

Smoke Free Partnership Position Paper on the
revision of the Council Directive 2011/64/EU
regarding Excises Duties for Tobacco Products



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1. Set an objective of 30% reduction in the prevalence of current tobacco use in people aged 15 years and over by 2025

This objective is already an EU commitment and tax policy is an important lever to ensure that it is achieved. The Directive is required¹ to ensure both the proper functioning of the internal market and, at the same time, a high level of health protection.² Including the 30% reduction target in the prevalence of current tobacco use in people aged 15 years and over by 2025 in the Directive would establish a clear criterion against which the success of the Directive should be assessed. This commitment also been taken by the EU and its member states as part of the Sustainable Development goals, the global Non-Communicable Diseases process, and by adopting decisions at the Conference of the parties for the Framework Convention on Tobacco Control.

2. Achieve upwards convergence of prices across Member States

This could be done by approximating the levels of minimum excise duties (MED) for each tobacco product towards a common high denominator across the EU, as a way to achieve a high level of health protection and the proper functioning of the internal market. Achieving upwards price convergence will:

- respond to the specific call of six EU Member States as part of the March 2016 Council conclusions;
- reduce the glaring inequalities in the level of health protection afforded by fiscal policies across the EU;
- reduce the incentives for cross-border tax evasion.

3. Align excise duties for roll-your-own and make-your-own tobacco with those of cigarettes

The tax and resulting price differences between cigarettes and roll-your-own tobacco undermines the health benefits of high excise duties on cigarettes by incentivising smokers that would have reduced or quit due to tax / price increases to switch to hand-rolled tobacco products and other lightly taxed tobacco products.

4. Introduce a specific definition and tax category for raw tobacco and relevant intermediate products, so that they are included in the excise system and covered by the control system (EMCS).

This paper elaborates on the importance of these policy proposals as well as on the evidence base for each of them.

¹ Art 2 of Council Directive 2011/64/EU states that : “The Union’s fiscal legislation on tobacco products needs to ensure the proper functioning of the internal market and, at the same time, a high level of health protection, as required by Article 168 of the Treaty on the Functioning of the European Union,”

² Articles 26, Article 113 and Article 168 of the [Treaty on the Functioning of the European Union](#)

Introduction

The Smoke Free Partnership leads a large coalition of 32 national and pan-European NGOs working exclusively on EU policy analysis and advocacy for the implementation of the Framework Convention on Tobacco Control (FCTC). Since its creation in 2006, SFP has led campaigns on important EU tobacco control policy areas, including smoke-free policies, the EU Tobacco Tax Directive, FCTC Article 5.3 Guidelines, FCTC Article 6 Guidelines, and the revised Tobacco Products Directive. The World Health Organization recognised the SFP for its tobacco control work with a World No Tobacco Day Award in 2011. SFP was also awarded the 2015 Luther L. Terry Award for outstanding global achievement and exemplary leadership in Tobacco Control.

Why a Position paper on Tobacco Taxation?

On 17 November 2016 the European Commission launched an Open Public Consultation on the possible revision of Council Directive 2011/64/EU which defines the product categories, structure, and minimum rates for excise duties on manufactured tobacco in the European Union. The open consultation aims at gathering the views of EU citizens and stakeholders on a set of possible options for the potential revision of the Directive. It also looks at ensuring the proper functioning of the internal market while ensuring a high level of health protection.

This position paper presents the top priorities of the SFP Coalition on the revision of the Council Directive 2011/64/EU and includes detailed explanations for each of them, including the public health implications of the fiscal treatment of the two main categories of consumption, cigarettes and RYO tobacco, though the recommendations may be generalised to the rest of tobacco products.

Children's health in the hands of finance ministries?

The overwhelming majority of smokers start smoking before they become adults; almost no-one starts smoking after the age of 21. It is crucial to put health at the centre of the revision of this Directive because making tobacco less affordable is the most effective measure in preventing young people from taking up smoking. Indeed, price policies are known to be the single most effective means for reducing the demand and consumption of tobacco products, as part of a comprehensive tobacco-control strategy.³ Furthermore, research clearly demonstrates that the most price-sensitive demographic for tobacco use is young people because they tend to have less disposable income. Increasing excise taxes on tobacco is by far the most effective and cost-effective tobacco control instrument.⁴ Raising the price of tobacco through taxation also raises the revenue for governments which in turn reduces the need for taxes on income and investment, and can be used to generate significant government revenues for health and development work.

Health is the responsibility of everyone, not only the responsibility of health ministers. We trust that those in charge of the negotiations will be mindful regarding the health implications related to the revision of this directive. Tobacco taxation and health should be a key priority because of the impact that higher tobacco

³ Ruger, J. P. Global Tobacco Control: An integrated approach to global health policy, *Development* (2005) **48**, 65–69.

⁴ Chaloupka FJ, Straif K, and Leon ME, "Effectiveness of Tax and Price Policies in Tobacco Control," *Tobacco Control* 20, no. 3 (2011).

taxation has on prices, and therefore on tobacco consumption, particularly among vulnerable groups such as young people. The health of our children is essential to our continued prosperity.

How bad is the smoking situation in the European region and at EU level?

Despite overwhelming evidence that has emerged since 1950 that smoking is the leading cause of premature death and disability, the European region still has the highest levels of smoking among adults (28%) and some of the highest prevalence of tobacco use by adolescents compared to the rest of the world⁵. Indeed, WHO has estimated that tobacco use is currently responsible for 16% of all deaths in adults over 30 in the Region.

Tobacco consumption is responsible for nearly 700,000 deaths every year. Around 50% of smokers die prematurely (on average 14 years earlier) having spent years in advance of their death dealing with the pain and disability caused by various types of cancer, cardiovascular and respiratory diseases.

The politics of tobacco taxation

EU Policy commitments relevant to the Directive

The [WHO Framework Convention on Tobacco Control](#) (FCTC): The EU and the 28 Member States have all ratified the FCTC and have committed (and are legally bound) to its implementation. In this context, FCTC Article 6 requires Parties to adopt tax and price policies to reduce tobacco consumption. The [FCTC Art 6 Guidelines](#), which were unanimously agreed at the 6th Conference of the Parties in 2014, can assist Parties in meeting their objectives and obligations under that article. Yet Article 6 of the FCTC, which encourages the use of price and tax measures as an effective method to reduce demand for tobacco, is the least well-implemented aspect of the FCTC.⁶

The Protocol to Eliminate Illicit Trade in Tobacco Products (ITP) and Art 15 of the Tobacco Products Directive: The ITP was developed in response to the growing international illicit trade in tobacco products, which poses a serious threat to public health. Illicit trade increases the accessibility and affordability of tobacco products, thus fuelling the tobacco epidemic and undermining tobacco control policies. It also causes substantial losses in government revenues, and at the same time contributes to the funding of transnational criminal activities.

The Protocol requires 40 ratifications to enter into force. Following a Commission proposal, the EU ratified the FCTC Protocol on 24 June 2016. To date there have been 25 ratifications, 6 of which are from the MS: Austria, Spain, Portugal France, Latvia and Lithuania. The European Commission is also preparing the implementing and delegated acts foreseen under Articles 15(11), 15(12) and 16(2) of the Tobacco Products Directive 2014/40/EU on an EU system for tobacco traceability and security features.

