

Executive Summary

Introduction

This analysis is a continuation of previous studies¹ London Economics has conducted on the taxation of fine-cut tobacco (FCT) in Europe, building on the experience of several markets such as **Belgium, Germany, the Netherlands** and the **United Kingdom**. The 2018 Study on FCT excise structure in the European Union demonstrated the key economic principles underlying a successful fiscal policy, establishing amongst others, **the importance of recognising the specific characteristics of FCT and its consumers in each market**, making a EU-wide one-size fits all fiscal policy unrealistic and undesirable.

The previous analyses also established that FCT can, under the right conditions, fulfil a **'buffer function' against illicit trade of tobacco products**. Whilst overall demand for tobacco products is highly inelastic², the demand for duty-paid tobacco products is much more responsive to changes in price. In economic terms, the buffer function associated with FCT reflects the fact that **FCT acts as a potential and legal alternative to consumers who are priced out of the market**. Maintaining an excise duty and price differential between domestic factory-made cigarettes (FMC) and FCT incentivises consumers to switch to legal domestic FCT rather than purchasing cross-border or illicit tobacco products.

Whilst previous works established economic principles, this study focuses on the specific scenario of **economic downturns**, and examines how consumers are likely to react to a deterioration of economic conditions and a reduction in disposable income. This study is divided in three sections:

1. **Understanding the impact of an economic downturn on FCT consumption:** the focus of this component of the analysis is to determine whether the relative consumption of FCT (as a percentage of the total legal FCT and FMC volume) changes during an economic downturn.
2. **Understanding the impact of an economic downturn on tax revenues:** this section quantifies the monetary value that the FCT 'buffer function' has during economic downturns by using the results from the econometric analysis of the first section.
3. **Understanding the relationship between an economic downturn and the illegal cigarette markets:** the focus of this third section is to assess the impact of the economic cycle on the consumption of illegal cigarettes.

This analysis demonstrates that **during economic downturns, smokers are more likely to switch to illicit consumption**, unless FCT is relatively more affordable than domestic cigarettes (FMC), in which case FCT can capture priced-out consumers and **mitigate the negative financial impact** of reduced duty-paid consumption on government revenues.

¹ <https://www.esta.be/wp-content/uploads/2019/01/London-Economics-ESTA-Report-Excise-Duties-on-FCT.pdf>

² https://www.who.int/tobacco/economics/2_2estimatingpriceincomeelasticities.pdf

Findings and implications

Impact of an economic downturn on FCT consumption

The first section of the analysis reports the results of an econometric analysis that was undertaken to investigate the relationship between the share of FCT and the unemployment rate in seven Member States characterised by different levels of FCT market maturity: **Belgium, Czech Republic, France, Germany, Italy, the Netherlands and Spain**. The regression analysis also includes other control variables that potentially affect consumers' purchasing power (such as the tax rates), and allows for the identification of how changes in macroeconomic conditions (for example the unemployment rate) affect the relative consumption of FCT (as a proportion of total legal tobacco consumption). The findings from this first analysis clearly show that during an economic downturn, smokers are more likely to switch from FMC to FCT. This effect is likely driven by affordability constraints.

Findings from this first analysis further support the concept of the buffer function associated with FCT. In particular, **substitution in this instance is not "tax-induced", as the difference in tax levels is not the factor that drives switching behaviours, but rather affordability constraints**.

Impact of an economic downturn on tax revenues

The second part of the analysis builds on the regression results identified in the first stage of the analysis, using historical data for 2020 and independent forecasts of the unemployment rates for 2021 to estimate the impact of change in unemployment in both years on FCT tax revenues. This approach provides an overview of the **additional tax revenues** that might be expected to be collected from FCT purchases in each market following forecasted increases in unemployment.

The findings suggest that following the expected increase in the share of FCT consumption, tax revenues - that might otherwise have been lost if consumers were to switch to illicit or non-domestic products - will be maintained. Governments' **revenues from FCT could increase by 1.3% to more than 7%** in the countries and years analysed. This additional revenue can significantly mitigate the negative financial impacts of reduced consumption of duty-paid cigarettes, whilst limiting the otherwise expected growth of non-duty paid consumption. Such an outcome assists fiscal authorities in their efforts to **overcome the forecasted and long-lasting economic downturn**.

Relationship between an economic downturn and the illegal cigarette markets

In the last section of the study, the econometric analysis focuses on the relationship between illegal cigarette consumption and changes in unemployment rate, incorporating variables such as the price differential between FMC and FCT. The analysis covered the same countries as in the first two stages of the analysis, with the addition of **Ireland, Poland, Portugal, Slovenia, and the United Kingdom**. The underlying hypothesis was that **changes in macroeconomic conditions** (as identified in the first section) **result in consumers shifting from legal FMC to illegal FMC**. The results of the analysis support the hypothesis and allow for the identification of a set of key economic principles of relevance when developing fiscal policies for tobacco products.

In essence, during economic downturns, smokers are more likely to resort to illicit products; however, this relationship is less pronounced in those markets where FCT is more affordable (i.e. where the price differential to FMC is greater). The analysis also demonstrates that **a FCT tax increase is associated with a larger increase in the prevalence of illicit products compared to an increase of FMC tax levels**, highlighting the importance of affordability constraints for FCT consumers.

Recommendations

Based on independent datasets covering the experience in several European markets over time, this analysis provides evidence that:

- FCT consumption is typically more price-sensitive compared to FMC consumption, even though Member States' markets are often very distinct in terms of the prevalence of FCT, as well as the characteristics of FCT consumers;
- During economic downturns when consumers' disposable incomes are under increased pressure, smokers are likely to seek cheaper alternatives; and
- Acknowledging and understanding the buffer function of FCT is crucial for safeguarding government revenues, as well as to containing illicit trade.

Therefore, the **relative affordability of FCT** compared to FMC should be maintained, which will **mitigate the negative impact of a long-lasting economic downturn** on the contribution of tobacco products to public finances. This supports the continued need for a **meaningful tax differential between FCT and FMC**. In absence of such, FMC consumers may not down-trade to FCT, but will seek other, mainly illegal alternatives. Similarly, and exacerbating the pressures on public finances, existing FCT smokers will also be driven to seek alternatives.