retail selling prices determined by the manufacturers who therefore are able to fix the price in function of the national market. Parallel imports are extremely cumbersome because of the requirement for health warnings in the national language as well as, in a number of Member States, for tax stamps, which will impose repackaging. In addition, the excise holding and movement system does not facilitate such parallel trade.

The Commission services are inviting the views of interested parties on these issues.

5.6. Illicit trade

Illicit trade covers Intra-EU and third country smuggling as well as counterfeit. Third country smuggling is simple circumvention of customs controls by fraudsters who smuggle products by various methods (concealment, false description and false declaration etc) from third countries where prices and taxes are low. Another upward trend concerns counterfeit cigarettes mainly, but not exclusively, produced in the Far East and Middle East. An estimate of counterfeit is difficult to make but it is certain that the market share of counterfeit cigarettes is rising in some countries. Apart from the loss of revenue and the health threat, all these illegal activities also impact on the legitimate trade and are often undertaken by organised criminal gangs which raises additional societal concerns.

The significant differences in TIRSP contribute to the problem of fraud. However, there are also other reasons for smuggling and counterfeit, namely weaknesses and loopholes in control arrangements and the low level of prices in neighbouring third countries. Therefore measures to approximate the TRISP differentials should be combined with a reinforcement of the fight against illicit trade.

6. THE STRUCTURE OF EXCISE DUTIES ON OTHER MANUFACTURED TOBACCO

Other manufactured tobacco covers cigars, cigarillos, hand-rolling tobacco and other smoking tobacco. The market for fine-cut tobacco intended for the rolling of cigarettes accounts for around 8% of the total EU market for tobacco products. The market for other smoking tobacco and cigars is less than 1%.

6.1. Fine-cut tobacco

Fine-cut tobacco and cigarettes have different characteristics; nevertheless they are competing in a way. Fine-cut tobacco is a semi-finished product and smokers of fine-cut tobacco are predominantly in lower income socio groups than cigarettes smokers. In addition, manufacturing fine-cut tobacco is a relatively labour-intensive process as compared to cigarettes.

Currently Member States are free to determine the excise structure for fine-cut smoking tobacco intended for the rolling of cigarettes (specific or ad valorem or mixed). The EU minimum requirement for fine-cut tobacco is set at 36% of the retail selling price inclusive of all taxes, or € 32 per kilogram. As a result, 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.

The substantial differences in tax levels among Member States on fine-cut tobacco, combined with major differences in pre-tax prices, encourage smuggling and cross border shopping between neighbouring countries and gives rise to distortions in the internal market. In addition, the gap between the level of taxation of cigarettes and fine-cut tobacco gives rise to substitution. In the period 2002 to 2004 the weighted average of quantities of cigarettes released in the EU-25 decreased by 10%. However, the quantities of fine-cut tobacco released increased from 2002 to 2004, by 20%[5]. From a health point of view, both products are harmful and, consequently, there is little justification for significant differences in the minimum rates for these products at Community level.

Since the current Directives maintain the difference in excise duties on cigarettes and on fine-cut tobacco, the Commission, upon request of a number of Member States, made the following statement to the Council minutes on Directive 2002/10/EC: "*The Commission states that, in its next review report provided for under Article 4 of Directive 92/79/EEC and Directive 92/80/EEC, it will present sufficient elements in order to proceed to an overall review of the possibility to bring the structure of excise duties for fine-cut smoking tobacco into line with the structure of excise duties for cigarettes.*"

However, given that EU minima for cigarettes are set by way of overall minimum requirements, this consultation paper questions whether the mixed structure for cigarettes should not be abolished and Member States could be given the freedom to levy either an ad valorem or a specific duty or a combination of both as long as they respect the EU minimum requirements. In this case the alignment of taxation on cigarettes and fine-cut tobacco could proceed on the basis of minimum rates, leaving Member States with the flexibility to determine the structure of the taxes.