Health in all policies: All EU policies are required by the EU treaty to follow a "*Health in all Policies*" (HIAP) approach. Indeed, health determinants such as tobacco consumption cannot be influenced by health

⁵ <http://www.euro.who.int/en/health-topics/disease-prevention/tobacco/data-and-statistics>

⁶ Castro JL, "We won't achieve sustainable development goals for NCDs or other targets without tobacco taxes" *The Lancet Global Health Journal*, <http://globalhealth.thelancet.com/2016/08/30/we-wont-achieve-sustainable-development-goals-ncds-or-other-targets-without-tobacco-taxes> (30 August 2016).

policy on its own - there is a need for coordination with other health-related policy areas in order to ensure that health concerns are being addressed adequately including strategies for growth and jobs and sustainable development. This is why the revision of the Council Directive 2011/64/EU must consider potential impacts on health or health systems.

What are the arguments against increasing tobacco taxes?

The tobacco industry has misused economic arguments in order to prevent adoption and implementation of tobacco control measures.^{7,8} It is well recognised that tobacco industry research reports tend not to be peer reviewed, are generally of a lower quality when compared to reports written by independent academics, are often biased, and ignore the public health detriments caused by smoking.^{9,10} The tobacco industry has misused economic arguments in order to prevent adoption and implementation of tobacco control measures.^{11,12} The tobacco industry's main argument against tobacco tax increases is that such measures will increase the illicit trade in tobacco products. This is a misleading and non-evidence based argument. On the contrary, studies show that such claims are unjustified.^{13 14 15 16}

Another argument of the tobacco industry is that high tobacco prices are regressive, i.e. that low income smokers pay a higher proportion of their income in tobacco duty. The same can be said of any tax on consumption. Indeed, the progressivity of a fiscal system depends on the whole set of tax and expenditure policies that it comprises, rather than the tax treatment of a handful of products. Furthermore, the evidence shows that low income smokers are most likely to respond to price increases by quitting. Overall, the public health benefits of high tobacco taxation are greater than the potential harms of the increased price among low-income smokers who do not quit. Using money raised from tobacco duty to pay for stop smoking services targeted at low income smokers is one way of addressing concerns that tobacco tax is unfair for poor smokers.

⁷ Ross H, "Undermining Global Best Practice in Tobacco Taxation in the ASEAN Region Review of the ITIC's ASEAN Excise Tax Reform: A Resource Manual," ed. Kolandai MA and Dorotheo U (Bangkok: Southeast Asia Tobacco Control Alliance (SEATCA), 2015).

⁸ Doward J, "Former UK Tax Chief Under Fire for Joining Smoking Lobbyists," *The Guardian*, (16 May 2015).

⁹ Ross H, "Undermining Global Best Practice in Tobacco Taxation in the ASEAN Region Review of the ITIC's ASEAN Excise Tax Reform: A Resource Manual," ed. Kolandai MA and Dorotheo U (Bangkok: Southeast Asia Tobacco Control Alliance (SEATCA), 2015).

¹⁰ Gilmore AB, Fooks G, Drope J, Bialous SA, and Jackson RR., "Exposing and Addressing Tobacco Industry Conduct in Low-Income and Middle-Income Countries," *The Lancet* 385, no. 9972 (2015).

¹¹ Ross H, "Undermining Global Best Practice in Tobacco Taxation in the ASEAN Region Review of the ITIC's ASEAN Excise Tax Reform: A Resource Manual," ed. Kolandai MA and Dorotheo U (Bangkok: Southeast Asia Tobacco Control Alliance (SEATCA), 2015).

¹² Doward J, "Former UK Tax Chief Under Fire for Joining Smoking Lobbyists," *The Guardian*, (16 May 2015).

¹³ Understanding the U.S. Illicit Tobacco Market:

Characteristics, Policy Context, and Lessons from International Experiences (2015)

¹⁴ Illicit trade in tobacco: a summary of the evidence and country responses [presentation]. Geneva: World Health Organization; 2015 <http://www.who.int/tobacco/economics/presentationstaxation/en/index11.html>;

Smith KE, Gilmore AB, Savell E. What is known about tobacco industry efforts to influence tobacco tax? A systematic review of empirical studies. *Tob Control*. 2013;22:144–53. doi:10.1136/tobaccocontrol-2011-050098. ;

International Tax and Investment Center. In: *Tobacco Tactics*. Bath: Tobacco Control Research Group, University of Bath; 2016, http://www.tobaccotactics.org/index.php/International_Tax_and_Investment_Center

¹⁵ Ross H, "Undermining Global Best Practice in Tobacco Taxation in the ASEAN Region Review of the ITIC's ASEAN Excise Tax Reform: A Resource Manual," ed. Kolandai MA and Dorotheo U (Bangkok: Southeast Asia Tobacco Control Alliance (SEATCA), 2015).

¹⁶ Gilmore AB, Fooks G, Drope J, Bialous SA, and Jackson RR., "Exposing and Addressing Tobacco Industry Conduct in Low-Income and Middle-Income Countries," *The Lancet* 385, no. 9972 (2015).

SFP Policy proposals

1. Set an objective of 30% reduction in the prevalence of current tobacco use in people aged 15 years and over by 2025

This objective is already an EU commitment and tax policy is an important lever to ensure that it is achieved. The Directive is required¹⁷ to ensure both the proper functioning of the internal market and, at the same time, a high level of health protection.¹⁸ Including the 30% reduction target in the prevalence of current tobacco use in people aged 15 years and over by 2025 in the Directive would establish a clear criterion against which the success of the Directive should be assessed. As cited in the consultation strategy for the Impact Assessment on the possible revision of the directive, *“A proper functioning internal market presupposes that the way in which Member States tax the consumption of products in this area neither distorts competition nor impedes the products’ free movement within the EU”*. In this context, the Directive should ensure that *manufactured tobacco products are correctly taxed in the Member State of final consumption*.¹⁹ Interestingly, nothing is said in the consultation strategy about the need for fiscal legislation on tobacco to ensure a high level of health protection as set out in the Directive (ref).²⁰ It should be noted that a similar objective of 10% reduction in smoking prevalence had already been endorsed and promoted by DG TAXUD in the past.²¹

To put this in context the EU and the 28 Member States have all ratified the FCTC and have committed (and are legally bound) to its implementation. Article 6 of the FCTC requires Parties to adopt tax and price policies to reduce tobacco consumption. Furthermore, the [FCTC Article 6 Guidelines](#), which were unanimously agreed at the 6th Conference of the Parties in 2014, are designed to assist Parties in meeting their objectives and obligations under Article 6. Finally, we would like to recall that this objective of a 30% reduction in the prevalence of current tobacco use in people aged 15 years and over by 2025 **was formally adopted in Decision 27**²² at the last session of the conference of the Parties to the FCTC in 2016.

2. Achieve upwards convergence of prices across Member States

The convergence of duties across Member States towards the highest common denominator is a desideratum expressed by several Member States that is aligned with public health objectives. Indeed, **as stated in Annex II of the Council Conclusions on the Commission Report on the REFIT evaluation of Directive 2011/64/EU and on the structure and rates of excise duty applied to manufactured tobacco**, Austria, Finland and France (later supported by Ireland and Sweden) want to achieve a closer convergence of excise duty applied to

¹⁷ Art 2 of Council Directive 2011/64/EU states that : “The Union’s fiscal legislation on tobacco products needs to ensure the proper functioning of the internal market and, at the same time, a high level of health protection, as required by Article 168 of the Treaty on the Functioning of the European Union,”

¹⁸ Articles 26, Article 113 and Article 168 of the [Treaty on the Functioning of the European Union](#)

¹⁹ With exception of the situation as described in Article 32 of Directive 2008/118/EC

²⁰ http://ec.europa.eu/smart-regulation/guidelines/ug_chap3_en.htm

²¹ The official page of DG TAXUD from 2014 had endorsed and contained a reference to Directive 2010/12 which foresaw a gradual increase in the EU minimum taxation levels on cigarettes and fine cut tobacco up to 2014 and 2018 respectively, specifically stating that in order to achieve greater convergence and to reduce consumption, the minimum levels of taxation in the Union for cigarettes and fine-cut tobacco intended for the rolling of cigarettes should therefore be increased. Furthermore, the version of that page stated that the Directive aimed to contribute to reducing tobacco consumption by 10% within the next 5 years.

