

The buffer function of fine-cut tobacco in Germany

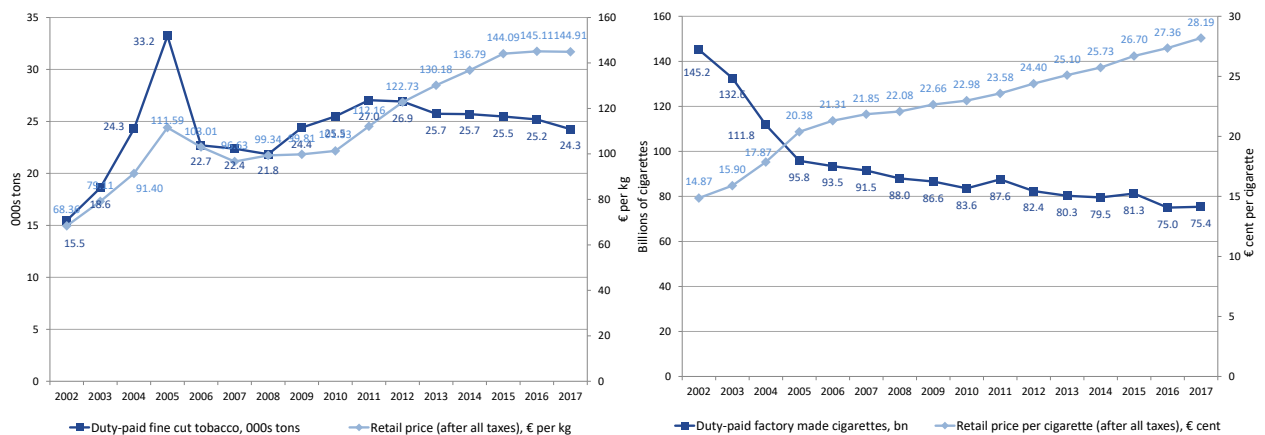
London Economics' analysis for ESTA

September 2018

The buffer function of fine-cut tobacco

While the five year policy of excise stability from 2011-2015 proved successful at both stabilising and growing overall tobacco excise revenue, a further trend also became apparent. Between 2002 and 2017, the size of the market for duty-paid cigarettes had decreased by **70 billion** sticks (equivalent to approximately **50%** of initial consumption) (presented in Figure 27, right hand panel) and purchases of non-German cigarettes had grown to **16.2 billion** sticks (KPMG, 2017). Whilst the total tobacco excise revenue in 2017 was **€0.5 billion** above 2002 levels, revenue from FMC was approximately **6%** lower – reflecting the role played by fine-cut tobacco in maintaining both the tax base and taxation receipts.

Figure 27: Retail prices and consumption of duty paid FMC (RHS) and FCT (LHS), 2002 - 2017



Note: Consumption of duty-paid FMC and FCT net of tax rebates. Values for each year incorporate any revisions based on the following year's publication. Numbers of 2017 are based on preliminary estimates. Note that the significant increases in FCT volumes is in part due to the increase in take up of so called of the pre-portioned tobaccos. According to estimates by the German Ministry of Finance, the volumes for pre-portioned tobaccos (included within FCT) in Germany increased from 1,000 tonnes in 2002 to approximately 18,500 tonnes in 2005. Since April 2006 pre-portioned tobaccos have been taxed as cigarettes (see judgement under C-197/04). Even excluding these volumes from the FCT series, between 2002 and 2013, the total volume of FCT increased from 14,500 tonnes in 2002 to 25,700 tonnes.

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

Historically, excise rates on fine-cut tobacco had followed the same trend as cigarette taxation. However, as FCT started from a lower base, these increases were larger in proportional terms. Between 2002 and 2017, FCT excise more than doubled (**134%**) in terms of average tax per kilogram while FCT taxation increased by around **78%**. In terms of retail prices, FCT remained at around half the price of FMC over the decade.

Fine-Cut tobacco sales increased steadily, by approximately **10,000** tonnes, between 2002 and 2013 (from **15,500** to **25,700** tonnes). This is equivalent to around **10 billion** sticks. From 2013 onwards, FCT sales remained constant at this level for the next 4 years. Government excise revenue from FCT more than **tripled**, over-compensating for any loss from FMC. Indeed a comparison of the growth of fine-cut sales (by the equivalent of **10 billion** cigarettes) with the size of the decrease of the duty-paid cigarette market (**70 billion** sticks) clearly indicates that the government's policy included a certain **degree of substitution between cigarettes and fine-cut tobacco**. However, the size of the non-German cigarette inflows (**16.4 billion** sticks) indicates that there *is* **substantial substitution between German duty-paid and non-German cigarettes**.

Without the existence of excise differentials between cigarettes and fine-cut tobacco, which feed into retail-price differentials, the share of the market represented by non-German inflow would likely be significantly higher. Without the increase in FCT sales volume, government excise revenue in 2017 would be significantly lower than in 2002.

Conclusions

The German government has successfully managed to strike a balance between its fiscal and public health objectives in the Tobacco and Duty Model by maintaining a tax differentiation between FCT and FMC that allows substitution. Modest excise increases, combined with the maintenance of a price differential between FMC and FCT mean that German excise revenues remain stable *both* when consumers who are priced out of the legal market choose to quit smoking, *but also* when they continue to choose to smoke – as the buffer function of fine-cut tobacco now offers them a legal, and excise-generating, alternative.