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COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION STAFF WORKING DOCUMENT

Accompanying the

Proposal for a

COUNCIL DIRECTIVE

amending Council directive 95/59/EC, 92/79/EEC and 92/80/EEC on the structure and the rates of excise duty applied to manufactured tobacco

IMPACT ASSESSMENT SUMMARY

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Summary

Commission staff working document accompanying the Proposal for a Council Directive amending Council Directives 95/59/EC, 92/79/EEC and 92/80/EEC on the structure and the rates of excise duty applied to manufactured tobacco.

The Commission services made an impact assessment focusing on potential measures that could modernise or add more transparency to the structure of excise duties on tobacco products. In addition, particular attention was paid to the relationship between public health and the final price of the products, taking stock of the WHO Framework Convention on Tobacco Control, as well as to the options to bring the structure and the rates of excise duties for fine-cut smoking tobacco ("roll-your-own"), into line with excise duties for cigarettes.

A broad consultation process preceded this impact assessment. Associations and other stakeholders (trade, health, etc.) were invited to submit position papers via a public web-consultation.

In order to examine how the different objectives for tobacco taxation could be addressed, the Commission assessed four basic approaches.

The first approach consists of **not intervening** further at Community level (the no policy change option). This approach will not solve the problem of distortions of cross-border shopping and smuggling currently existing on the tobacco market, which has consequences in terms of revenue and health protection.

In addition, it will not resolve the fiscal instability and distortions of competition which are currently created by the most popular price category (MPPC) concept. It will also not address the problem of substitution and tax induced distortions of competition between the different products of manufactured tobacco. It was therefore not an option that the Commission chose to pursue.

The second approach option consists of **changing only the structure of excise duties on cigarettes**. In order to resolve the problems which are currently created by the MPPC concept, the Impact assessment examines abolishing the concept of the MPPC as benchmark for minimum requirements. Currently excise duties must be at least 57% of the tax inclusive retail price and at least €64 per 1000 cigarettes of the MPPC. Instead, the Impact assessment examines two alternatives: a) applying the EU minimum requirements of 57% and €64 to all cigarettes or b) applying the minimum requirements in accordance with weighted average prices (WAP). Simultaneously the impact is assessed of providing more flexibility to Member States as concerns the structure of the excise duties at national level.

Both alternatives would simplify the arrangements as compared to the current situation. Neither applying minimum requirements on all cigarettes or on WAP would entail an increase of administrative costs for any of the stakeholders. Both alternatives would also resolve the problem of the fiscal instability and distortions of competition which are currently created by the MPPC concept. However only applying the minimum of €64 on all cigarettes would create a tax floor for all cigarettes in the EU. It would also reduce the tax and price gap between Member States more than the other options and, to an appreciable extent, integrate public health concerns. Therefore this option gets priority from an internal market and a

health point of view. However, applying the 57% rule on all cigarettes would for a number of Member States result in a compulsory ad valorem duty and not be in line with the objective to provide more flexibility to Member States as concerns the relation specific and ad-valorem duties. Therefore applying the 57% rule on WAP is the favoured option.

The second approach would, however, not sufficiently take account of health considerations.

The third approach consists of **increasing the minimum rates of excise duties on cigarettes** (in addition to changes to the structure). The Impact assessment simulated a number of increases of the minimum rates of excise duties on cigarettes, either the 57% or the minimum of €64 per 1000 cigarettes. It concludes that an increase of the monetary minimum of €64 is the best instrument to achieve approximation of taxes and prices of cigarettes in the EU in the interest of the Internal market and with a view to tobacco control. However an increase of the monetary minimum should be combined with an increase of the 57% minimum requirement, which would require an update of the escape clause, currently set at €101 (when the excise duty is at least €101 on the MPPC member States do not any longer have to comply with the 57% requirement). An update to €122 would keep pace with the recent evolution of excise duties on cigarettes in the Internal Market and would have the same effect as in 2001, namely cover the five highest taxing Member States.

Over the last five years the consumption of cigarettes in the EU declined by more than 10%. In the same period the excise duties have increased by more than 30%. In order to trigger a similar decline in consumption over the coming 5 years further increases in excise duties would be desirable. Taking into account a price elasticity of -0.43 as suggested by the World Bank, a 25% price increase is needed to achieve a 10% reduction in demand. A 10% reduction over a period of 5 years would also be inline with the European Strategy for Tobacco Control" (ECTC), adopted by the Regional Committee for WHO Europe which sets as the principal target to bring smoking prevalence down by 2% per year.

In view of the above, the Commission has considered a number of possible increases.

An increase to €90 on all cigarettes and 63% on WAP would trigger a probable decrease of demand of on average 10% in 22 Member States¹. In addition it would pave the way for further increases of excise duties on cigarettes, also by those Member States which already have a high level of taxation. Apart from BG and RO it would not render prices extremely expensive as compared to the local purchasing power in the Member States.

All in all, in the field of cigarettes, this approach appears best suited to ensure the proper functioning of the Internal Market and, at the same time, a high level of health protection.

The fourth approach consists of **changing the structures and minimum rates of excise duties on other products**, in particular fine-cut tobacco, in order to avoid substitution of cigarettes by less taxed tobacco products.

The substantial differences in tax levels among Member States on fine-cut tobacco entail smuggling and cross border shopping between a number of neighbouring countries and give rise to distortions in the internal market. In addition, the gap between the level of taxation of cigarettes and fine-cut tobacco gives rise to substitution. Official releases for consumption of cigarettes in the EU 27 decreased during 2002-2006 by around 13%. Conversely, the releases

¹ Not in DE, UK, IE, FR (and RO was not included in the simulation)

for consumption of fine cut tobacco increased by around 10%. There is little justification for significant differences in the minimum rates for these products at Community level. This applies both in a perspective of fair competition and, given the harmful character of both products, from a health point of view. Therefore the minimum rates for fine-cut tobacco intended for the rolling of cigarettes should be brought into line with the rate for cigarettes.

For fine-cut Member States may choose between complying with a monetary or an *ad valorem* minimum rate. However since the monetary minimum requirement is the best approximating factor, there should be (in addition to the *ad valorem* minimum rate a compulsory monetary minimum rate for all Member States, as for cigarettes.

Taking account of the specific characteristics of fine cut tobacco, the previous Commission report stated the minimum excise for fine-cut tobacco could be fixed at about two thirds of the minimum excise incidence for cigarettes. In order to respect a two thirds relationship between fine-cut and cigarettes, the monetary minimum requirement should be fixed at €43 per kilogram and the proportional minimum requirement at 38%.

Applying the aforementioned 2:3 relationship on the suggested increases for cigarettes, would increase the minimum rates for fine cut to €60 and 42% over a period of five years. Assuming the same price-elasticity as for cigarettes, an increase of the minimum requirements to €60 and 42% would trigger a reduction in demand of around 20% in 19 Member States.