²² http://www.who.int/fctc/cop/cop7/FCTC_COP7_27_EN.pdf?ua=1

manufactured tobacco towards the highest common denominator as a way to achieve a high level of health protection and the proper functioning of the Internal Market. Minimum Excise Duties are the key policy lever for this purpose. They operate by establishing a *tax* floor under which the sale of tobacco products results in loss for government's revenues so they tend to lift the low end of the distribution of retail prices. In this sense the SFP advocates for reforms that approximate the **levels of minimum excise duties (MED) for tobacco products towards a common high denominator across the EU.**

How could this be done?

As this report will document below, the variability of prices in the EU has not changed over time either for cigarettes or RYO tobacco. In an integrated market for goods and services, this means that the public policy effects of tax policies are undermined by lax fiscal stances elsewhere²³. **We believe that in order to achieve price convergence for tobacco products it is necessary to tie domestic tax policies to a measure of the general fiscal stance in the whole EU.**

Our proposal is to establish a rule that links the minimum excise duty of domestic markets to an EU Level Weighted Average Price (EWAP), defined as the volume-weighted average of the domestic WAP over Member States. To this effect, note that, in 2015, while all Member States levied an overall excise duty on cigarettes that is at least 60% of the WAP in their domestic market, these domestic excises ranged from 30% to 125% of the EWAP thus defined.

For Cigarettes: The revision of the Tobacco Tax Directive should establish that the domestic overall excise duty on cigarettes should reach not only 60% at least of the domestic WAP (as is currently the case) but also reach at least 60% of the EWAP. Please note that we envision the EWAP to be in addition to the WAP, not to replace it.

For RYO and MYO tobacco as well as borderline products such as cigars and cigarillos: We are aware that, currently, the current requirement as laid out in Art 14 (1) of the Directive specifies that Member States can choose to apply an excise duty which may be an ad valorem or a specific duty or a mixture of both. Our proposal is to remove this possibility and to establish a minimum nominal value for **the overall excise duty of RYO and MYO tobacco** in the same way as cigarettes (i.e. the domestic overall excise duty on RYO and MYO tobacco as well as borderline products such as cigars and cigarillos should also reach not only 60% at least of the domestic WAP but also reach at least 60% of the EWAP in each product category).

The calculation and updates of the EWAPs for the different tobacco products should be entrusted to the European Commission, which already elicits information on tax, prices and sales from the Finance Ministries of Member States. The starting point for the calculation for the EWAP could be based on the 2015 Commission numbers for cigarette releases which would place the minimum tax requirement at €147.14 per 1000 cigarettes. The values of the official EWAPs used for the purposes of setting excise duties for tobacco products should be updated at least once every four years (in accordance with the practice set in article 19 of Directive 2011/64/EU which requires the Commission to submit every four years a report to the Council and, where appropriate a proposal for amending the Directive).

²³ (Lakhdar 2008)

3. Bridge the gap between the prices of RYO tobacco and cigarettes

Another priority for the revision of the TTD is to close the loophole that permits the overall excise duty burden of RYO tobacco and cigarettes to differ by a wide margin, as shown below. This requires the alignment of tax rules and rates on a standardized quantity basis.

First, in similarity to the treatment of cigarettes, the new Directive should establish a minimum nominal value for the overall excise duty of RYO tobacco, to safeguard against situations where the WAP of RYO tobacco in the domestic market is low.

Second, this nominal floor should be equal, in sticks equivalents terms, to the floor set for cigarettes. Analysis based on a 2010 survey shows the median weight of a hand-rolled cigarette across 18 countries in Europe was approximately 0.75g²⁴. However, there was significant variance with the UK, with high taxes on RYO, having the lowest mean weight of 0.48g. We would propose therefore at the current time to use a conversion rate of 0.7 grams of RYO per stick, but this should be reviewed as part of the regular four yearly reviews of the Directive required by Article 19. At the current level of 90 € per 1000 cigarettes, the nominal floor for RYO tobacco should then be 128.5 € per kilogram (because 1000 grams of RYO tobacco can be used to roll 1428.5 sticks at 0.7 grams per stick). This is much higher than both the current minimum of 54 € per kg. and the 60 € per kg. that the current Directive states must be applied by 2020. More than half of the Member States levy less than 100 € per kilogram of RYO tobacco at this time, and this would represent a significant increase, but need not be unduly disruptive if it is staged and transitional periods are granted where appropriate.

Third, these two measures will not address the problem of the tax gap between RYO tobacco and cigarettes in Member States where the overall excise yield of RYO tobacco already reaches the level proposed above. Therefore it would be necessary to establish measures that guarantee that the overall excise duty levied on the two products tends to converge over time within each of the Member States markets. We propose a staged progression towards 100% for the ratio of the MED (in sticks equivalents terms) on RYO tobacco over the MED on cigarettes.

Although this paper focuses on the two main tobacco products, cigarettes and RYO, these recommendations can be extended to the cases of cigars and cigarillos, pipe tobacco, or any other borderline product that the tobacco industry promotes in order to circumvent tax rules. In this regard note that provisions for cigars and cigarillos in the current directive generate loopholes that are similar in nature to the ones that we have discussed here in the case of RYO tobacco.

What evidence supports our proposals?

Our position is informed by an analysis of prices and patterns of consumption in the EU over the last 12 years. This analysis shows that:

- i) Between 2004 and 2015, the median price of cigarettes and RYO, measured by either the Most Popular Price Category or the Weighted Average Price, has increased by about 40% in real terms.

²⁴ (Gallus, S., Lugo, A., Ghislandi, S., La Vecchia, C. and [Gilmore, A. B. C.](#), 2014. [Roll-your-own cigarettes in Europe: Use, weight and implications for fiscal policies.](#) *European Journal of Cancer Prevention*, 23 (3), pp. 186-192.)

- ii) The variability of cigarette prices across Member States has not changed substantially over this period. That of RYO tobacco prices has increased.
- iii) There exists a substantive and persistent gap between the median prices of cigarettes and RYO tobacco. On a standardized 20 sticks per pack basis, this gap was narrowest (1.53 €) at the start of the period, reaches its peak in 2011 (2.52 €) and stands at 2.16 € in 2015.
- iv) The price of RYO tobacco remained mostly flat from 2004 to 2011, a period over which cigarette prices experienced the bulk of their increase. In contrast, when RYO prices experienced their greatest rise, 2012 to 2016, the pace of growth in cigarette prices diminished substantially. Consequently, as cigarettes were becoming pricier, a cheap alternative product, RYO tobacco, was progressively gaining a competitive advantage.
- v) The combined total releases for consumption of the two products decreased by 24.2%, from 753.87 billion to 570.76 billion, between 2004 and 2015. However, while releases of cigarettes decreased by 33.6% (from 672.71 billion to 446.03 billion), releases of RYO increased by 53.6% (from 81.11 billion to 124.73%). Even though total releases experienced a marked decrease, the last decade has been a lost opportunity to achieve yet greater gains in public health. This was a period over which the tobacco industry marketed successfully an alternative to cigarettes, RYO tobacco, at very competitive prices.

