



Study on the measuring and reducing of administrative costs for economic operators and tax authorities and obtaining in parallel a higher level of compliance and security in imposing excise duties on tobacco products

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Executive Summary

Introduction

In the context of its obligation to make regular reports on tobacco taxation¹, the Commission is aiming to revise the main legislative acts in order to generate a reduction of administrative expenses for tax administrations and economic operators while increasing the level of compliance and security in applying excise duties on tobacco products and protecting Member States' budgetary interests. The present study aims at *evaluating* the current EU legislation imposing excise duties on tobacco products (Council Directive 2011/64/EU).

To this purpose, the study maps the main characteristics of the national excise systems for tobacco products, within the framework of the two main directives² regulating excise duties, and excise duties on tobacco in particular. It then assesses the effectiveness of the EU excise duty system for tobacco products in terms of its capacity to safeguard Member States' budgetary objectives, and ensure the proper functioning of the Internal Market while avoiding distortions in competition.

Using a case-study approach, the study goes further in depth into a number of selected issues, while also assessing the administrative and compliance costs of implementing and complying with some elements of the legislation. A final, cross-country analysis has enabled the identification of good practices while enabling the formulation of recommendations. The main evaluation questions are presented below:

Table 1, Evaluation Questions

Evaluation Questions
Question 1. Background: What are the current arrangements for the collection of excise duty on tobacco products in the Member States?
Question 2: To what extent do the current arrangements for tobacco excise duty on tobacco products safeguard Member States' budgetary objectives?
Question 3: To what extent do the current arrangements for excise duty on tobacco products ensure the proper functioning of the Internal Market and avoid distortions in competition?
Question 4: To what extent are the current arrangements for excise duty on tobacco products implemented in a cost-effective way?
Recommendations

In order to appropriately answer these questions, the study has completed:

- A broad consultation of Member States administrations³.
- An online survey of economic operators.
- Field measurements in six⁴ Member States, including visits to both authorities and economic operators.
- Qualitative analysis of existing legislation, past studies and economic literature.
- Quantitative analysis of economic data.

¹ According to Article 45 of Directive 2008/118/EC, By 1 April 2015, the Commission shall submit to the European Parliament and the Council a report on the implementation of this Directive. While according to Article 19 of Directive 2011/64/EU, every four years, the Commission shall submit to the Council a report and, where appropriate, a proposal concerning the rates and the structure of excise duty laid down in this Directive.

² Directive 2011/64/EU and Directive 2008/118/EC

³ 27 out of 28 Member States have provided detailed responses to the study questions

⁴ Denmark, Finland, Greece, Poland, Romania and the United Kingdom; an additional case study has been conducted in Germany; however this has been achieved mainly through phone interviews and desk research.

Safeguarding Member States' budgetary objectives

The amount of duty that tax administrations lose to illicit trade is about €11.1 billion. However illicit tobacco prices are below retail prices. This means that if illicit consumption was eliminated total tobacco consumption would fall as consumers previously buying illicit products would face higher prices. The realisable level of duty figure, after adjusting for such volume changes, is estimated in the range of €6.1 billion to €7.2 billion per annum. If the illicit cigarette-buying population is more price sensitive than the average population, then the realisable values could be lower than this. On the other hand, inclusion of other drivers of duty loss (e.g. misclassification) would drive the gap upwards.

Extent to which definitions of excisable tobacco products enable adequate collection of excise duties

With a number of exceptions, which are detailed below, this evaluation concludes that, overall, the definitions of Art 2-5 Directive 2011/64/EU have proven to be effective and are generally appropriate for enabling adequate (correct categories and rates) collection of excise duties for the large majority of manufactured tobacco products.

A number of key findings qualifying the conclusion above are, however, necessary:

- At the moment, EU excise duty legislation does not consider e-cigarettes to be an excisable tobacco product. In light of the growing consumption of e-cigarettes, as a substitute to excisable tobacco products, the long term budgetary implications of not including e-cigarettes within the framework of harmonised excise duties may prove to be significant.
- The current formulation of Art 4 (1) of the Directive contains both objective as well as subjective criteria for classifying a tobacco product as a cigar/cigarillo for excise duty purposes. Even though the interpretation of these criteria lie at the heart of existing disputes, differences in the level of taxation between excise duty categories are being credited as a driving factor in the reported emergence of so called "borderline"⁵ products, particularly those seeking to take advantage of the lower levels of taxation of cigars/cigarillos.
- Even though the size of the cigarillos market (of which most 'borderline' products are a subset of) is relatively small when compared to the total market of excisable tobacco products, the *hypothetical* budgetary implication of misclassification on some of the individual countries which have reported problems may be significant.⁶
- The current definition of Art 5(1) (a) and specifically, the wording of "*without further industrial processing*", appears not to be appropriate in light of giving sufficient legal clarity for the inclusion of a number of products which arguably can be smoked as smoking tobacco. This includes products such as raw tobacco, partially processed tobacco, dried leaves and other types of tobacco which are reported to being sold directly to consumers. However, in the absence of measures of monitoring and control, it was not possible to adequately quantify the resulting revenue impact.
- Due to the fact that Art 5 (1) (a) represents a catch-all category, its main purpose is to enable the taxation of tobacco products that are not specifically de-

⁵ Tobacco products which arguably fulfil the minimum criteria for inclusion in one excise tax category but whose classification is disputed or called into question by tax authorities on the basis of their properties and normal consumer expectations.

⁶ Potential revenue losses caused by potential misclassification are not included in the excise duty gap calculation and would add to the total value.

fined in the other articles, this evaluation has found that this purpose is adequately fulfilled in the case of water-pipe tobacco, however products in this category generally exhibit characteristics which are very different than the ones of water-pipe tobacco, meaning that: applying the same rate to water-pipe tobacco may lead to (a) water-pipe tobacco being over taxed, pushing consumption towards the illicit market, or (b) other types of products in the category being under-taxed, leading to potential revenue losses and harmful tax-induced price advantages.

- In the current definition of Art 5(1) (b) "put up for retail sale and which can be smoked", the treatment of bulk tobacco refuse put up for sale is unclear. In order to remove this legal uncertainty it has been suggested to remove the wording "retail" from the definition.

Extent to which definitions of excisable tobacco products enable monitoring, verification and authentication, and identify illicit trade, evasion and abuse in the Internal Market

As currently formulated, the definitions of Art 2-5 are not fully appropriate in light of enabling effective and efficient monitoring of excisable tobacco products.

The findings of this evaluation have shown that the EMCS and the mechanism of administrative cooperation and exchange of information are key elements in the fight against tax fraud. Additionally, Member State administrations have pointed out that it is not possible to use administrative cooperation of the Council Regulation (EU) 389/2012 for products not monitored via EMCS.

As a result of this, any negative influence that the current definitions of excisable tobacco product has on the functioning of those systems will decrease the capacity of Member States to monitor the logistics of excisable tobacco products, fight illicit trade, abuse and fraud.

There are two different ways in which the functioning of the system is negatively affected: The first stems from the inconsistent treatment of certain excisable tobacco products across the Member States. The second manner in which the system is negatively affected results from the limitation of scope of the Directive, which excludes certain tobacco products (raw tobacco in particular), from the definitions of excisable tobacco products and hence from the scope of the EMCS.