As stated in the previous report, given the different characteristics of the two products, it seems reasonable that the minimum excise for fine-cut tobacco could be fixed at about two thirds of the minimum excise incidence for cigarettes**.** Such a ratio would allow Member States to take into account the difference between a semi-finished and a finished product, the purchasing power of different groups of smokers, differences in cost price between the two products and the relatively labour-intensive process of manufacturing fine-cut tobacco. However, from a purely public health perspective, one can argue that both products are equally harmful and should be equally taxed.

To enable a comparison of tax levels on fine-cut tobacco used for the hand-rolling of cigarettes and manufactured cigarettes, it is necessary to establish the weight of tobacco used to prepare hand-rolled cigarettes. The ISO norm on measuring tar and nicotine in hand-rolled cigarettes (ISO norm 15592-3) refers to 0.4 and 0.75 gram of tobacco per hand-rolled cigarette. In order to obtain at least two thirds of the € 64 minimum on 1000 cigarettes (which weigh about 750 gram) the minimum specific duty on fine-cut tobacco would have to be

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5 This includes so-called “sticks” which pursuant to the European Court of Justice's judgment in Case C-197/04 (10 November 2005) cannot longer be taxed as fine cut tobacco. However, even without these "sticks" there is a clear upward trend in fine-cut consumption.

increased to € 56 per kilogram. On the other hand, there is also a large difference between the minimum excise incidence of 57% of the retail selling price for cigarettes of the price category most in demand and the minimum excise incidence of 30% of the retail selling price for fine-cut tobacco. A two thirds minimum would result in the minimum incidence for fine-cut tobacco rising from 36% to 40%.

However, the fine cut sector argues that as factory made cigarettes predominantly include filter and hand made smoking articles predominantly do not, additional tobacco weight equivalent to the filter has to be considered. Consequently the weight of 1 kg smoking tobacco would correspond to 1,000 factory made cigarettes. Under this option, in order to obtain at least two thirds of the € 64 minimum on 1000 cigarettes (which are supposed to weigh about 1kg) the minimum specific duty on fine-cut tobacco would only have to be increased to € 43 per kilogram. (Annex H contains a simulation of the impact of these options on the level of taxation in the Member States)

The views of interested parties are sought on the above.

6.2. Definitions of other manufactured tobacco.

Since different categories of manufactured tobacco are taxed differently, manufacturers and importers of tobacco products will try to categorise their products in the lowest taxed category. In order to avoid inappropriate taxation, the definitions of the different categories of tobacco products should be accurate and fraud proof. .

6.2.1. Other smoking tobacco (and in particular pipe tobacco)

Currently, excise tax for pipe tobacco is lower than fine-cut tobacco taxation in 13 EU markets. Some of these markets face the problem of pipe tobacco being used for hand rolling or tubing of cigarettes. Therefore, the definition of smoking tobacco should be adapted in order to better differentiate between pipe and fine-cut tobacco and to avoid inappropriate taxation.

A proposal to make a general and binding increase of the cut width from 1.0 to e.g. 1.4 mm. would only partially solve the problem as in some markets consumers would continue to use pipe tobacco for cigarette making regardless of the cut width, if the price differential remains attractive enough.

Therefore the Commission services take the view that the second paragraph of Article 6 of the Directive 95/59/EC should be adapted. According to this provision, regardless of the cut width, pipe tobacco can be taxed as fine-cut tobacco if it is sold or intended to be sold for cigarette making.

The reason why those Member States do not apply this provision despite the fact that they believe there are some indications for pipe tobacco being used for cigarette making is the lack of practical tools to deliver the proof of use or the proof of intention for use. This provision partially allows the Member States which are affected to apply the appropriate taxation, but it is not sufficient enough to achieve the target.

Therefore, a solution should be found in order to better achieve the purpose of the second paragraph of Article 6.

The views of interested parties are sought on how it can be reworded in order to better fulfil its function without disturbing the classical pipe tobacco.

6.2.2. Cigars and cigarillos

Cigars constitute a special tobacco product with regard to consumption and production. Cigars are supposed to be mainly consumed by adult male consumers of a mature age (over 35) and the frequency of consumption is, as compared to cigarettes and fine cut tobacco, low. The production is labour intensive, characterised by small units with a low speed of production. The excise regime takes into consideration the nature of this industry and the particular characteristics of its products and consumers. As a consequence, the minimum excise rate for cigars is set at 5% of the retail selling price inclusive of all taxes or € 11 per 1000 items or per kilogram, which is approximately 15% of the minimum excise rate for cigarettes.