The causes for these shifts is related to the existing tobacco tax provisions. In particular, the gap in prices is attributable to the unequal overall excise duty levied on the two products. Similarly, the lack of convergence in prices results from widely differing tax burdens across Member States.

The Appendix describes in detail the empirical evidence base. It is structured as follows: Section 1 analyses the evolution of the prices of the two products and their gap over the period 2004-15. Section 2 reviews the concomitant changes in the structure of consumption. Section 3 shows the underlying tax norms that generate the patterns of prices seen in Section 1.

4. Introduce a specific definition and tax category for raw tobacco and relevant intermediate products

The last priority for the revision of the TTD is to introduce a specific definition and tax category for raw tobacco and relevant intermediate products, so that they are included in the excise system and covered by the control system (EMCS).

Directive 2011/64 does not apply to raw tobacco and to intermediate tobacco products, unless they are in a 'smoke-able' form. However, the definitions set out in the Directive (see below) contain some 'subjective' elements, which might cause classification uncertainties, disparities of treatment across countries, and result in disputes. Article 5.1 : "For the purpose of this Directive smoking tobacco shall mean: (a) tobacco which has been cut or otherwise split, twisted or pressed into blocks and is capable of being smoked without further industrial processing; (b) tobacco refuse put up for retail sale which does not fall under Article 3 and Article 4(1) and which can be smoked [...]"

A second problem is that raw tobacco and intermediate products can be diverted to the illicit manufacturing of smoking products or sold in small quantities to consumers for home processing. The magnitude of this

problem is unknown and probably varies across countries. Since these products are not covered by the Directive, some of the key tools to prevent and fight tax fraud, including the Excise Movement and Control System (EMCS), cannot be currently used to monitor the movement of raw tobacco.

What arguments and evidence supports this proposal?

Because the Tobacco Tax Directive does not have a specific definition and tax category for raw tobacco and relevant intermediate products they are not subject to the EMCS control systems and can therefore be easily diverted to illegal production of tobacco products.

Increasing volumes of raw tobacco are being imported in some Member States much of which cannot be accounted for by legitimate use. Since 2011/12 import data indicates a 100% increase in the volume of raw tobacco being imported from 'third countries' to non-registered tobacco producers, with a total of 64 tonnes being imported in 2013/14. This data does not include tobacco imported from within the EU, this means that the actual total volume entering the MS will be substantially higher. The Illicit manufacture of cigarettes and hand-rolling tobacco from raw tobacco deprives governments' revenue of the duty which should be paid and makes cheaper illicit tobacco products more accessible to people, especially the young and vulnerable and so undermines the Government's public health objectives.

This is a problem which is likely to be a growing for many Member States too. For this reason SFP supports the inclusion of an additional tax category within the scope of the Directive for raw tobacco as an excisable product so that it can be brought into the Excise Movement and Control System (EMCS) as this will help MS control the illicit trade of tobacco products.

Appendix. Evidence base for SFP proposals

Section 1. Analysis of prices

1.1 Cigarettes

The analysis of cigarette prices is based on the price for the Most Popular Price Category (MPPC) of each country or, when this statistic is not available, the Weighted Average Price (WAP).

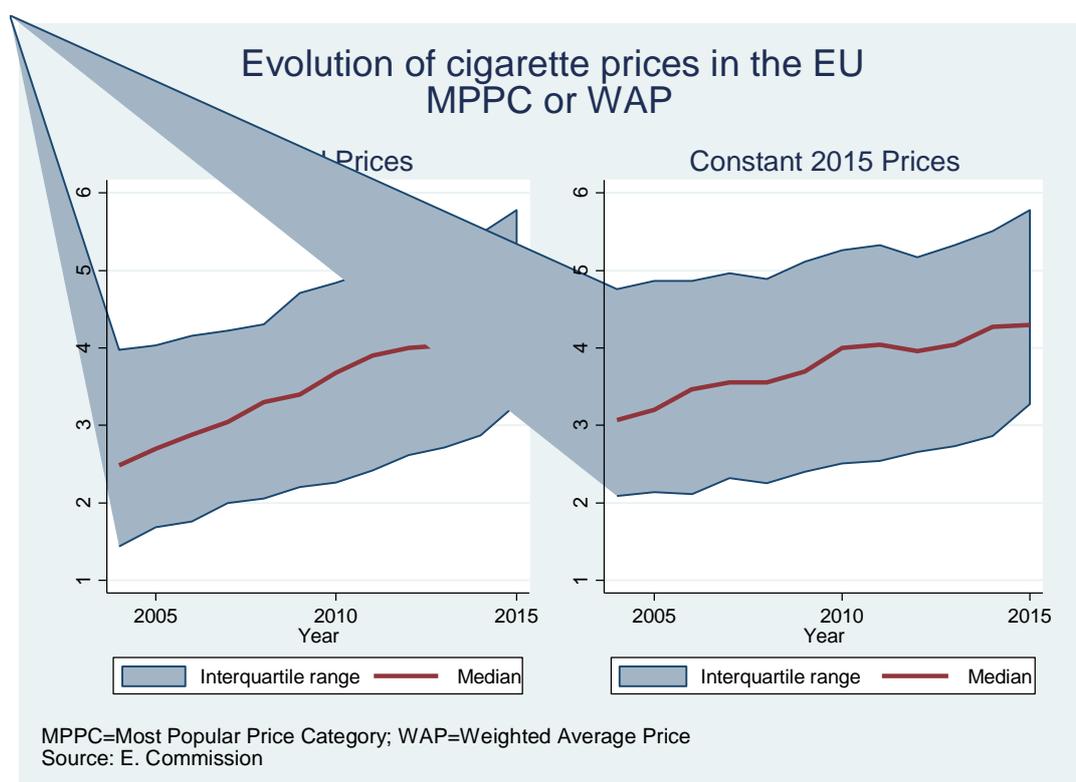


Figure 1. Evolution of cigarette prices in the EU 2004-2015

The median nominal price for a pack of 20 cigarettes in the EU has increased from by 72% from 2.5 € to 4.3 € over the 12 year period (2004-2015) shown in Figure 1 (left panel). What matters for public health, though, is the real increase in prices so these nominal figures need to be adjusted to account for the increase in the general level of prices (i.e. inflation) in each of the Member States during the period. This is done in the right panel of Figure 1, which shows the median real price of a pack of 20 cigarettes at constant prices of 2015. In real terms the increase from 2004 is much less marked. In fact, the median price in the EU in 2004 (at 2015 prices) was 3.07 € per pack, which implies that the real increase over the period amounts to 40.5%. As the left panel of Figure 1 suggests, the bulk of this increase, 30%, occurs during the first 8 years (2004 to 2011), while the last 5 years (2012 to 2015) witnessed the remaining 10% increase.

Another important feature of cigarette prices shown in Figure 1 is their variability across Member States. This is represented by means of the interquartile range, that is, the difference between the price just above three

quarters of the price distribution (upper quartile) and the price just above one quarter of the distribution (lower quartile). In this regard, the data shows that this statistic has not changed substantially (2.66 € in 2004 to 2.49 € in 2015). An alternative measure of the variation in cigarette prices, the standard deviation (1.95 € to 1.88 €), offers a similar picture.