With respect to the former issue, this evaluation has found that the inconsistent inclusion of a number of tobacco raw materials, intermediaries or by-products within the scope of the EMCS and the administrative cooperation, negatively affects the capacity of Member States to monitor and control the logistics of excisable tobacco products and fight illicit fraud. While not necessarily causing the inconsistent treatment, the dual classification⁷ of tobacco products for excise and customs purposes exacerbates the legal uncertainty around the treatment of certain products whose classification as excisable is contested. This effect is mostly present with respect to products belonging to CN classifications which include both excisable as well as non-excisable tobacco products. In certain cases, it also regards products whose tariff classification (and accompanying explanatory notes) is inconsistent with the definitions of the Directive.

⁷ *Despite the fact that, from a legal perspective, the treatment of tobacco products for excise purposes is not bound by the treatment of the product for customs purposes, due to the various processes of classification and monitoring, and indirect link between the two exists de facto*

Our analysis of the extent to which the treatment of products not defined by the Directive impacts the ability to perform monitoring of trade/ logistics of taxable tobacco products suggests the following conclusions:

- Member States have reported that raw tobacco is diverted from the “legal” supply chain and used in the large and medium scale production of excisable tobacco products outside the premises of an authorised warehouse keeper, hence away from the control mechanisms of Member States
- Despite the lack of mechanisms in place to adequately quantify the amounts of raw tobacco diverted into the illegal supply chain, the quantification of illicit trade, as included in the excise duty gap section of this report, includes “contraband” (i.e. fake) as well as non-duty-paid (NDP) products. Quantities of raw tobacco diverted from the legal circuit will serve as raw materials to the “contraband” part of illicit trade and are included in the calculation of the excise duty gap
- Systematic, real-time data and information on the logistics of raw tobacco would increase the ability of Member States to fight illicit trade and increase their capacity to fight against criminal organizations involved in the illicit production of excisable tobacco products
- The current arrangements for regulating the movements and logistics of raw tobacco applicable at national⁸, EU or international level are unable to generate systematic, real-time data in electronic format; as such they are not suitable for use in risk assessments and the targeting of control measures in a cost-effective manner.
- Any systematic monitoring of raw tobacco across the EU is not possible in the absence of a unified definition of what constitutes raw tobacco for the purpose of attaining the objectives of excise duty legislation.

As a result, on the final point, this evaluation concludes that the absence of systematic, real-time monitoring of raw tobacco across the EU has a strong negative impact on the ability of Member States to perform monitoring of the logistics of excisable tobacco products and fight against illicit production and trade.

Ensuring the proper functioning of the internal market

Overall, we find that the current arrangements for excise duty on tobacco products do not fully ensure the proper functioning of the Internal Market, mainly due to the impact of the differentiated application of the rules regarding the Minimum Excise Duty (MED)⁹; the inconsistent treatment of a number of tobacco products and of e-cigarettes and the tax induced substitution between and within product groups. The lack of harmonisation of anti-forestalling measures¹⁰ also somewhat hinders the functioning of Internal Market. Full harmonisation of anti-forestalling measures, however, is seen to be neither feasible nor welcome by Member States.

With those exceptions, this evaluation has concluded that the current structure and rates generally allow for neutral conditions of competition and the free formation of

⁸ Only two countries (SK and HU) have reported to collect systematic, real-time data on the production, movement and overall logistics of raw tobacco.

⁹ Minimum Excise duty, as regulated by Art 7 (4) and 8 (6) of Directive 2011/64/EU

¹⁰ Anti-forestalling measures are certain legislative or administrative measures which aim to limit to ability of economic operators to take advantage of the lesser duty rates before a planned duty change, for example, by releasing for consumption large quantities of excisable tobacco products in periods before a duty change is known or expected to occur)

prices and has found no clear evidence of changes in trade patterns being induced by recent changes in the tobacco excise duty levels.

Derogations and exceptions are found to have a limited impact on cross-border shopping and illicit trade.

Extent to which the rules on the MED¹¹ allow neutral conditions of competition

The MED is applied only in certain Member States and its level differs significantly. It affects the relative price of economy cigarettes and affects relative prices between Member States.

Given the various interpretations given by Member States with respect to the limitations of the MED, the nature of the MED and the applicable rules regarding its use do not seem to be clear, despite the Commission having answered a request for clarification. There is some evidence of non-compliance with the rules concerning the level at which the MED on cigarettes may be set.

There is evidence to suggest that the implementation of the MED has affected neutral conditions of competition (by distorting relative prices of different types of cigarettes) and the proper functioning of the internal market (by affecting some countries to a greater extent than others). However, as the market share of economy cigarettes in the EU has increased over time, this evaluation concludes that the negative influence of the MED is most likely offset by other factors.

Extent to which changes in trade patterns have been induced by changes in excise duty levels

Our analysis of the extent to which changes in trade patterns have been induced by changes in the tobacco excise duty levels provides the following key findings:

- Changes in excise duties only affect trade patterns via the impact on retail prices – if excise duties were absorbed by manufacturers there would be no impact on trade;
- Duty changes are generally fully passed through to consumers and both economic operators and tax administrations believe that this has led to excise duty shopping by consumers and increased levels of illicit trade;
- The incentive for excise duty shopping has changed somewhat over time but the impact on trade cannot be identified by economic data;
- Changes in excise duties have almost no impact on the choice of manufacturing location;
- Illicit trade is often more affected by abrupt changes in excise duty rates than by the actual level at which it is set. Illicit trade, once established, declines very slowly and is difficult to reduce.

Extent to which the current rate structure guarantees the proper functioning of the internal market

Our analysis of the extent to which the current structure and rates of the excise duties for manufactured tobacco guarantee the proper functioning of the Internal Market suggests the following conclusions:

¹¹ *Minimum Excise duty, as regulated by Art 7 (4) and 8 (6) of Directive 2011/64/EU*

- The current structure and rates are generally considered to allow for neutral conditions of competition and the free formation of prices, although the MED is considered by some stakeholders to place a constraint on these;
- Changes in the level of excise duties can lead to substitution both within a given type of tobacco product (e.g. from premium to economy brands, or vice versa) and between different types of tobacco products (e.g. from cigarettes to Roll your own (RYO) tobacco or vice versa). Many other factors affect demand for tobacco products (e.g. household incomes) and these influences can dominate excise duty changes;
- Impacts do not seem to differ significantly between manufacturers as all manufacturers will adjust their product portfolios in line with demand (e.g. many manufacturers are currently entering the market for e-cigarettes in response to increased demand for this product).

The impact of derogations and exceptions on the Internal Market

Our analysis of the impact of derogations and exceptions has identified the following key results:

- There are mixed feelings amongst tax administrations and economic operators concerning the impact of derogations and exceptions;
- Those respondents that considered that there is a non-trivial impact of derogations and exceptions highlighted cross-border shopping, illicit trade / smuggling, classification uncertainty and ease of adaptation to be the key impacts.

Extent to which non-harmonisation of anti-forestalling is detrimental to the proper functioning of the Internal Market

Our assessment of the extent to which non-harmonisation of anti-forestalling measures is detrimental to the proper functioning of the Internal Market has found that:

- A wide range of measures are currently in place across the EU;
- The measures in place are considered to be beneficial by tax administrations and some economic operators but other economic operators feel that the measures are not effective.
- The lack of harmonization is perceived to somewhat hinder the functioning of the single market but there is little call for harmonization by either tax administrations or some economic operators. Full harmonization is not considered feasible in the absence of harmonization of tax collection systems (e.g. tax stamps, fiscal markings, etc.).

