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Executive Summary

London Economics' analysis for ESTA

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The EU market for fine-cut tobacco

Our analysis shows a number of key features associated with fine-cut tobacco and its consumers.

- **The consumption of fine-cut tobacco varies widely across the European Union**, both in absolute terms, and relative to the consumption of factory-made cigarettes (FMC). In some Member States, almost half of all tobacco consumption is represented by fine-cut tobacco, while in others, FCT consumption is negligible.
- **Not all consumers of tobacco products are similar**. Specifically, detailed analysis of the personal and socioeconomic characteristics of consumers of tobacco products from recent Eurobarometer surveys suggests that those individuals who consume FCT rather than FMC have a lower probability of being in employment, face greater financial or affordability constraints, and are more sensitive to prices.
- **There is no one single identifiable market for fine-cut tobacco across the European Union;** rather, there are many inter-dependent markets, differentiated by different consumer preferences, political and economic conditions, and excise rates. Within any of these individual Member States, consumers can select between a range of duty-paid tobacco products (such as FMC or FCT) at different price points to reflect preferences, affordability constraints and consumer choice. In addition, the EU's Single Market means that many consumers can also straightforwardly cross national boundaries, and purchase duty-paid tobacco products elsewhere for personal use if there are sufficient reasons. Consumers who are priced out of the legitimate tobacco market may also switch their consumption from legal to illicit tobacco products.

The *buffer function* role of fine-cut tobacco

The widespread perception is that the demand for tobacco is relatively unresponsive to changes in price. Given this, governments have traditionally sought to increase tobacco excise in order to raise tax revenues. However, this reflects only part of the story, in the sense that although the overall demand for tobacco products is highly inelastic, **the demand for *duty-paid tobacco products* is much more responsive to changes in price**. Therefore, following a sudden significant increase in tobacco taxation that feeds through to retail price, governments may see a decrease rather than an increase in tax revenues, as well as market disruption, due to consumers switching to non-domestic duty-paid tobacco and/or illicit products.

In economic terms, the **buffer function** associated with fine-cut tobacco reflects the fact that FCT acts as a potential **alternative proposition** for illicit tobacco products. Domestic duty-paid FMC, cross-border purchased FMC and illicit FMC are to some extent substitutes for each other. Therefore, one would expect an increase in the excise duty imposed on duty-paid FMC to *increase* demand for both cross border FMC and/or illicit FMC. However, FCT provides an alternative domestic-duty paid tobacco product to consumers who are priced out of the market for domestic duty-paid FMC. The maintenance of some excise duty and price differential between domestic FMC and FCT encourages consumers to **switch to legal FCT *rather* than purchasing cross-border FMC or illicit tobacco products**. As such, FCT acts as a **buffer** between domestic duty-paid tobacco, and cross-border or illicit tobacco products that generate no taxation revenue for the government.

Despite the fact that demand for FCT is negatively impacted by increases in excise duties, **maintaining a difference in excise duties between FMC and FCT acts to reduce the negative fiscal impact associated with raising duties** on FMC, and hence consolidates the tobacco tax receipts that are accrued by the government.

What happens when jurisdictions get it wrong?

Netherlands

In the Netherlands, after a period of stability, from 2013, the structure of tobacco excise **changed dramatically,** commencing with a substantial increase in excise duties in January 2013. The government initiated **a major shift away from *ad valorem* taxation** towards ***specific*** taxation. This resulted in an increased tax burden on FCT of approximately **26%** between 2012 and 2014, significantly more than the increase in tax burden on FMC[1]. In parallel, as a result of these taxation changes**, the differential in the FCT tax burden** between the Netherlands and neighbouring countries nearly **doubled** (from **€18** per kg in 2004 to **€32** per kg in 2012 presented in Figure 1)**.**

