



Spotlight on the European Commission proposals to amend EU Directives on the rates and structure of taxes on manufactured tobacco

(Amending Directives 92/79/EEC, 92/80/EEC and 95/59/EEC on the structure and rates of excise duty applied on manufactured tobacco)

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Introduction

In July 2008 the European Commission published a proposal updating current EU rules on the taxation of tobacco products. In this edition of Spotlight we aim to explain the background to the proposals, the legislative procedure they will follow at EU level and, most importantly, why tobacco taxation is one of the most effective and efficient methods to reduce smoking rates.

Smoking is still the biggest cause of preventable death in the EU, with 650,000 smoking-related deaths each year¹. Taxation as part of an overall tobacco control strategy can play a major part in reducing this toll. According to the World Bank, a high price due to high taxes on tobacco is the

single most effective intervention to prevent smoking.²

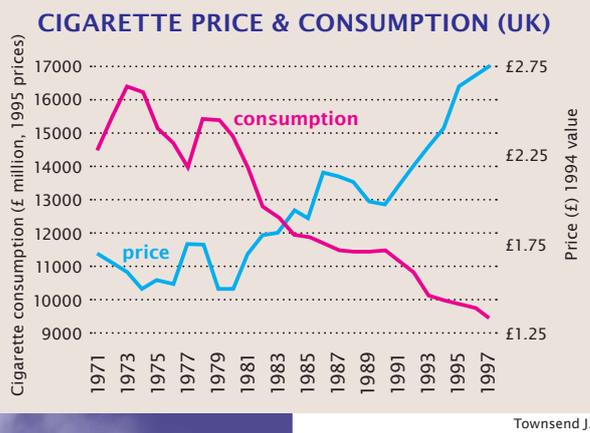
Why tax tobacco products?

Historically tobacco taxes have been a stable source of revenue for governments and aim to cover (at least in part) the associated costs of smoking. Tobacco taxation also helps deter consumption of tobacco. Increasing the price of tobacco through taxation has proved to be the most effective way of helping people quit³. Studies show that a price increase of 10% results in a 2.5% - 5% smoking reduction in the short run and possibly up to 10% in the long run, if prices are increased to keep pace with inflation. Young people are particularly

¹ http://ec.europa.eu/taxation_customs/resources/documents/common/whats_new/tobacco-20080716/COM459_en.pdf

² Jha P, Chaloupka FJ. *Curbing the Epidemic: Governments and the Economics of Tobacco Control*. Washington DC: World Bank, 1999

³ Hu T-W, Sung H-Y, Keeler TE. Reducing cigarette consumption in California: tobacco taxes vs. an antismoking media campaign. *Am J Public Health* 1995b;85(9):1218-22



was no decrease in smoking rates. Between 2002 and 2007, teenagers' smoking decreased from 17.6 percent in 2001 to 8.5 percent in 2007, a level nearly two-thirds lower than the latest available US national teen smoking rate⁴. Poorer socio-economic groups are also more sensitive to tax changes⁵.

MAIN PROVISIONS OF THE PROPOSAL:

Abolish the Most Popular Price Category (MPPC) as a reference point for EU minimum requirements on excise duties. MPPC refers to the retail selling price of cigarettes in the most popular price category in a country.

Introduce the concept of a **weighted average price (WAP)** of all cigarettes for determining the tax base. The excise tax will gradually increase over 5 years until it is at least € 90 per 1000 cigarettes (tax floor whatever the WAP) and at least 63% of WAP.

Introduce a compulsory monetary and ad valorem minimum tax incidence for **fine-cut tobacco** at the level of 2/3 of cigarette tax. As from 1 January 2014, Member States shall apply an excise duty on fine-cut smoking tobacco intended for rolling of cigarettes of at least 42% of the retail selling price inclusive of all taxes, and not less than € 60 per kilogram (i.e. a new tax floor as for cigarette tax).