Efficiency of the current arrangements

The analysis of the administrative and compliance costs borne by tax administrations and economic operators indicates that the greatest negative impact stems from the current definitions as laid down in Directive/2011/64 and in the existence of inconsistencies between them and the Explanatory Notes to the CN. In both cases efficiency is negatively affected by the increase in the operating costs.

The analysis shows that the primary driver is represented by legal uncertainty over the treatment of specific products.

Even though the costs at a systemic level are (still) relatively small as disputed cases concern niche products, the impact on the single business/tax administration can be

significant. In the case of the tax administration, resources need to be spent on dealing with the dispute thus they are diverted from other tasks.

From the perspective of the economic operator, the direct costs of preparing the case (e.g. legal opinions) add up to more indirect costs such as the forgone revenues for a delayed launch of the product, financial distress, etc.

Additionally, the application of differentiated definitions of tobacco products for excise duty and for customs purposes is considered to be problematic as it translates into double entries and legal uncertainty for smaller operators. Larger manufacturers on the contrary, did not report problems, the reason likely being that they use advanced IT platforms which automate the process of dealing with EMCS and coding.

One area of significant potential reduction of costs regards the compliance with the requirements of economic operators with excise stamp obligations, and in particular, with the rules regarding the proof of destruction in light of recovering excise duty due for products which became unfit for consumption or for tax stamps which were never applied to products. This finding, however, relates to national measures applied at Member State level. EU legislation allows the use of tax stamps but does not regulate the procedures which are applicable.

Recommendations

In line with the objectives of the current legislation on tobacco taxation, the recommendations presented in the context of this study aim to:

- Safeguard the budgetary interest of MS
- Ensure proper functioning of the internal market
- Promote the efficient working of both tax authorities and economic operators

The main domains found to have the greatest potential for improvement relate to the definitions of excisable tobacco products, duty rates and tax structure and fiscal marks. The executive summary reproduces the most important recommendations in these domains.

Definitions of excisable tobacco products

The revision of Art 2-5 of Directive 2011/64/EU, which defines excisable tobacco products has the potential to bring significant improvements to the effectiveness (safeguarding budgetary interest of Member States and improving the ability of Member States to control the logistics and monitoring of excisable tobacco products) as well as the efficiency of the tax collection system. In this area, the following recommendations are suggested:

- The possibility of including e-cigarettes within the scope of the harmonised system of excise duty on tobacco products should be further investigated.
- The possibility of introducing raw tobacco within the scope of monitoring of excisable tobacco products should be further considered in order to ensure that the data on the logistics of raw tobacco becomes available, in a systematic and comparable format across the territory of the EU. This recommendation, however, may imply significant costs for tax administrations¹² as well as the economic operators involved, for this reason, it is considered necessary for the as-

¹² E.g. setting up the legislative framework, increasing administrative capacity for control and verification, upgrading IT systems, etc.

pect of cost to be adequately investigated and taken into account when deciding on further measures.

- It is recommended that water-pipe tobacco be introduced in a separate tax category, allowing the imposition of an adequate rate in relation to the characteristics of the product.
- Steps should be taken towards more objective criteria for classification. This recommendation could be achieved by describing excise categories with reference to the CN codes, as is the current practice with alcohol and mineral oils.

Rates and structure of Excise duty

It is recommended to align minimum excise duty taxes (i.e. through a mechanism similar to the MED on cigarettes¹³) of cigars/cigarillos to the minimum excise taxes on cigarettes. In order to eliminate the incentive to market “borderline” products, such a mechanism does not need to go beyond the objective of ensuring that the same minimum excise tax is levied per unit of cigar/cigarillo as the minimum excise tax levied per unit of cigarette. This recommendation may also be taken up individually, by Member States, which, under the existing arrangements can apply a minimum tax floor¹⁴ on cigars/cigarillos when using an ad valorem or mixed tax structure.

This evaluation recommends that the Commission revises the rules surrounding the MED on cigarettes to provide sufficient legal clarity with respect to the upper and lower limits at which it may be set.

Excise stamps and Track and Trace systems

In light of the evidence collected and presented in the context of this evaluation¹⁵, the complete substitution of excise stamps by track and trace systems is not recommended at this moment.

The measurement of administrative and compliance cost conducted has revealed that the management of excise stamps imposes significant operating costs for economic operators; as a result of this, the continuous development of the track and trace systems should continue to be within the focus of the EU Commission and Member States. A future phasing out of excise stamps, when the capabilities and features of the systems will be, at minimum, on par with the expectations of the Member States in terms of their monitoring, control and authentication functions should be considered.

¹³ The MED is allowed by Art 7(4) and 8 (6) of Directive 2011/64/EU

¹⁴ Art 14. Directive 2011/64/EU

¹⁵ As detailed in Appendix 5 – Question 1: Background Information, and specifically in Q1.2

Introduction

Rationale, objectives and scope of the study

In the context of the obligation to make regular reports on tobacco taxation¹⁶, the Commission is aiming to revise the main legislative acts in question in order to generate a reduction of administrative expenses for tax administrations and economic operators while increasing the level of compliance and security in applying excise duties on tobacco products and protecting Member States' budgetary interests. Against this backdrop, Directorate General Taxation and Customs Union (DG TAXUD) has commissioned this study.

The present study aims at *evaluating* the current EU legislation imposing excise duties on tobacco products (Council Directive 2011/64/EU). This evaluation is resolutely *formative*, in the sense that it should facilitate learning in order to help improve the legislation. The objective is to provide The Commission with the economic information to adopt a policy and assess the likely impact of this future policy for revising Directive 2011/64/EU between 2014 and 2016.

In this respect, the evaluation should:

- Assess the extent to which Directive 2011/64/EU meets its objectives in terms of securing the revenues of tax administrations and ensuring the proper functioning of the internal market;
- Identify issues that have the highest potential for efficiency gains in terms of securing the revenues of tax administrations and reducing administrative and compliance costs, while meeting the requirements for a proper functioning of the internal market;
- Formulate recommendations, possibly based on good practices, on how best to address identified issues.

To this purpose, the study maps the main characteristics of the national excise systems for tobacco products, within the framework of the two main directives¹⁷ regulating excise duties, and excise duties on tobacco in particular. It then assesses the effectiveness of the EU excise duty system for tobacco products in terms of its capacity to safeguard Member States' budgetary objectives, and ensure the proper functioning of the Internal Market while avoiding distortions in competition.

Using a case-study approach, the study goes further in depth into a number of selected issues, while also assessing the administrative and compliance costs of implementing some elements of the legislation. A final, cross-country analysis has enabled the identification of good practices while enabling the formulation of recommendations.

Evaluation questions

In addition to the evaluation questions that have been answered by the present study, a mapping of the current arrangements reflecting the different approaches of the na-

¹⁶ According to Article 45 of Directive 2008/118/EC, By 1 April 2015, the Commission shall submit to the European Parliament and the Council a report on the implementation of this Directive. While according to Article 19 of Directive 2011/64/EU, every four years, the Commission shall submit to the Council a report and, where appropriate, a proposal concerning the rates and the structure of excise duty laid down in this Directive.