1.2 RYO tobacco

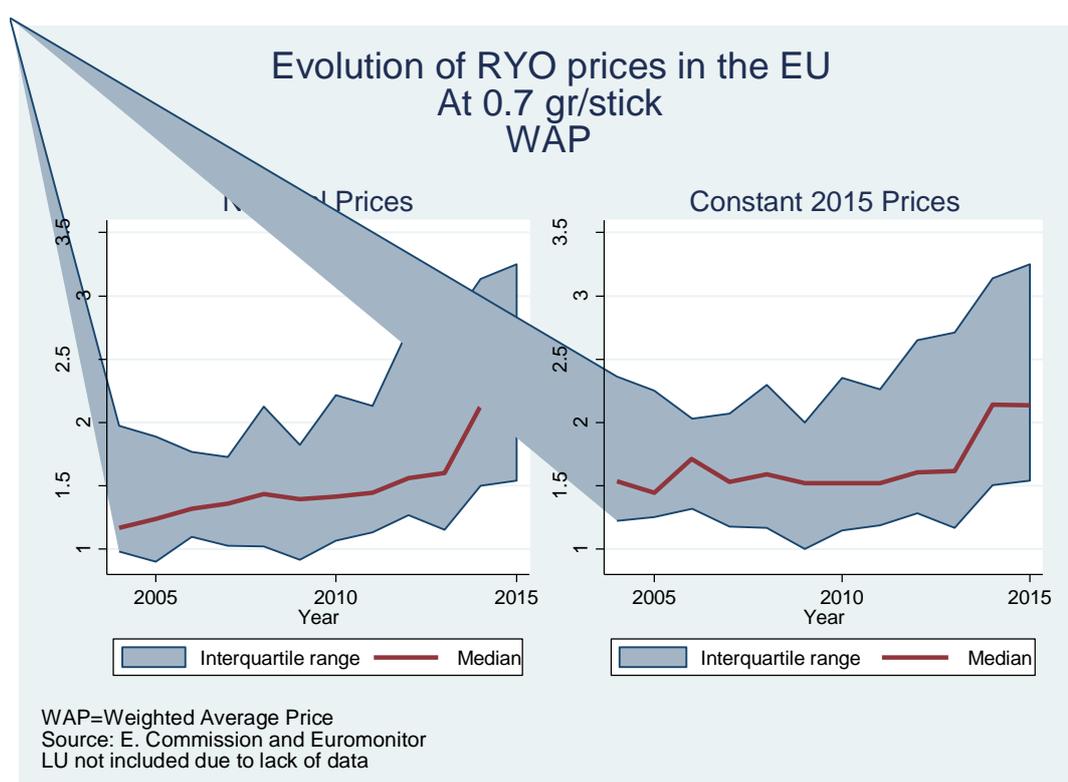


Figure 2. Evolution of RYO prices in the EU 2004-2015

Figure 2 presents the evolution of prices for RYO tobacco. The price measure shown is the weighted average price (WAP) estimated as the ratio between total sales and total volume. This is then transformed to a pack of 20 “stick equivalents” using a 0.7 grams per stick conversion rate. The right panel, which shows the evolution in constant prices of 2015, reveals that the median real price increased from 1.53 € to 2.13 €, which amounts to a 40% increase. Unlike the case of cigarettes, the bulk of this change occurs between 2012 and 2015. In fact, the median real price remained at about 1.5 € between 2004 and 2011.

As for the variation of prices across Member States, note that the interquartile range is greater at the end of the period (1.71 €) than at the start (1.14 €). The increase in variability can also be detected by the increase in the standard deviation of real prices (from 1.73 € to 1.88 €).

1.3 The price gap between cigarettes and RYO tobacco

It is useful to consider the difference in real prices between cigarettes and RYO tobacco, as shown in Figure 3.

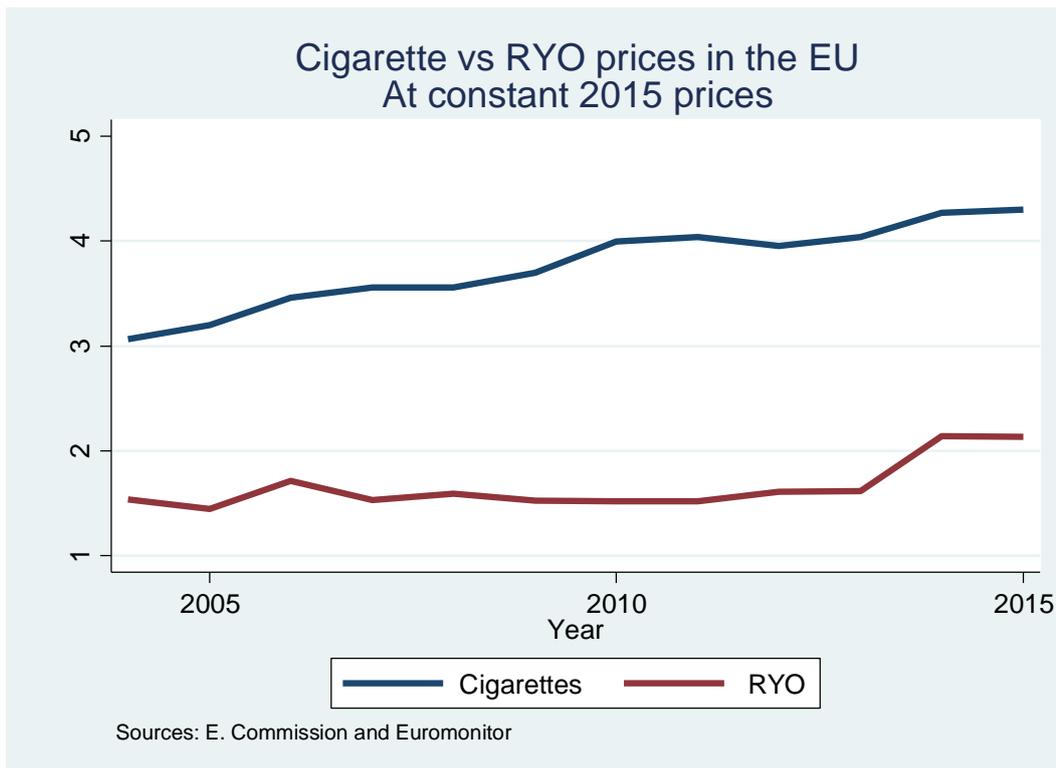


Figure 3. Cigarette vs RYO prices in the EU 2004-2015

There are two clear features in the relationship between the median prices of cigarettes and RYO. The first and most obvious is that there exists a substantive and persistent price gap between the two products. This gap was narrowest (1.53 €) at the start of the period, reaches its peak in 2011 (2.52 €) and stands at 2.16 € in 2015.

The second feature is that the price of RYO remained mostly flat from 2004 to 2011, which is precisely the period over which cigarette prices experienced the bulk of their increase. In contrast, when RYO prices experienced their greatest rise, 2012 to 2016, the pace of growth in cigarette prices diminished substantially (an alternative summary measure for the distribution of prices in the EU, the mean, confirms this empirical pattern). Consequently, as cigarettes were becoming pricier, a cheap alternative product, RYO tobacco, was progressively gaining a competitive advantage. This feature is a key factor for the changing patterns of demand of tobacco products which we are about to present.

Section 2. Changes in patterns of demand cigarettes and RYO tobacco

Figure 4 presents the evolution of the volumes of cigarettes and RYO tobacco released for consumption in the EU from 2004 to 2015 according to official European Commission figures in terms of sticks (cigarettes) or stick equivalents at 0.7 grams per stick (for RYO tobacco).