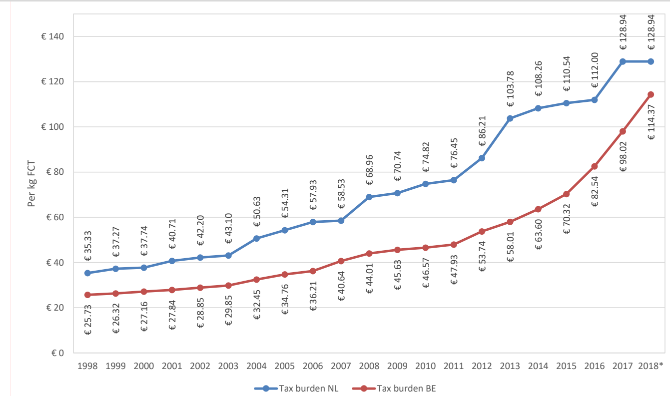
Consumption of duty-paid FCT declined more or less steadily from 2002 to 2012, showing a cumulative decline of **33%** over this period.

However, in response to the increase of **36%** in FCT tax burden in 2012 and 2013, **there was an abrupt (21%) drop in FCT consumption in 2013.** Clearly, this decline in duty paid consumption reflects the **very significant increase in duties in the Netherlands**, but also the rapid **increase in the excise gap between the Netherlands and Belgium**.

Following the sharp increase in excise rates in 2013, government tobacco tax revenues fell by **16% (corresponding to more than €430 million)**. From 2013, tobacco taxation receipts have followed a relatively erratic path; however, **a clear negative trend in government revenue is identifiable**. Despite the buffer function of FCT and consumers switching between FMC and FCT, this decline reflects increased cross-border shopping (despite Belgium increasing its excise duties) and an increase in illicit purchases.

The analysis suggests that when setting duty rates on tobacco products, national authorities need to

Figure 1: Tax burden per 1 kg FCT - in the Netherlands and Belgium – 1998-2018



Note: Prices at end of year. Tax burden is the sum of specific duty, ad valorem tax and VAT. *Current as of 1 May 2018

Source: EC DG Taxation and Customs Union, EXCISE DUTY TABLES Part III – FCT Tobacco

Figure 2: Government tax revenues from tobacco products 1998 - 2017 (€ billion)

*Preliminary data

Source: Statistics Netherlands (CBS)

[1] Note further that between July 2015 and July 2016, the minimum excise duties imposed on FCT in the Netherlands have increased by 16.3% (from €85.32 per kg (here) to €99.25 per kg (here)). In contrast, the minimum excise duty on FMC has increased from €181.49 to €181.58 per 1,000 sticks over the same period, corresponding to an increase of 0.05%. This has been associated with a 12% increase in FMC consumption between the two years. The decline in FCT consumption of FCT between 2012 and 2016 was estimated to be 22%.

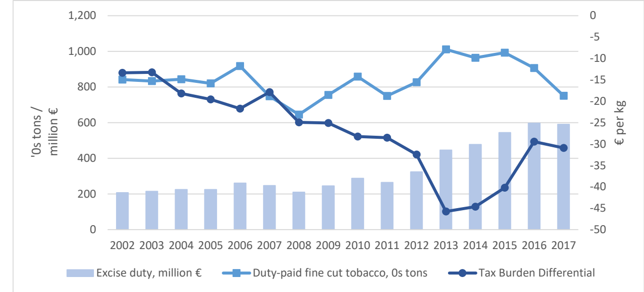
take account of the duty rates in neighbouring countries. If domestic duties increase rapidly and differ markedly from those in neighbouring countries, evidence suggests that a significant share of domestic consumption will be sourced abroad. Recent developments in the Netherlands demonstrate that these principles of FCT taxation have not been followed, resulting in a sharp decline of government tobacco tax receipts and market disruption.