¹⁷ Directive 2011/64/EU and Directive 2008/118/EC

tional systems for excise duty collection has been conducted, this background consists of the following elements:

Table 2 Mapping of current arrangements

Background: What are the current arrangements for the collection of excise duty on tobacco products in the Member States?
Q.1.1 What is the structure of the excise duty applied in each Member State, inclusive of the minimum excise duty?
Q.1.2 What are the main features of the tobacco taxation collection systems?
Q.1.3 What licencing and authorisation apply to operators involved in the tobacco supply chain?
Q1.4 What are the processes / activities performed by Member States' authorities to ensure the collection of tax revenue (e.g. in terms of monitoring, tax assessment, collection, authentication and verification, auditing, etc.)?
Q1.5 What IT technologies are used by tax authorities to combat illicit trade and ensure the collection of tax revenue?

Table 3 presents a brief summary of the evaluation questions that have been analysed in the context of this study; Appendix 1 – *Evaluation Matrix and Evaluation Design* of this report presents in detail each evaluation question, including sub-questions, indicators, descriptors, as well as evaluation criteria and data sources.

The complete methodological approach used for providing answers to these questions may be found in the same appendix.

Table 3 Evaluation questions

Question 2: To what extent do the current arrangements for tobacco excise duty on tobacco products safeguard Member States' budgetary objectives?
Q2.1 To what extent do the definitions of taxable products in Articles 2-6 of Directive 2011/64/EU allow for adequate (correct categories and rates) collection of the due excise duties for manufactured tobacco products?
Q2.2 To what extent are the definitions of taxable products in Articles 2-6 of Directive 2011/64/EU appropriate to enable monitoring, verification and authentication, and identify illicit trade, evasion and abuse in the Internal Market?
Q2.3 How does the treatment of products not defined by the Directive impact the ability to perform monitoring of trade/ logistics of taxable tobacco products?
Question 3: To what extent do the current arrangements for excise duty on tobacco products ensure the proper functioning of the Internal Market and avoid distortions in competition?
Q3.1 To what extent do the current rules on MED (Minimum Excise Duty) allow for neutral conditions of competition and the proper functioning of the internal market (avoiding distortion of competition or trade)?
Q3.2 To what extent have changes in trade patterns been induced by changes in the tobacco excise duty levels?
Q3.3 To what extent does the current structure and rates of the excise duties for manufactured tobacco guarantee the proper functioning of the Internal Market?
Q3.4 What is the impact of the derogations and exceptions granted to/by certain Member States/EU regions in application of the tobacco excise duties on the Internal Market?
Q3.5 To what extent non-harmonisation of anti-forestalling measure is detrimental to the proper functioning of the Internal Market.

Question 4: To what extent are the current arrangements for excise duty on tobacco products implemented in a cost-effective way?

Q4.1 Are there any administrative tasks, monitoring or control procedures that could be improved in order to achieve a high level of efficiency for the tax authorities (i.e. in terms of administrative costs)?

Q4.2 Are there any administrative tasks, monitoring or control procedures that could be improved in order to achieve a high level of efficiency for economic operators (compliance costs)?

Recommendations

What are the measures to be considered at EU level in order to ensure that the tax debt is effectively collected?

What are the measures to be considered at EU level in order to ensure the proper functioning of the Internal Market and avoid distortions in competition?

What are the measures to be considered at EU level in order to decrease administration / compliance costs on tax administration and economic operators?

Content and structure of the report

As a **final report**, this report contains the full results of the work undertaken in the context of the study. This document is a revised version of the draft report presented in the context of the “*Tobacco round table*” organised by the European Commission on the 6th of June 2014 in Brussels.

The present introduction contains general considerations with respect to the purpose, objectives and scope of this evaluation.

The following two chapters: “Background” and “Methodology”, provide a brief presentation of the current legislative framework applicable in the area of excise duties on tobacco products and explanations on the analytical design and data collection work. In order to improve the readability of the report, these relevant sections are accompanied by detailed appendixes¹⁸ which present in more depth the same issues. These preparatory chapters are meant to serve as an introduction to the main concepts and terminology that is present throughout the rest of the evaluation. A much more thorough descriptive of the main features of the tax collection system has been done in the context of Question 1.

In light of the fundamentally descriptive nature of Question 1, in order to improve readability, the findings connected with all sub-questions within this chapter have been taken out of the body of the report and annexed as Appendix 5 – *Question 1: Background Information*

The main body of the report is structured along the lines of the set evaluation questions in order to present the specific impacts of the Directive on the effectiveness of the main objectives pursued (direct budgetary impact, functioning of the internal market, ensuring proper monitoring and control) as well as on the efficiency of the system for administrations and economic operators.

All evaluation questions are answered on the basis of collected data and indicators, as described in the evaluation matrix. In order to ensure transparency and build a convincing narrative, the evidence gathered and analysed is presented in the body of the report in support of the conclusions presented.

¹⁸ Appendix 1 – Evaluation Matrix and Evaluation Design; and Appendix 5 – Question 1: Background Information

A summary of the main conclusions for each evaluation question is included at the end of each chapter.

The final chapter is dedicated to recommendations directed at the European Commission, as supported by the evidence gathered in the context of this study.

In light of the need to reduce the size of the report, appendixes have been prepared with the aim of sharing relevant information collected in the context of the study with the Commission.

Background

This chapter contains a brief overview of the general legislative context in which the current arrangements on excise duties on tobacco function. This overview summarises and described the most important legislative acts and other arrangements applicable at the moment of the evaluation.

This chapter is necessary in order to clarify some of the concepts and terms used throughout the evaluation. With the exception of this present chapter, the body of the report and the answers to the evaluation question will assume a high level of background knowledge from the reader and will not contain explanations with respect to the concepts.

In accordance with the principles of the single market, the Treaty on the Functioning of the European Union (TFEU) stipulates that “*the Council [...] shall adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition*”¹⁹.

The basic principles applicable to all products subject to excise duties have been laid down in Directive 92/12/EEC²⁰ subsequently replaced by Directive 2008/118/EC²¹. The latter represents the reference point for the production, handling and movement of excisable products.

Council Directive 2008/118/EC

The rationale behind the adoption of a common framework for all products subject to excise duties is detailed in the preamble of Council Directive 2008/118/EC. The main objectives are the proper functioning of the internal market and the effective collection of the tax debt to safeguard the budgetary interests of Member States.

The Directive, inter alia:

- Lists the categories of goods for which excise duty is levied, while referencing the legislative acts which further define each category;
- Defines certain terms in order to ensure harmonisation and common understanding in the internal market, including a taxonomy of the different economic operators involved in the supply chain of tobacco products;
- Enumerates some of the derogations and exemptions applicable;
- Sets forth certain common provisions relating to the production, processing and holding of excise goods;
- Lays down the procedure applicable for the movement of excise goods under duty suspension and certain aspects which relate to the movement and taxation of goods after their release for consumption.

¹⁹ Article 113, Treaty on the functioning of the European Union, Official Journal of the European Union, C 83/94, 30.3.2010

²⁰ Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products OJ L 76, 23.3.1992

²¹ Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC, Official Journal of the European Union L 9/12, 14.1.2009

Council Directive 2011/64/EU

The arrangements on the taxation of tobacco products were first introduced in 1972²². Significant changes and amendments were made in the course of the 1990s through the adoption of a series of Directives aimed at simplifying and updating the general framework²³.

Since then, a number of successive revisions amended the legislative framework²⁴. In 2011 in the interest of clarity and rationality and with the aim to streamline and simplify the provisions on the taxation of tobacco products, a single legislative act was adopted, namely Council Directive 2011/64/EU. This latter act, together with Council Directive 2008/118/EC, represents the reference point for the taxation of tobacco products at the moment.