From a fiscal point of view, cigars are of minor importance. European cigar consumption decreased slowly but steadily from 10.9 billion pieces in 1975 to 6.8 billion in 2005. Cigar consumption in the EU-15 was approximately 1% of the total EU consumption of all tobacco products (in pieces). Since enlargement to the EU-25 this percentage has decreased even further to approximately 0.8%.

The internal market for cigars is working relatively well. The current excise system, together with low consumption volume and the distinctiveness of the national markets, does not give rise to considerable fraud or smuggling.

However, several Member States and the trade have reported that new products have appeared which are presented and marketed as cigars - they have the colour of a cigar or cigarillo, rather than the white colour of a cigarette – but in terms of function, taste and presentation must be regarded as cigarette substitutes. The manufacturing process for these products is similar to that for cigarettes. Under the current legislation, these products are taxed in the Member States at the same rate as cigars and cigarillos. These products are not only competing with cigarettes, but are also disrupting the market for cigars and cigarillos. This is because the only way that Member States can counteract such a development is by increasing the excise duty on *all "cigars"*.

This problem was highlighted in the last report and for this reason the definition of cigars and cigarillos was amended by Directive 2002/10/EC in order to restrict the application of the lower minimum rate to conventional cigars as was originally intended. However, this has not prevented new products being developed which meet the amended definition for cigars but are ostensibly cigarettes or cigarette substitutes.

Against this background, one possibility would be to further amend the EU cigar definition so as to exclude the category of products which in terms of function, taste and presentation must be regarded as cigarettes or cigarette substitutes. One of the options for achieving this would be to stipulate, in point 3 of the current cigar definition in Article 3 of Directive 95/59/EC, more stringent requirements regarding the weight, diameter, content, etc of the products concerned. However, the disadvantage of such an approach would be that the already highly complex definition could in practice become completely unworkable and unenforceable. Indeed, experience over recent years has also shown that the scope for tax avoidance by *entrepreneurs* seeking to produce products which meet the definition will always exist.

Therefore it would be preferable to remove point 3 completely from the current cigar definition. Such an amendment would ensure uniform taxation of these products and restrict application of the lower minimum rate to traditional cigars and cigarillos. Such a proposal has the support of the vast majority of the cigar industry.

However, Germany has the option of continuing to apply until 1 January 2008 the pre-2002 cigar definition. As a consequence, there is a large market for low-priced products referred to as "eco-cigarillos" (a product category which in terms of function, taste, filter and presentation can be regarded as a cigarette substitute). Whereas the conventional German cigar market has for years remained stable at around 1.2 billion cigars, the "eco-cigarillos" increased from 1.3 billion in 2000 to 2.8 billion in 2005. By way of comparison, the total EU volume of conventional cigars was 6.8 billion in 2005. This development in Germany should in principle not be problematic, if the amendment of Germany's cigar definition as of 1 January 2008 results in the "eco-cigarillos" segment ceasing to exist. However, similar products have since been introduced into the German market. Although they meet the new (2002) cigar definition, in terms of function, taste, filter and presentation must be regarded as a cigarette or cigarette substitute. Consequently, given the high volumes at stake, sudden abolition of paragraph 3 would have a substantial impact on this market and appropriate transitional periods could be considered.

The views of interested parties are sought, on the above.

6.2.3. Herbal cigarettes

Herbal cigarettes and other products not containing tobacco are marketed in a number of Member States. These cigarettes are sold without health warnings and marketed as "safer" alternatives to cigarettes with tobacco.

In a recent case[6] concerning the tax treatment of herbal cigarettes in the Netherlands, the European Court of Justice ruled that non-tobacco cigarettes are exempted from excise duty only when the medical use of the cigarette is *"supported by objective characteristics linked to the properties of those products"*. In particular, the Court stated that there must be scientific evidence that the "*product contains substances the combustion or inhaling of which produce scientifically recognized medical effects of a curative or preventive nature*" The Court concluded that "*cigarettes without tobacco which do not contain substances having a medical effect but which are presented and marketed as an aid to giving up smoking are not "used exclusively for medical purposes" within the meaning of Article 7 of Directive 95/59/EC"* and consequently should be taxed.