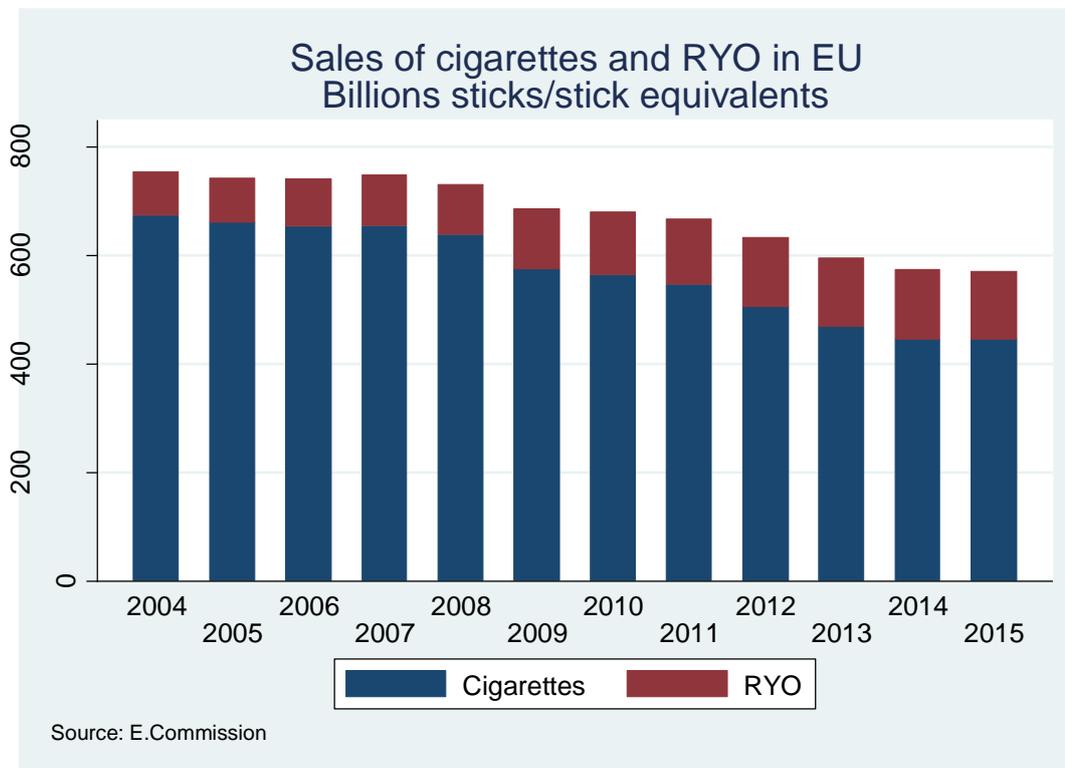


Figure 4. Sales of cigarettes and RYO in the EU 2004-2015

As Figure 4 shows, total releases decreased by 24.2%, from 753.87 billion to 570.76 billion, between 2004 and 2015. However, while releases of cigarettes decreased by 33.6% (from 672.71 billion to 446.03 billion), releases of RYO increased by 53.6% (from 81.11 billion to 124.73%).

Figure 5 shows that these cumulative changes are, for most of the period of analysis, the result of a sustained decrease for cigarettes and an equally sustained increase for RYO tobacco. Indeed, the rate of change in cigarette releases with respect to the previous year was always negative except for years 2005 and 2007 (although for these two years its sign was positive, its size was negligible). In contrast, (with the exception of year 2008) the releases of RYO tobacco experienced quite substantial yearly increases (e.g. 18% in 2009) up to year 2013, after which the annual rate of change becomes negative or close to zero.

Thus it appears that over the period 2004-2011, when, as seen in the previous section, cigarette prices grew and RYO prices remained stagnant, cigarette consumption fell intensely to the benefit of RYO tobacco. The period 2012-2015, on the other hand, when RYO prices grew faster than those of cigarettes, is characterized by a moderation in the rates of decrease (increase) in the consumption of cigarettes (RYO tobacco).

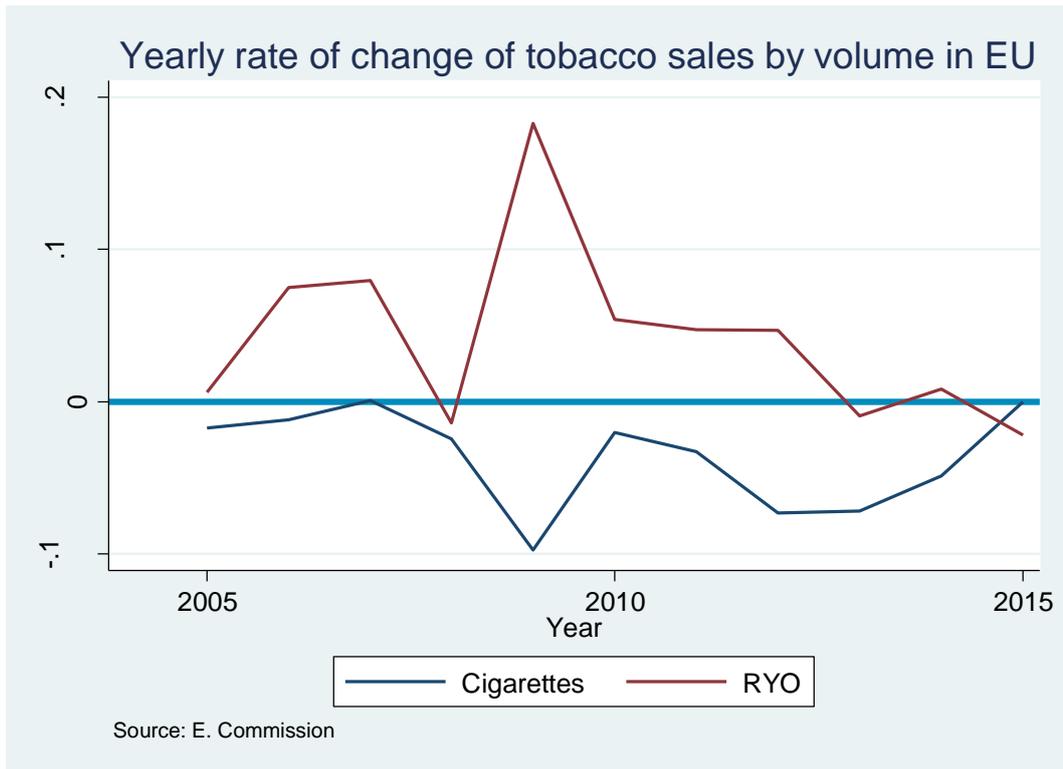


Figure 5. Yearly rate of change of tobacco sales by volume in the EU

In retrospect, it is reasonable to conclude that while the last decade has witnessed a marked decrease in overall consumption, it has also been a lost opportunity to achieve yet greater gains in public health and tax revenue. This was a period over which the tobacco industry seized the opportunity to market RYO as an alternative to cigarettes at very competitive prices, as the evidence on the price gap between cigarettes and RYO tobacco shown before reflects.

Unfortunately, this gap persists, and, as we shall see in the next section, it reflects the underlying differences in the tax treatment of these two tobacco products, differences which are amenable to policy change.

Section 3. The relationship between taxes and retail prices in the context of the EU Tobacco Tax Directive

As it is well known, tobacco products bear taxes based both on their monetary value, or *ad valorem* taxes, and on some measure of physical quantity (number of sticks in the case of cigarettes and weight in the case of RYO tobacco), or specific taxes. EU member states are able to set the rates for these taxes within the limits established by the current Tax Directive CD 2011/64/EU.