Directive 2011/64/EU lays down general principles for the harmonisation of the structure and rates of the excise duty to which the Member States subject manufactured tobacco. More specifically, it contains:

- Further explanations on the meaning of “manufactured tobacco” and specific definitions for cigarettes; cigars and cigarillos; and smoking tobacco (fine-cut tobacco for the rolling of cigarettes or other smoking tobacco);
- Specific tax provisions applicable to cigarettes and the other categories defined, including:
 - The definition and limits for an ad valorem component excise duty (calculated on the maximum retail selling price);
 - The percentage of the specific component of excise duty in the amount of the total tax burden calculated on the basis of the weighted average price;
 - The minimum amount of the overall excise duty;
 - The methods for calculating the weighted average retail selling price (hereafter WAP);
 - Provisions regarding the application of minimum consumption taxes on cigarettes (hereafter MED).

The provisions of Council Directive 2011/64/EU in terms of tax rates and structure distinguish between cigarettes, cigars / cigarillos, fine-cut tobacco for the rolling for cigarettes and other smoking tobacco. Special attention is paid to the issue of fine-cut tobacco for the rolling of cigarettes in light of its high degree of substitution with manufactured cigarettes.

Excise duties can be specific, ad valorem or mixed. A specific excise is levied as a fixed monetary amount of tax per quantity, volume or weight of tobacco, while an ad valorem excise is levied as a percentage of some measure of product value (currently the weighted average price of tobacco).

In a purely specific excise structure, the same mixed monetary amount is applied to all tobacco products of a given quantity, volume or weight, irrespective of their pre-

²² Council Directive 72/464/EEC, later amended by Directive 1979/32/EEC

²³ Council Directive 92/79/EEC of 19 October 1992 on the approximation of taxes on cigarettes; Council Directive 92/80/EEC of 19 October 1992 on the approximation of taxes on manufactured tobacco other than cigarettes and Council Directive 95/59/EC of 27 November 1995 which consolidated the previous arrangements on tobacco products

²⁴ Firstly in 2002 by Council Directive 2002/10/EC and in 2003 by Council Directive 2003/117/EC, followed by an in-depth revision which involved the preparation of an external study, a Commission Report, and an Impact Assessment which led to Directive 2010/12/EC

tax price. This structure tends to discourage consumption of tobacco products, irrespective of their price, is relatively easy to administer, delivers greater budgetary stability and narrows the gap between low- and high-priced tobacco brands. However, a fixed monetary amount disproportionately affects lower-priced products and does not automatically keep pace with inflation and must be adjusted regularly.

Conversely, a purely ad valorem structure tends to lead to lower prices, with a wider gap between low- and high-price brands, but reduces the incentives for (costly) qualitative improvements. While a purely ad valorem structure keeps pace with inflation, it is more complex to administer as both prices and quantities must be kept monitored.

Combining a specific and ad valorem²⁵ component (where the relative weight of each can vary across countries) allows exploiting the best elements of each and at the same time to compensate for their respective weaknesses and to simultaneously pursue a variety of objectives.

The provisions for cigarettes

From the 1st of January 2014, the overall excise duty burden (specific plus ad valorem excluding VAT) must represent at least 60% of the WAP and not less than EUR 90 per 1,000 cigarettes. The 60% rule need not be complied with if a country levies an excise duty of at least EUR 115 per 1,000 cigarettes. Bulgaria, Estonia, Greece, Latvia, Lithuania, Hungary, Poland and Romania are granted a transitional period until 31 December 2017. The territory of Corsica has also been granted a transition period, whereas small-scale producers in the remote regions of Azores and Madeira are given an exemption.

The minimum excise duty (MED) and the weighted average price (WAP)

The two concepts mentioned above are worth explaining as they represent pivotal elements of the current system, namely the minimum excise duty and the weighted average retail selling price.

A minimum excise duty (hereafter MED) can be defined as a fixed monetary amount per quantity, volume or weight that applies if the excise duty falls below a minimum floor. In a system with MED, lower-priced products are taxed at the specific minimum rate, while higher-priced (i.e. above the floor) products are taxed at the normal rate, which includes the ad valorem component. In the European context, the MED has usually been understood as a specific amount since its introduction in Article 16(5) of Council Directive 1995/59/EC. The primary effect of the MED is to counterbalance the effects of the ad valorem component in the case of cheaper products.

Articles 7 (4) provides that *"where necessary, the excise duty on cigarettes may include a minimum tax component, provided that the mixed structure of taxation and the band of the specific component of the excise duty as laid down in Article 8 is strictly respected"* and Article 8(6) allows for the introduction of a MED.

The issue of the weighted average retail selling price (hereafter WAP) represents a major aspect of discontinuity with the past. Taking stock of the outcomes of the revision that took place in 2008 and led to the adoption of Council Directive 2010/12/EC, the current Directive confirms the use of the WAP instead of the most popular price category (MPPC) as a reference point for setting minimum tax requirements. As

²⁵ According to Par. 11 Council Directive 2011/64/EU, the specific component is calculated per unit of product, while the ad valorem component is based on the retail selling price, inclusive of all taxes.

pointed out in the 2008 Impact Assessment²⁶, the use of the MPPC entailed distortions of the competition. Not only was the MPPC highly volatile due to changes in tax component, price structure and external factors, but also it gave the dominant tobacco manufacturer the power to strategically shift the price of the MPPC brand so as to increase the tax burden of the competitors. Moreover, as the MPPC could fall in a low price category in some Member States, and in a high price category in others, it was ill suited to ensure a uniform minimum level of taxation. The current provision thus adopts the WAP defined as the total price of all quantities released for consumption divided by the total quantity (based on data from the previous calendar year).

The provisions for tobacco products other than cigarettes

Unlike cigarettes, other manufactured tobacco products are not required by the Directive to be subject to a mixed structure, as a result, manufactured tobacco products other than cigarettes are taxed with either a purely specific, a purely ad-valorem or a mixed system, depending on the individual choices of Member States.

At the moment, the minimum requirements for the overall excise duty charged in tobacco products other than cigarettes differ across product groups. In the case of cigars and cigarillos, the overall excise duty cannot be lower than 5% of the retail selling price (including all taxes) or EUR 12 per 1,000 pieces or per kilogram. As pointed out in previous paragraphs, particular attention is paid to fine-cut tobacco for the rolling of cigarettes. The initial level of taxation (40% of WAP or EUR 40 per kilogram) is set to increase progressively starting from 1 January 2013 until 1 January 2020 when it will reach 50% of WAP (or EUR 60 per kilogram). This pattern suggests that it is an explicit objective of the European Commission and the Council to bring the minimum levels of taxation on fine-cut tobacco closer to that of manufactured cigarettes to better account for their high degree of substitution²⁷.

In the case of "other smoking tobacco" the excise duty may not be lower than 20% of the retail selling price (including all taxes) or EUR 22 per kilogram. Table 4 summarizes the requirements.