Belgium

In relation to FCT, between 2002 and 2017, excise duties levied on FCT have increased by **190% per kg FCT** over the period, compared to **100%** increase in the excise duties on FMC. However, importantly, these increases in excise duties were concentrated in the latter period (since 2013) following a decade of generally moderate increases. As previously mentioned, **the differential in the FCT tax burden** between Belgium and the Netherlands nearly **doubled** (from **€18** per kg in 2004 to **€32** per kg in 2012, and **€46** per kg in 2013).

However, despite the very large increases in excise duties levied in Belgium over the period, the decline in consumption in tobacco products in Belgium has been concentrated within the FMC market, while FCT consumption was actually higher in 2016 than in 2002. This was partly due to the switching behaviour of consumers between FMC and FCT, but also as a result of the cross border purchases from other Member States – in particular the Netherlands.

Figure 3: FCT consumption, government FCT revenue, and Netherlands-Belgium tax differential



Source: London Economics' analysis of EC DG Taxud data

FCT duty-paid consumption stood at more than **10,000** tonnes in 2013, and between **9,000** and **10,000** tonnes in each of the three years subsequently), which compares to **6,500** tonnes in 2008. The result was a **doubling** of government FCT taxation receipts between 2008 and 2013 (from **€210 million** in 2008 to **€446 million** in 2013).

However, since 2013, there have been sharp increases in the levels of excise duties imposed in Belgium. These increases ranged between **8%** and **11%** per annum between 2013 and 2015, but reached approximately **17-19%** between 2016 and 2017. These most significant increases were imposed to fund Belgium's 'tax shift'[2] policy aimed at reducing taxes levied on both households and businesses). At the same time, the tax differential between the Netherlands and Belgium narrowed, cross-border trade became less attractive, and greater numbers of consumers switched to illicit trade. As a result, the volume of duty paid FCT in Belgium declined from **10,110** tonnes in 2013 to **7,507** tonnes in 2017, and is expected to decline further in 2018.

At the beginning of 2016, government revenue from tobacco excise duties was expected to be approximately **€3,238 billion**; however, by the end of 2016, only **€3,087 billion** had been collected. By 2017, tobacco duties had further declined to **€3,004 billion**. In other words, even though excise duties were increased with the aim of raising revenues, a fiscal shortfall of approximately **€500 million** has been created in 2016 and 2017. This outcome illustrates the sensitivity of the demand for FCT to changes in excise duties, the role of FCT as a buffer function between the market for FMC

[2] KPMG (2015). *De Belgische 'taxshift'* (*here*)

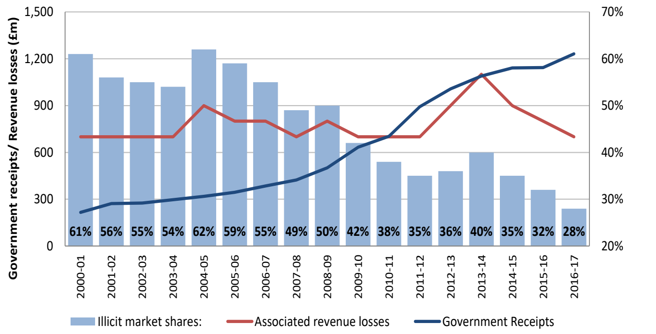
and illicit tobacco, and also the importance of the rapidity of changes in excise duties on consumer behaviour.

United Kingdom

The United Kingdom adopted a tobacco tax 'escalator' policy (between 1993 and 2000) to drive up excise duty on tobacco products in real terms – that is to say after accounting for inflation. Specifically, excise duties rose by between 3% and 5% more than inflation between 1993 and 2000. In 2001, the escalator policy was halted and taxes on tobacco products were frozen in real terms. This taxation slowdown continued (essentially unchanged) until 2010 when the escalator policy was re-introduced.

The UK has suffered from some of the highest levels of illicit trade over the last decade. At the time of the suspension of the tobacco duty escalator (2000-01), approximately **60%**[3] of total consumption of FCT was accounted for by illicit trade, with a further **12%** associated with cross border trade. Reflecting the inflation-only increase of FCT duties over the next decade – and subsequent re-introduction of the tobacco escalator at moderate levels, the level of illicit trade declined to its lowest level of **28%** in 2016-17, with a further **4%** associated with cross border trade.