Raise the specific tax element to be at least 10% and not more than 75%. (was 5% to 55%)

Narrow the definitions of cigars and pipe tobacco. Taxes on cigars are very low compared to cigarettes. New products have emerged which fall under the definition of cigars but are consumed and presented like cigarettes thereby avoiding the higher rate of tax. This will not be possible under the new definition.

Introduce obligations on Member States to provide the Commission with information on quantities and prices of tobacco products. This will assist the Commission in estimating the impact of tax policies

sensitive to price rises and may reduce their smoking at two to three times the rate of older people. For instance, in 2002, the New York City's tobacco control program put in place by Mayor Michael Bloomberg included raising the tobacco tax. For the 10 years before New York City's program was implemented, there

Tobacco taxes are successful in reducing smoking levels as they:

- Motivate smokers to quit and young people not to start using tobacco
- Reduce the impact of second hand smoke on non-smokers
- Are effective immediately
- Impose only minimum cost on the government
- Increase government revenue
- Reduce health inequalities as particularly motivate poorer socio-economic groups to quit or smoke less

How are tobacco products taxed at EU level?

Like most goods, cigarettes are subject to Value Added Tax (VAT). Tobacco products,

like alcohol and petrol, are also subject to an excise duty. Unlike other excise taxable goods, manufactured tobacco in the EU is subject to a mix of two types of excise duty – specific and ad valorem.

- **Fixed or specific excise duties** are imposed as a fixed amount per 1000 cigarettes (or per pack of 20 cigarettes). The same tax is applied whatever the base price thereby not increasing price differences between cheaper and more expensive brands. In addition, specific tax does not allow tobacco manufacturers to manipulate the price in order to reduce their tax liability.
- **Ad valorem excise duties** are based on the price of the tobacco products (e.g. a specific percentage of the manufacturers' or retail prices). This can lead to greater price differences between cigarette brands. Unlike specific excise tax, ad valorem taxes increase with inflation such as manufacturers' or other price increases.

Who benefits from EU tobacco taxes? Excise duties on alcohol, tobacco and mineral oils are national taxes, i.e. all revenue collected from excise duties goes directly to the EU Member States.

Why do tax levels vary between Member States?

With the introduction of the European Single Market in 1993, minimum EU levels of excise were set. Member States' discretion to apply higher excise tax resulted in absolute differences in the amount of tax levied on tobacco products. The differences in price/tax levels were further exacerbated when 12 new countries with low levels of excise duties joined the EU in 2004 and 2007. Several of these countries were given derogations to EU rules on excise duties to allow them time to raise their rates of excise duty to the minimum EU levels. An analysis of the prices and excise rates for cigarettes in the EU shows that for example, in 2006, cigarettes belonging to the Most Popular Price Category were nearly seven times as expensive (all taxes included) in the United Kingdom compared to Latvia.

Why is it necessary to update the current system?

- The current large disparities in the absolute level of taxes and prices of cigarettes among EU Member States allow consumers to avoid taxes by product substitution, cross border and illegal purchases of tobacco products. This can undermine tobacco control policies and lead to a loss of tax revenue.
- The importance of tax as an effective and efficient tobacco control measure has been further recognised since the original EU excise rates were agreed.
- EU tobacco tax rules must reflect developments in EU policy such as Article 152 of the EU Treaty which states that a high level of human health protection shall be included in all Community policies.

⁴ <http://www.ersnet.org/IrPresentations/84/bloomberg/index.htm>

⁵ Townsend J, Roderick P, Cooper J, Cigarette smoking by socio-economic group, sex and age: effects of price, income and health publicity. *BMJ* 1994;309:923-927

- In 2005 the European Community and 26 EU Member States signed the WHO Framework Convention on Tobacco Control. Article 6 of the FCTC recognizes that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons⁶. Countries implementing the FCTC must take account of public health objectives when determining taxation policies.

What does the Commission proposal aim to do?