Table 4 Excise duty structure and limits for tobacco products other than cigarettes

Overall duties ²⁸ excluding VAT	
Cigars and cigarillos	5% of retail selling price (inclusive of all taxes) or €12 per 1000 items or per kilogram
Fine-cut smoking tobacco for the rolling of cigarettes	40% of WAP or €40 per kilogram. Increases are foreseen to bring the overall excise duty to 50% of WAP or €60 per kilogram by 2020
Other smoking tobaccos	20% of retail selling price (inclusive of all taxes) or €22 per kilogram

Exemptions and derogations

Council Directive 2011/64/EU and Council Directive 2008/118/EC foresee derogations and exemptions in the application of the provisions. For instance, Article 4 of Directive 2011/64/EU allows for Germany and Hungary to postpone the application of the definition of cigars and cigarillos until 1 January 2015. Articles 12(2) and 14(4) give

²⁶ Commission staff Working Document, Accompanying document to 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. (SEC(2008) 2266)

²⁷ Ibid 26

²⁸ Expressed as a percentage, as an amount per Kg or for a given number of items

France the possibility to temporarily apply lower excise duty rates to cigarettes and other tobacco products in Corsica²⁹. By means of Article 10(2) Bulgaria, Estonia, Greece, Latvia, Hungary, Poland and Romania are granted an extension until 31 December 2017 for bringing their overall excise duty on cigarettes within the mandated range. Finally, Portugal can apply a reduced duty rate to cigarettes consumed in the remote communities of the Azores and Madeira made by small-scale local producers.

The provisions laid down in Directive 2008/118/EC apply to the whole territory of the Community made exception for the Canary Islands, the French overseas departments, the Åland Islands and the Channel Islands. Furthermore, the territories not forming part of the customs territory are also excluded, these being the Island of Heligoland, the territory of Büsingen, Ceuta and Melilla, Livigno, Campione d'Italia and the Italian waters of Lake Lugano. These are summarised in Table 5:

Table 5 Exemptions and derogations

	Exemptions (permanent nature)	Derogations (temporary nature)
Directive 2008/118/EC	Canary Islands, the French overseas departments, the Åland Islands and the Channel Islands, Island of Heligoland, the territory of Büsingen, Ceuta and Melilla, Livigno, Campione d'Italia and the Italian waters of Lake Lugano	
Directive 2011/64/EU	Azores and Madeira (PT)	Germany and Hungary (definition of cigars and cigarillos) Bulgaria, Estonia, Greece, Latvia, Hungary, Poland and Romania (57%-rule on cigarettes)

Other aspects of the taxation of tobacco products

In addition to the above mentioned Directives, other arrangements have been made to enhance the ability of Member States to pursue their fiscal objectives. These include the Excise Movement and Control System (hereafter EMCS), the provisions on administrative cooperation, track and trace systems and anti-forestalling measures.

Excise Movement and Control System

The EMCS is a computerised system for monitoring movements of excise goods under a duty-suspension arrangement within the EU. The legal foundations of EMCS are to be found in Decision 1152/2003/EC of the European Parliament and of the Council, dated 16 June 2003, and in Regulation 2009/684 implementing Directive 2008/118/EC. The computerization of the system was preceded by a Feasibility Study conducted in 1999 and 2000 following the recommendations of a High Level Group endorsed by ECOFIN in 1998.

EMCS has been introduced following a "1+3"-phases roadmap that run between 2002 and 2012. It has become operational on 1st April 2010 with the conclusion of Phase 2. The paper-based Accompanying Administrative Document (AAD) had been progressively replaced by an electronic Administrative Document (e-AD) with a phase-in period that lasted until 31 December 2010 after which the AAD lost its legal basis. The e-

²⁹ As made clear in Par. 22 of the Preamble of Council Directive 2011/64/EU derogations will be valid until 31 December 2015.

AD helped to simplify the procedures, making the movement of the goods under duty-suspension more secure and the release of the guarantee for trader quicker. Moreover, the availability of real-time data enhanced the ability of Member States to keep the logistics of the goods under control. The system was upgraded and its functions expanded in 2012 with the possibility for Member States to exchange information and enquiries on the movement of excisable goods.

Administrative cooperation and the exchange of information

The current provisions on cooperation between national tax administrations and the European Commission have been laid down in Council Regulation 389/2012 which provides for "procedures to enable the competent authorities of the Member States to cooperate and to exchange, by electronic means or otherwise, information that is necessary to ensure the correct application of legislation on excise duties" (Article 1(1)). Taking stock of the past experience and the most recent developments (including EMCS), the current provisions acknowledge the benefits and promote the systematic use of electronic means in view of enhancing the effectiveness and the efficiency of the system of excise duty collection.

Among other things, Council Regulation 389/2012:

- Lays down clearer rules and procedures enabling the competent national authorities to cooperate and to exchange other any information that may help to apply the provisions in an effective manner;
- Differentiates between mandatory (with or without prior request) and optional exchange of information;
- Creates a single point of contact in each Member State ('central liaison office') with the possibility of the latter to delegate the task to other authorities/officials for questions of efficiency ('liaison departments');
- Mandates that each Member state should maintain an electronic database with information on registered economic operators and premises authorized as tax warehouses so as to facilitate a rapid exchange of data (e.g. identification number, address, category and nomenclature of the products held/received in each premise);
- Establishes EMCS as the normal means through which information concerning administrative cooperation is exchanged.

Track and trace systems

The main rationale for the adoption of tracking and tracing systems is the facilitation of the investigations into tobacco smuggling and illicit trade, i.e. the identification of the point of diversion of the tobacco products³⁰. A global scale system would allow for a detailed analysis of the logistics of tobacco product and the analysis of smuggling trends, thus it would make it easier to carry out inspections in an efficient and effective way.

Tracking means "systematic monitoring by competent authorities [...] of the route or movement taken by tobacco products through their respective supply chains of manufacture, sale, distribution, storage, shipment, import or export, or any part thereof" (Joossens 2011:2). Tracing instead amounts to recreating the route or movement taken by tobacco products, thus it should be conceived as a retrospective system³¹.

³⁰ European Commission, 2011, *Pricing Policies and Control of Tobacco in Europe (PPACTE)*, Deliverable 5.2: *Illicit tobacco trade in Europe: issues and solutions*, Luk Joossens.

³¹ *Ibid* 30

Given the global nature of the problem of illicit tobacco trade, a first coordinated international response was achieved in 2005 with the signing of the WHO Framework Convention on Tobacco Control (hereafter FCTC)³². In this context, the so called Illicit Trade Protocol (ITP)³³ has been negotiated as a supplementary treaty to the FCTC and it is currently being ratified by the Parties. In Article 8 of the ITC, the arrangements on the adoption of a global scale tracking and tracing regime are laid down. Within five years³⁴ of entry into force of the Protocol, each Party shall require that unique, secure and non-removable identification markings are affixed or form part of all units packed such that a minimum amount of information on the logistics of the product is made available (e.g. data and location of manufacture, machine used, warehousing and shipping, intended market of retail sale, etc.).

³² WHO Framework Convention on Tobacco Control, adopted by the World Health Assembly on 21 May 2003 and entered into force on 27 February 2005.

³³ WHO Protocol to Eliminate Illicit Trade in Tobacco Products, adopted on 12 November 2012 at the fifth session of the Conference of the Parties in Seoul, Republic of Korea.