Figure 4: Illicit market share/revenue losses and government tax receipts associated with FCT (2000-01 to 2016-17)



London Economics' analysis of HM Revenue and Customs and EC DG TAXUD data

The long-term decline in the level of cross border and illicit trade in FCT, alongside the increase in UK-duty paid consumption has resulted in **significantly increased tobacco taxation receipts** for the UK government (from **£272 million** in 2001-02 to **£1,231 million** in 2016-17). However, despite this decline in illicit trade, it is important to note that the loss in government tax revenues has remained high (at between **£1,100 million** and **£700 million** between 2013-14 and 2016-17).

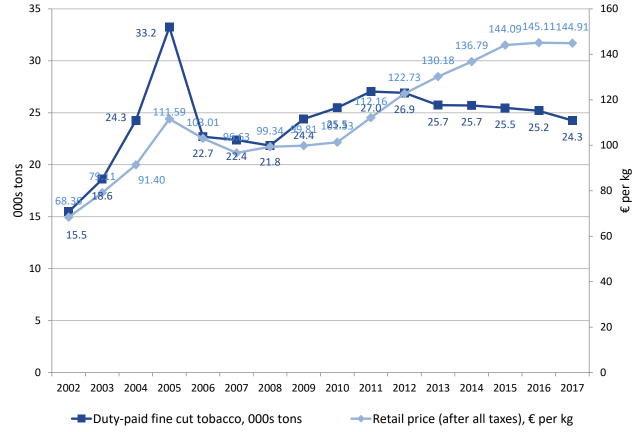
[3] Note that all estimates presented relate to mid-point estimates contained in HMRC Measuring Tax Gaps official publications.

Can countries learn from their mistakes?

Germany

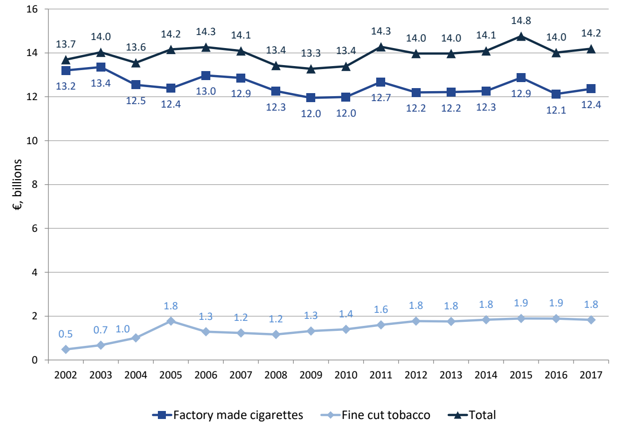
Between 2002 and 2005, the German government implemented several significant increases in tobacco taxation duties. As a result of the associated increases in cross-border shopping, as well as the increase in the volume of illicit trade, tobacco taxation revenues declined. Given this, the German Government responded by keeping the headline tobacco excise rates unchanged from 2006 to 2010, raising only the minimum excise rate in January 2006.

Figure 5: Retail prices and consumption of duty paid FCT (left panel), 2002 - 2017



Source: London Economics' analysis of Statisches Bundestamt (2018) and Statistisches Bundesamt (2014a, 2017, 2018)

Figure 6: Government tax receipts from duties on FMC and FCT, 2002 – 2017



Source: London Economics' analysis of Statisches Bundesamt (2018)

However, with Poland and the Czech Republic joining the Schengen agreement in 2008, the ease of cross-border shopping increased, and resulted in a large increase in the purchase of non-domestic tobacco products. The share of non-domestic products in the German market increased markedly, from its 2005 level of **16.1%** to a "new normal" of **20%** or higher. As a consequence, between 2008 and 2010 tobacco excise revenues fell below 2002 levels.