Although the ECJ ruling provides more clarity, Article 7(2) of Directive 95/59/EC could be amended in order to address the growing diversity and supply of herbal cigarettes and other cigarettes not containing tobacco or nicotine. An alternative would be to delete Article 7(2), second subparagraph.

The views of interested parties are therefore invited.

6 C-495/04, A.C. Smits-Koolhoven v Staatssecretaris van Financien, 30 March 2006

6.2.4. *Smokeless tobacco products*

The current taxation requirements do not cover any kind of smokeless tobacco. This kind of products has a limited market share. Nevertheless, the possibility of including them in Community excise legislation has been suggested.

The views of interested parties are therefore invited.

7. MINIMUM RATES OF EXCISE DUTIES ON OTHER MANUFACTURED TOBACCO.

The minimum rates applicable to cigars, cigarillos, hand-rolling tobacco and other smoking tobacco are expressed both as a percentage of the retail selling price and as a specific amount.

In order to maintain the ratio established when the rates were first set in 1992, the minimum specific amounts were adjusted in line with inflation following the 1998 and 2001 reviews. The minimum specific amounts for other tobacco products laid down in Directive 2002/10/EC are as follows:

- for cigars and cigarillos: € 11 at 1 July 2003;
- for fine-cut tobacco intended for the rolling of cigarettes: € 32 at 1 July 2004;
- for other smoking tobacco: € 20 at 1 July 2003.

In theory an adjustment of the specific excise duty for cigars and cigarillos and for other smoking tobacco is needed to take account of inflation for the period 2003 to 2007. On the basis of Eurostat data on the annual rate of change of the HICP (Harmonised Index of Consumer Prices) between 2003 and 2007, the rate of inflation can be estimated at around 2% a year or at 8% over the period as a whole. Applying this percentage to the minimum specific amounts and rounding up to the nearest unit gives € 12 for cigars and cigarillos and € 22 for other smoking tobacco.

A similar adjustment for hand-rolling tobacco for the period 2004 - 2007 would give € 34. However, as mentioned, in order to obtain at least two thirds of the minimum on cigarettes the minimum on fine-cut tobacco would have to be increased above inflation. An immediate alignment however to two thirds would have a substantial impact on the market in a number of Member States. Consequently the increase would need to be introduced on a gradual basis. Member States which do not currently maintain such a ratio between their rates for cigarettes and fine-cut tobacco or which set their rates at a very low level could, therefore, be given the necessary time to adjust to the new minimum rates.

Finally, again, from a purely public health perspective, one can argue that all tobacco products are equally harmful and all should be equally taxed.

The views of concerned parties are invited on the analysis above.

8. CONCLUDING REMARKS

Many of the issues mentioned in this paper have already been the subject of discussions with representatives of business and the Member States. The reflexion on the structure and rates of excise duty on manufactured tobacco products leads us to conclude that a number of important amendments to the existing legislation are necessary.

The Commission services are of the view that priority should be given to questions of simplification and transparency of the structure of excise duties on tobacco products. In addition, attention should be paid to the wider objectives of the Treaty, in particular health policy

Accordingly comments are invited on the contents of this note from interested parties on the issues identified and on possible options for addressing them.

The ideas set out reflect the analysis of the Commission's services and, as such, may not necessarily be an exhaustive catalogue of all the issues needing attention or include the full range of possible solutions.

ANNEX

List of annexes

Annex A: Releases for consumption of manufactured tobacco (2002-2004)

Annex B: Current rates for cigarettes in the Member States

Annex C: Current rates for fine-cut tobacco intended for the rolling of cigarettes

Annex D: Current rates for cigars and cigarillos

Annex E: Current rates for other smoking tobacco

Annex F: Simulation of minimum requirements applicable to all cigarettes.

Annex G: Simulation of the impact of the impact of weighted average prices as reference for minimum rates.

Annex H: Simulation fine cut tobacco