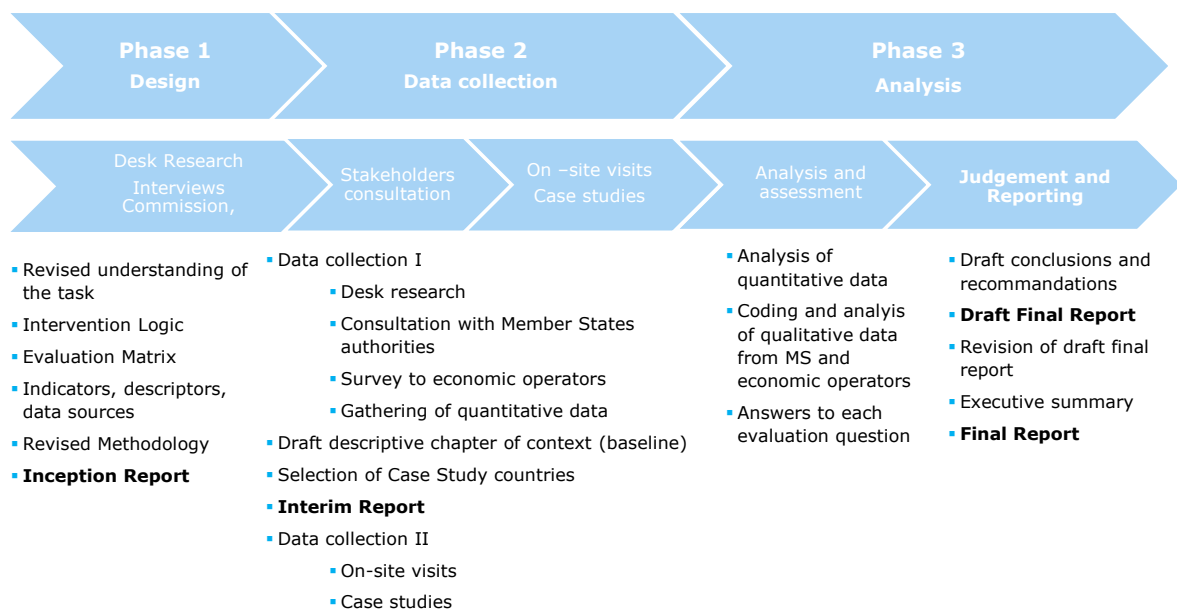
³⁴ An extended roadmap (ten years) is envisioned for tobacco products other than cigarettes

Methodology

This chapter briefly describes the methodological approach used for this evaluation. It offers a simplified overview of the data collection steps which were implemented by the project team. A more detailed insight into the conceptual design and the analytical strategy can be found in Appendix 1 – *Evaluation Matrix and Evaluation Design*

As Figure 1 indicates, the evaluation has been organised into 3 major phases, Design, Data collection and Analysis.

Figure 1 Overall organisation of the work



During the design phase of the study, Ramboll has participated in the Fiscalis seminar on tobacco excise duties in Vilnius (LT) between 29th and 31st October 2013 in order to help better design and focus the evaluation questions towards “problematic” areas, and also to ensure sufficient understanding. The presence in the seminar also helped clarify the scope and role of the present study towards the authorities of Member States while also building the necessary relationships to help prepare a participatory approach.

Below, each phase of the evaluation will be described in broad outline.

Phase 2.1 – Data collection I - Stakeholder consultation

Survey to Member States

In the first phase of data collection, a broad consultation of national tax authorities by means of a survey questionnaire was undertaken. The questionnaire covered almost all aspects of the evaluation and established a comprehensive baseline of the current EU excise duty system as implemented nationally. A copy of the questionnaire is attached in Appendix 2 – *Questionnaire to Member States*.

Following a short piloting phase with a small number of Member States, the questionnaire was sent to all tax administrations by e-mail on 8th November 2013.

The wide majority of Member States have chosen to deliver responses in writing. All submissions have been followed-up by phone, ensuring consistency, avoiding possible misunderstandings. Wherever possible, (as a result of proximity and interest shown by a number of Member States³⁵) face-to-face interviews have been conducted.

The participation rate is considered to be excellent, as 27 out of 28 Member States have provided very detailed answers to the questionnaire.

Survey to Economic operators

A consultation of economic operators by the means of an online-survey has been undertaken. Its main aim was to collect perceptions on and experience with the functioning of the current excise duty structure and identify the most burdensome activities³⁶ in relation to excise duties.

The analysis of the survey answers have taken into account any potential bias or concerted answers in order to give a fair indication of the position of different economic operators involved.

The scope of the questions addressed to economic operators was somewhat different than those addressed to Member States, with most questions focusing around the impact that the current measures have on the activities of operators while others focused on the compliance steps performed.

The survey was officially launched on the 9th of December 2013; The main industry associations of stakeholders (CECCM; ESTA; ECMA; BDTA; COPA-COGECA) were invited to distribute the survey further to all interested economic operators.

The initial deadline for providing answers to the questionnaire was set at 23rd of December 2013; however, due to extraordinary circumstances related to increased workload of economic operators in the weeks preceding the end of the year. The deadline was extended until 15th of January 2014.

Details on how the survey was administered, together with a Microsoft Word version of the questionnaire may be found in *Appendix 3 – Survey Questionnaire to Economic Operators* and in *Appendix 4 – Analysis of survey data from economic operators*.

A total survey population of 48 responses were taken into account in the final analysis of survey data. – However the survey population for a number of graphs may differ from this number due to the design of a number of questions, which allowed respondents to provide an answer for each individual Member State in which they operate.

Details on the survey population as well as a detailed analysis of the answered received can be found in *Appendix 4 – Analysis of survey data from economic operators*.

Desk research and literature review

A broad literature review and desk research has also been conducted; this task has been supported by the study of legislation, administrative notes, academic literature, and statistical data. Where appropriate, it has been complemented by expert input.

³⁵ Belgium, Denmark and Romania

³⁶ i.e. the most time-consuming and resource-demanding activities

Phase 2.2: Data collection 2 (field study)

Upon completing the first round of data collection, a number of good practices as well as problematic areas were identified through the responses of stakeholders. The field study was therefore designed to further investigate the practical implications of these issues, documenting the administrative and compliance costs for tax administrations and economic operators.

Objectives

The objective was to identify good practices and areas that offer the highest potential for improvement in terms of effectiveness and efficiency for the national tax administrations.

The (compliance) costs for businesses were also analysed as part of the field study. The purpose was to get a deeper understanding of the activities they perform in relation to excise duties and assess the extent to which the identified issues result in added compliance cost and/or legal uncertainty.

The country case studies therefore analysed in more detail the administrative tasks, monitoring or control procedures and tools. The time and resources spent on the collection of excise duties were mapped and identified, to the extent possible.

Conducting case studies in selected Member States

The core of the field measurement was constituted by a series of case studies of selected Member States,

The case studies entailed a series of face-to-face interviews with representatives from tax administrations and economic operators from the tobacco supply chain. On average 2-3 group interviews have been conducted in each Member State. For each interview, persons with operational knowledge in the different areas, connected with the implementation of the evaluated provisions were present. As a result, the entire process of compliance and implementation was mapped while the key steps (and/or actions) were further investigated and measured in terms of administrative and compliance costs.

In addition, some desk research was also necessary to extract and supplement some information from legislative acts or administrative notices with respect to obligations and processes that economic operators have to comply with in dealing with excise duty goods.

The cost of current practices and systems for the tax administration were assessed using an Activity Based Costing (ABC) inspired approach in order to estimate the time and resources spent. This has allowed the study team to get an in-depth understanding of the tasks performed in order to collect excise duty on tobacco, and understand how good practices or weaknesses matter in terms of costs.

The process

When conducting the case studies the team members used similar tools, (i.e. interview guides and reporting templates) to conduct the interviews in a uniform manner that ensured consistency in approach.

The results of each case study were reported in a similar and consistent framework, organised on the basis of evaluation questions, facilitating cross-country analysis and reporting.

Selection of countries and motivation for selection

The selection of countries for case studies was an important element of the study design. It reflected the diversity of national contexts (i.e. large/small countries), different national approaches for enabling the collection of excise duties (e.g. with or without tax stamps) as well as different contextual factors (e.g. reported experiences with “problematic issues”).