In 2010, learning from the costly mistakes of a decade in which it had sought to increase tobacco revenues, the German government implemented a long-term tobacco excise policy (Tobacco Duty Model). This implementation of the Tobacco Duty Model aimed to provide greater long term certainty and **predictability** to German tobacco excise policy through the adoption of **moderate increases** in excise duties determined over a **five-year period.**

This policy has **balanced** fiscal and public health objectives, **increased government revenue**, and **reduced 'non-German' product inflow** while also **decreasing consumption**. Moderate fine-cut tobacco taxation has played an important role in this turnaround.

The Netherlands

Learning from the costly fiscal errors from raising tobacco tax duties whilst ignoring the rate movements operating in neighbouring jurisdictions, the Dutch government has now implemented a long term tobacco taxation plan, taking into consideration the buffer function of FCT and facilitating predictable and stable government revenues.

With the latest increase in tobacco excise introduced on 1st of April 2018, future increases of excise have already been implemented in law. In particular, until 2021 excise duties will increase (every 1st of January), and includes detailed information on the specific duties to be levied on both FCT and FMC, as well as the ad valorem tax on FMC. Although the minimum duties applied to FCT being greater than the corresponding duties for FMC in percentage terms (but the same in absolute terms), the long term planning adopted by the Dutch government has established step-by-step increases whilst at the same time securing a tax differential between product categories. This new approach seems to better reflect the economic realities of tobacco taxation.

Policy implications

Based on evidence from a number of national statistical agencies and the European Commission, the London Economics' analysis provides evidence that:

- Although markets across Member States are very distinct in terms of the prevalence of FCT, as well as the characteristics of FCT consumers, there is a degree of **interdependency** between Member States' product markets across the European Union;
- **Abrupt and sharp increases in tobacco taxation can create strong incentives for consumers to change their purchasing behaviour** – reflected by increases the incidence of **cross-border duty-paid purchases**, but also the prevalence of **illicit tobacco**. Sharp increases in FCT duties have generally resulted in **significant declines in government taxation receipts**;
- **FCT consumers are typically lower-income and more price-sensitive** than FMC consumers, and as such, fine-cut tobacco provides an **important buffer function** between domestic duty paid tobacco and both cross-border trade and the illicit market. **Acknowledging and understanding the buffer function of FCT is crucial for safeguarding government revenues and for containing illicit trade.**

Recommendations

- Based on the evidence, in order to facilitate the role of FCT as a buffer between FMC and non-duty paid consumption, it is essential to offer a **differentiated tax treatment** between tobacco product categories, taking into account their different tax-bearing capacity and the characteristics of their respective consumers. By maintaining differential tax rates between fine-cut tobacco and factory-made cigarettes, the domestic duty-paid FCT market acts to preserve the tax-base and maintain government taxation receipts.
- In practice, maximising the role of FCT's buffer function also requires that tax increases follow a long term, predictable and transparent approach. This is because the certainty associated with this approach has been illustrated to be more efficient in containing illicit trade and protecting government revenues compared to dramatic duty increases and subsequent policy reversals. Increases in the tax rates applied to fine-cut tobacco should be implemented in a gradual manner in a way that acknowledges both **consumer affordability issues**, but also the availability of **domestic substitutes**, **cross border purchases**, and the **prevalence of illicit tobacco products**.
- **At country level,** individual Member States should always consider their own national market and its characteristics, but also explicitly take in account neighbouring jurisdictions and the interdependency between markets across national borders. There are many examples where **failure to account for the impact of domestic policy decisions** on consumers' decisions to engage in cross border shopping **have resulted in a deterioration in national tobacco taxation receipts**.
- For this to be possible, tobacco taxation, and taxation policy in respect of FCT in particular, must allow Member States to define the structure and the rates that best fit their domestic policy and taxation objectives