- Update the EU tobacco tax levels to allow for inflation since they were last set
- Ensure minimum price levels for health reasons
- Amend the current distortions in EU trade which can lead to tax avoidance and product substitution (e.g. between manufactured cigarettes and roll-your-own cigarettes using fine-cut tobacco)
- Simplify the excise tax system
- Reduce tobacco tax differences between EU countries

What is the expected impact of the proposal?

- **Decrease in tobacco consumption:** Economic studies show that an increase in tobacco taxation leads to a decrease in tobacco consumption. The World Bank estimates that a 10% drop in real prices decreases cigarette use by about 4%. Economists call this concept 'Price elasticity of demand'. Young people and poorer socio-economic groups are more sensitive to changes in the price of tobacco products. New economic studies show that smokers want higher taxes in order to 'nudge' them, or help them to quit⁷.
- **Level up the prices of tobacco products in the EU:** This should help reduce the amount of cross-border shopping and tax avoidance.
- **Continue to provide revenue for EU Member States:** The tobacco industry often argues that raising tobacco taxes will result in a loss of revenue for governments. In fact, tax revenues can be expected to rise because higher prices reduce consumption but by a smaller proportion than prices will rise⁸.
- **Help combat tobacco smuggling:** while price is not the most important driver of smuggling, large tax/price differences can encourage smuggling. Smuggling does not solely occur from low-priced to high-priced countries. In Europe until recently, the highest levels of smuggling were found in

WHAT IS PRICE ELASTICITY OF DEMAND?

It is a measure of how demand responds to a change in price. Elasticity varies among products. Products that are necessities (or addictive or lacking substitutes) tend to be less sensitive to price changes as consumers tend to continue buying these products despite price increases.

The elasticity can be estimated using econometric analysis, and is usually negative indicating that increasing price reduces demand. Changes in price can result in a change in the number of people using the product and in the quantity of the product bought.

People with lower incomes tend to have higher price elasticity.

MPPC EUR/20 CIGARETTES

July 2008



countries with the lowest tobacco taxes.⁹ In the mid 1990s, Spain had both lower tobacco taxes and more smuggling than most other European countries. By 2002 smuggling was reduced in Spain from 16% to <2% of the market, and tobacco prices had doubled. Tax revenues also rose by 155%¹⁰. **Smuggling is a criminal activity and effective action can only be taken by active law enforcement.**

How was the tobacco tax proposal developed?

Prior to drafting the proposals the Commission consulted with EU Member States, health organisations and tobacco companies. In 2007 all interested parties were invited to respond to a web based consultation.

What is the procedure for introducing the new tax proposal?

All EU Member States must agree to the proposal before it can be implemented.

⁶ http://www.who.int/tobacco/framework/WHO_FCTC_english.pdf

⁷ Jonathan H. Gruber and Sendhil Mullainathan: Do Cigarette Taxes Make Smokers Happier. *Advances in Economic Analysis & Policy*. Volume 5, Issue 1, Article 4, 2005.)

⁸ Joossens L, Raw M, Progress in combating cigarette smuggling: controlling the supply chain, *Tobacco Control* 2008;17:399-404 available online <http://tobaccocontrol.bmj.com/cgi/content/full/17/6/399>

⁹ Action on Smoking and Health (ASH). Tobacco smuggling. Factsheet No. 17. August 2004. Available online at <http://oldash.org.uk/html/factsheets/html/fact17.html>

¹⁰ Tobacco or health in the European Union: past present and future. The Aspect Consortium of the European Union, 2004. Available online at http://ec.europa.eu/health/ph_determinants/life_style/Tobacco/Documents/tobacco

Will the EP play a role?

Yes. The European Parliament will be asked for its opinion on the proposals. While this will have no legal impact, positive support by MEPs will send a strong signal to EU Member States to put the interests of public health ahead of the economic interests of a limited number of tobacco companies.

When will the proposal come into force?

Following discussions in 2008-09, the proposals will be enacted in 2009 if they are ratified by all EU Member States. Once agreed, the proposal will be phased in over 5 years and will be fully implemented by 31st December 2013 with an extra 1-2 year derogation period for new EU states.

Does the public support tobacco taxation?

