

The study at a glance

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.

Conclusions

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 run 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 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.