For the case of cigarettes, an important provision of this Directive is that it currently requires Member States to apply cigarette taxes so as to ensure that the **overall excise duty** (i.e. the sum of the *ad valorem* tax and the specific tax) must be at least 60% of the weighted average price of cigarettes (WAP) **and in no case less than 90 € per 1000 sticks** (except during transitional periods applying to some Member States). The latter restriction ensures that the overall excise tax does not fall below a safeguard nominal value of 90 € per 1000 sticks regardless of the average price level of cigarettes in each of the Member States. Some Member States introduced similar safeguards before the publication of CD 2011/64/EU. While in 2005 only 14 of the current 28 Member States used them, the number grew to 19 by 2007, to 20 by 2009, to 23 by 2012 and to 25 at the time of writing this paper. The only Member States that have not applied them to date are Sweden, Denmark, and the UK (which is introducing an MET in its Budget in March 2017), but these are States where cigarette taxation has relied more on specific taxes set at levels that comply with the minimum 90 € per 1000 sticks rule by a wide margin. In fact, for Member States that obtain a yield of at least 115 € per 1000 sticks the 60% rule is waived.

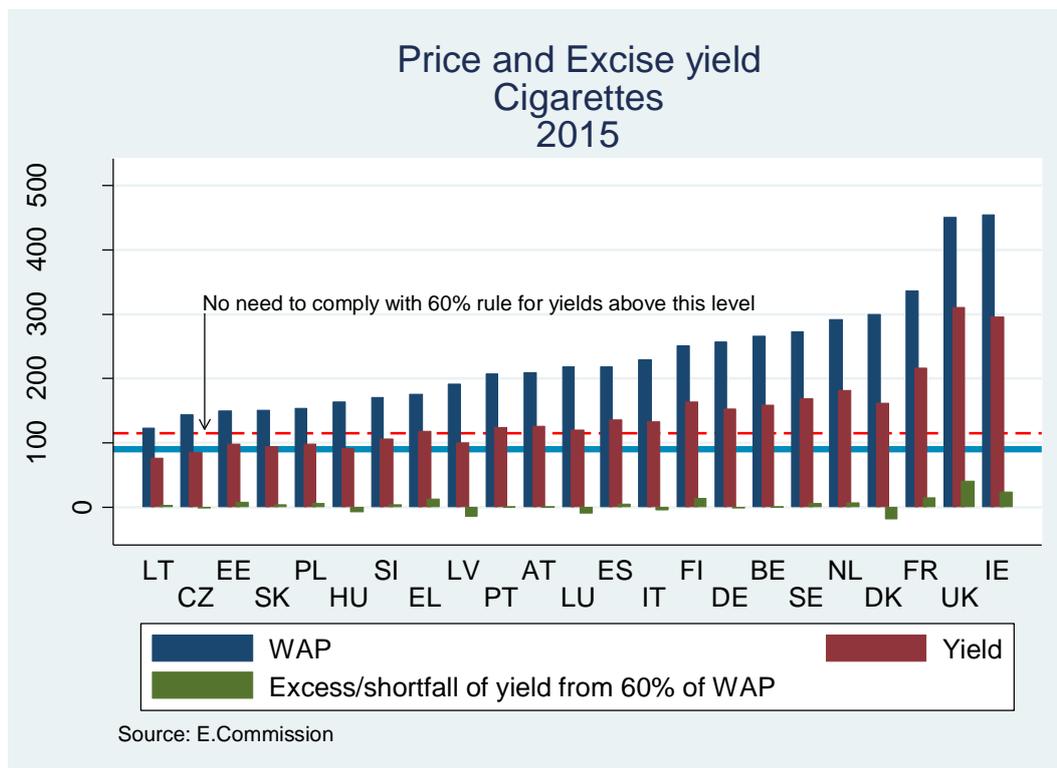


Figure 6. Price and excise yield, cigarettes in 2015

Figure 6 presents the weighted average price of cigarettes and their overall excise yield in the year 2015 for the Member States used in the analysis. It also shows the excess or shortfall of the yield with respect to 60% of the WAP, and a horizontal (blue) line for the 90 € per 1000 sticks minimum threshold.

Note the following from Figure 6.

First, all Member States (except for LT, HU and LV, which have a temporary exemption granted until 31st December 2017) comply with the rule that states that, if not greater than 115 € per 1000 sticks, the overall excise duty yield must be at least 60% of the WAP. Moreover, the excess or shortfall of the overall excise duty from the level set by 60% of the WAP is quite small (except for the outlying case of the UK where it is about 40 € in excess).

Second, the overall excise duty yield of a sizeable group of Member States is clustered around the 90 € per 1000 sticks threshold. Of these, LT and CZ actually fall short. The case of LT is justified by the exemption mentioned above but the case of CZ seems to be a genuine violation.

And third, the differences in the level of prices across Member States, as measured by the WAP, mirror the differences in overall excise duty. This identifies the levers available to policy makers interested in increasing the retail price of cigarettes at either the EU or Member State levels. In particular, note that a lower bound for the overall excise duty yield in any Member State is the maximum of the following three values:

- a) The combined effect of the domestic rates for the specific tax and the ad valorem tax. That is *specific*(1+ad valorem tax)*
- b) The domestic (nominal) minimum for the overall excise duty, if applied
- c) The EU nominal minimum for the overall excise duty (64 € over 2011-13 and 90 € since 2014 with the applicable temporal exemptions to some Member States)

This lower bound explains nearly perfectly the variation in prices across the EU and over time (the R-squared measure of goodness of fit is 91.7%), as Figure 7 shows.

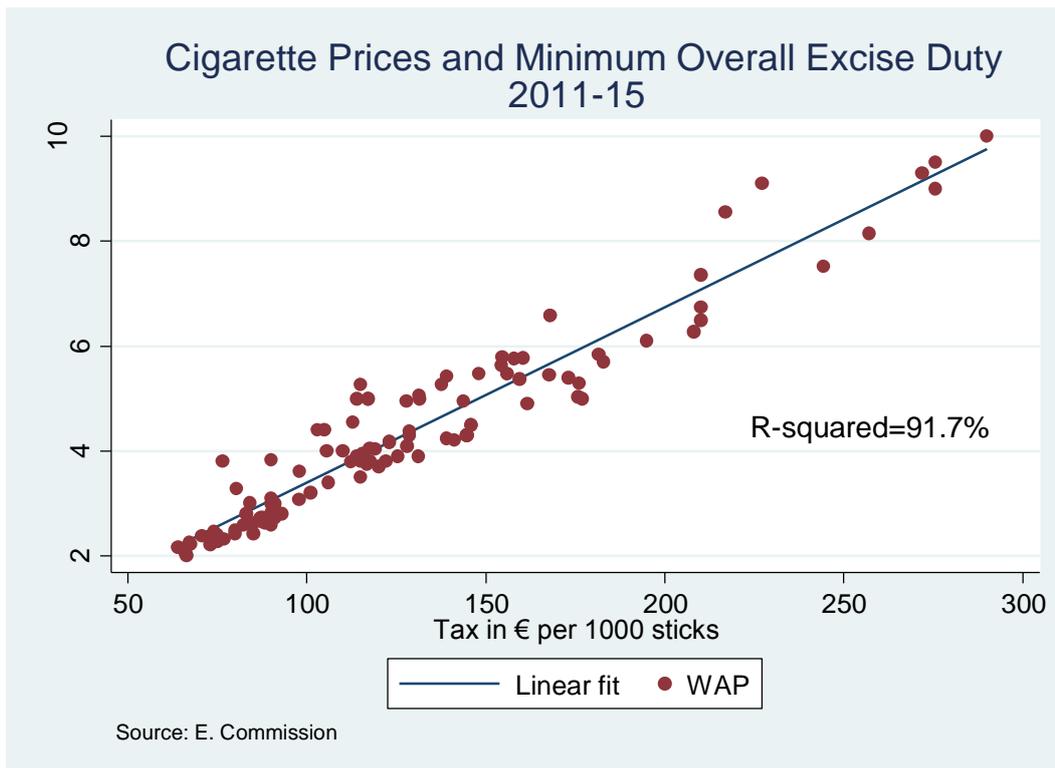


Figure 7. cigarette prices and Minimum Overall Excise Duty, 2011-2015

The implications of this relationship for the revision of the TTD will be discussed in the following section, but before that, let us consider the case of RYO tobacco.