Tobacco taxes have been used for centuries by governments worldwide. They are well accepted by both the public and political leadership because tobacco is not an essential good and is relatively easy to collect taxes on. A recent YouGov poll commissioned by ASH UK in February 2008 found that 64% of the British public supported an increase in tobacco taxation as a policy measure. There is evidence that allocating tax revenues for tobacco control and other health and social programmes further increases their popularity.¹¹

Does the tobacco control community support the proposals?

Basically **yes**. We welcome the inclusion of public health as an objective of EU tax policy, but have some reservations. **Fine cut tobacco** will still benefit from lower rates than cigarettes. The rate of inflation has risen since the proposals were developed and inflation will continue. For the taxes to have a continuing impact on prices, they need to be indexed at least in line with inflation, otherwise there will be in effect a reduction in the real tax level. We urge national governments to take stronger measures than the minimum ones proposed in the new law.

What does the tobacco industry think about tobacco tax?

In 1996 the journal 'Tobacco International'¹² described the EU failure to then revise tobacco taxes at EU level as a clear victory for the industry: *"Lobbying by national tobacco industries, muddled thinking by the bureaucrats in Brussels, and a weak college of Commissioners have all combined to consign to the dustbin the latest draft proposals by the EU Commission to raise minimum excise levels on cigarettes and roll-your-own (RYO) smoking tobacco"* and *"while the Commission was in the process of formulating its proposals, the tobacco industry could, and did, intervene this time successfully"*. In 2008, Tobacco International is conspicuously avoiding any mention of the EC proposal on the taxation of tobacco products; but an article relating to the Imperial Tobacco Group which, in common with its peers (BAT and Phillip Morris) is trying to gain a stronghold in developing/emerging markets reveals clearly the impact that tax already has in Europe compared to other parts of the world: Declines in mature markets due to smoking bans and taxation are expected to be offset by gains in newer markets, where regulations are not as restrictive and the cost of doing business not as high¹³.

Is tax an important component of the FRAMEWORK CONVENTION ON TOBACCO CONTROL (FCTC)?

Yes. Article 6 of the FCTC recommends parties take into account tax and price policies as a part of their overall national health policy. WHO recommends that all governments raise tobacco taxes, tobacco products should be taxed similarly and need to be regularly adjusted for inflation. Taxes on cheap tobacco products should be equivalent to that on cigarettes, to prevent substitution in consumption. In addition, the conclusion of negotiations at the third Conference of the Parties (COP) in November 2008 agreed that the WHO's Tobacco Free Initiative¹⁴ would develop a technical report on Article 6 (taxation), for presentation to the next COP in 2010.

"The most effective way to deter children from taking up smoking is to increase taxes on tobacco. High prices prevent some children and adolescents from starting and encourage those who already smoke to reduce their consumption."

World Bank, *Curbing the Epidemic, 1999**
* <http://www1.worldbank.org/tobacco/reports.asp>

¹¹ Disease Control Priorities in Developing Countries | Prabhat Jha, Frank J. Chaloupka, James Moore, and others <http://files.dcp2.org/pdf/DCP/DCP46.pdf>

¹² Garran, R., Setback for RYO : EU's tobacco tax harmonisation, Tobacco International, December 1995, 43-45.

¹³ <http://www.tobaccointernational.com/0808/feature2.htm>

¹⁴ <http://www.who.int/tobacco/en/>



The **Smoke Free Partnership (SFP)** is a strategic, independent and flexible partnership between the European Respiratory Society, Cancer Research UK, the Institut National du Cancer and the European Heart Network. It aims to promote tobacco control advocacy and policy research at EU and national levels in collaboration with other EU health organisations and EU tobacco control networks.

Drafters: Gráinne Crowley and Florence Berteletti Kemp

Editors: Luk Joossens, Hana Ross, Joy Townsend, and Archie Turnbull

Smokefree Partnership
49-51 rue du Treves, 1040 Brussels, Tel: +32 2 238 53 63
www.smokefreepartnership.eu