For RYO the corresponding provision requires Member States to apply taxes so as to generate an overall excise duty of at least 54 € per kg., **or at least** 46% of the weighted average (WAP) price of fine cut tobacco products. Note that, in contrast with the case of cigarettes, there is no lower bound for the level of overall excise tax that must be generated per unit of quantity (as far as it reaches 46% of the WAP of RYO products) in the current Directive. Nonetheless, 11 Member States have introduced a nominal safeguard overall excise duty per unit of quantity of RYO to date.

A lower bound for the overall excise yield for RYO tobacco in any Member State is the maximum of the following three values:

- a) The combined effect of the domestic rates for the specific tax and the ad valorem tax. That is $specific * (1 + ad\ valorem\ tax)$
- b) The domestic (nominal) minimum for the overall excise duty, if applied
- c) The EU minimum for the overall excise duty. This, in turn is the minimum of the following two values
 - a. 46% of the WAP (40% for 2011-12, 43% for 2013-14)
 - b. 54 € (40€ for 2011-12, 47 € for 2013-14)

This lower bound also explains a high proportion of the variation in the prices of RYO (R-squared=71.3%), as figure 8 shows.

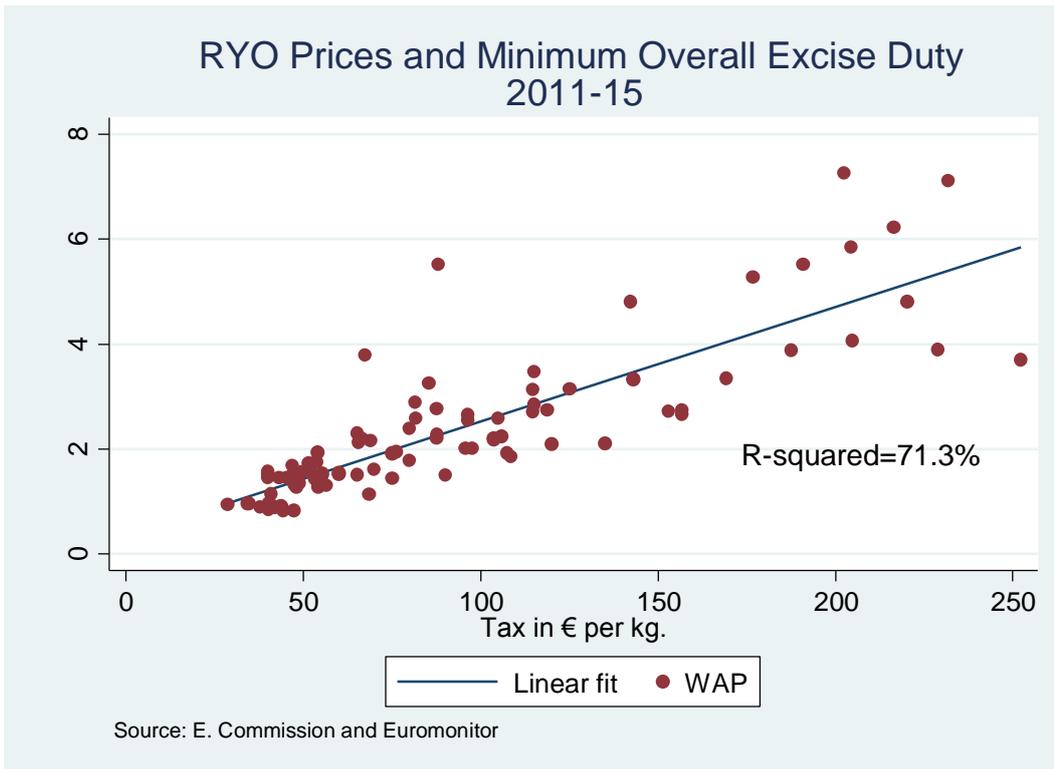


Figure 8. RYO Prices and Minimum Overall Excise Duty 2011-2015

The explanatory power of the the two tax measures that we have considered suggests that the key to understand the gap between the retail prices of cigarettes and RYO tobacco is their differential tax treatment.

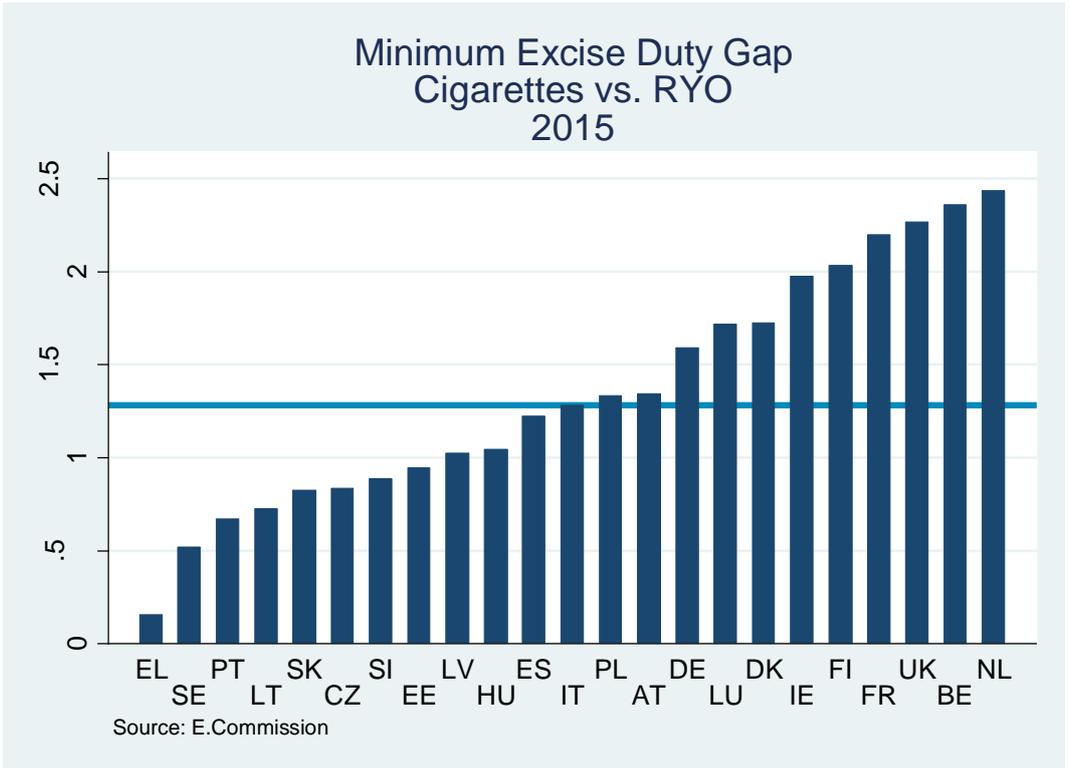


Figure 9. Minimum Excise Duty gap, cigarettes vs. RYO, 2015.

Figure 9 presents, for year 2015, the gap in the measure of minimum excise duty between the two products on a standardised quantity basis of 20 sticks (at 0.7 grams per stick in the case of RYO tobacco). Its median across the Member States is 1.28 € per 20 sticks. This is about 60% of the difference between cigarette and RYO tobacco retail that we have discussed earlier (2.16 € for year 2015).