The selection is considered to have been diverse enough to enable extrapolations and to ensure a solid empirical foundation.

The following Member States were included in the second round of data Collection: Finland, Greece, Denmark, United Kingdom, Romania, Poland³⁷ and Germany³⁸.

Phase 2.3: Data collection 3 (Euromonitor data)

Euromonitor provides country-level tobacco data for each of the EU Member States via its online ‘Passport’ data service. The data available include:

- unit price and retail sales values/volumes by product category (cigarettes, cigars etc.) and sub-category (large cigars, cigarillos etc.);
- average cigarette price by price band;
- penetration of illicit trade in cigarettes;
- volume of trade in cigarettes;
- smoking prevalence.

These data were used in our analysis of the economic impacts of the 2011 Directive, together with data gathered through other desk-based research (e.g. price elasticities) and the information obtained through stakeholder engagement. We have also used the DG TAXUD excise duty tables to form estimates of tax revenues.

There are no reliable, consistent and comprehensive data on the prices and sales volumes of tobacco products across the EU in the public domain.

The value of Euromonitor data is that a consistent methodology is used to estimate the statistics in each Member State. In our assessment, they also avoid the drawbacks of the DG TAXUD releases for consumption data³⁹. Also, the Euromonitor data are broken down between cigarettes, cigars, cigarillos, fine-cut and pipe tobacco whereas in DG TAXUD’s releases for consumption data fine-cut is grouped with other smoking tobacco in several countries

Euromonitor’s business model depends on its provision of non-biased data that are as accurate as possible. The data have been used in previous reports for the European Commission and its Executive Agencies⁴⁰. For these reasons, we consider that the Eu-

³⁷ As a result of resource constraints within the administration, the authorities of Poland did not take part in interviews pertaining to the second round of data collection. The level of detail of the answers given in the first round of consultation and additional desk research, however, allowed the study team to finalise the case study at a satisfactory level.

³⁸ As a result of the explicit request of the German authorities, input to the second round of data collection has been collected in writing, as a result, no country visits were performed in Germany and the interviews with economic operators were undertaken by phone.

³⁹ In particular, in a note to the tables DG TAXUD states that “for a number of Member States, as a result of forestalling (release for consumption of large volumes immediately prior to a tax increase) releases for consumption are artificially high in certain years as compared to the normal pattern”.

⁴⁰ See, for example, Executive Agency for Health and Consumers, 2013, *Economic analysis of the EU market of tobacco, nicotine and related products, Revised Final Report, Matrix Insight*

romonitor data are more reliable than data that are in the public domain and the consistent cross-country methodology means that the data are well-suited to the analysis undertaken in this study.

Phase 3: Analysis and recommendations

The analytical strategy for this evaluation followed the lines defined in the tender and described in Appendix 1 – *Evaluation Matrix and Evaluation Design*.

Through careful triangulation of data and cross-country analysis and comparison, it was possible to establish a baseline in terms of the problems faced by tax administrations and economic operators and their drivers and subsequently answer each evaluation question and sub-question.

Additional mentions regarding the analytical approach to managing quantitative data were further detailed in our request for additional data. For the sake of brevity, these are not re-published in the body of this report.

Question 2: To what extent do the current arrangements for tobacco excise duty on tobacco products safeguard Member States' budgetary objectives?

This question aims to identify potential weaknesses in the current system for collecting excise duty on tobacco products. We begin by looking at the total revenue collected through tobacco excise duties and also the value of revenue avoided, for example because of illicit trade. The latter may, in broad terms, be referred to as the excise duty gap (more strictly the gap is the difference between what should have been collected and what is effectively collected, expressed as a percentage of the revenue due). We estimate the excise duty gap to provide an understanding of its scale

We then look at the contribution of various elements of Directive 2011/64/EU to safeguarding Member States' budgetary objectives. Specifically, we analyse the current tobacco excise system, structure and scope to provide a holistic understanding of the issue.

Total Excise Duty Collected – Cigarettes

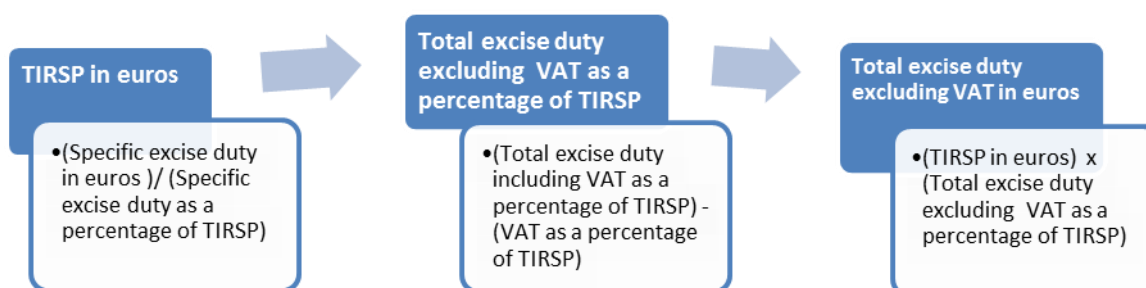
DG TAXUD has published data on the revenues from taxes on consumption of manufactured tobacco between 2008 and 2012. However, these data are not always disaggregated by tobacco product. For example, in Austria, Poland and Greece, tax revenues for cigars, cigarillos and other smoking tobaccos were aggregated with cigarettes tax revenues so that only a single figure is reported. As such, it is difficult to obtain a clear picture of the tax revenues accrued from each type of tobacco directly from these data.

We therefore calculated the total tax revenue from cigarettes based on our knowledge of cigarettes' excise tax rate (from DG TAXUD's excise duty tables⁴¹) and data on the volume of cigarettes sold⁴² in order to estimate the total tax collected. This calculation is illustrated below:

⁴¹ The total tax burden per 1000 cigarettes on excise duty tables includes VAT. A series of calculations were done to obtain the ex VAT value. The calculation also differs between years as some years use TIRSP as a reference point, others use WAP.

⁴² These data were accessed from Euromonitor. We note that there are no data on Cyprus, Malta and Luxembourg and that 2013 data are forecasted values. Our decision to use Euromonitor sales data for this calculation rests on the fact that they avoid a significant drawback of the DG TAXUD releases for consumption data. In particular, in a note to the tables DG TAXUD states that "for a number of Member States, as a result of forestalling (release for consumption of large volumes immediately prior to a tax increase) releases for consumption are artificially high in certain years as compared to the normal pattern". Also, the Euromonitor data are broken down between cigarettes, cigars, cigarillos, fine-cut and pipe tobacco whereas in DG TAXUD's releases for consumption data fine-cut is grouped with other smoking tobacco in several countries and there are no data on releases for consumption of cigars, cigarillos or pipe tobacco.

Figure 2 Calculation of excise duty on cigarettes



In July 2011, DG TAXUD changed its reporting practice. Previously, all excise duty numbers were shown as a percentage of Tax Inclusive Retail Sales Price (TIRSP). Under the new rules, the excise duty data are shown as a percentage of Weighted Average Price (WAP). Given this, we have adopted different calculation methods before and after this switch, as shown in Table 5. A comparison of excise duty net of VAT before and after the change also reassures that the change in methodology itself did not have significant impact on the final results obtained.

The table below shows the detailed transformation performed to obtain the estimate of total excise duty net of VAT on cigarettes from 2008-2013.

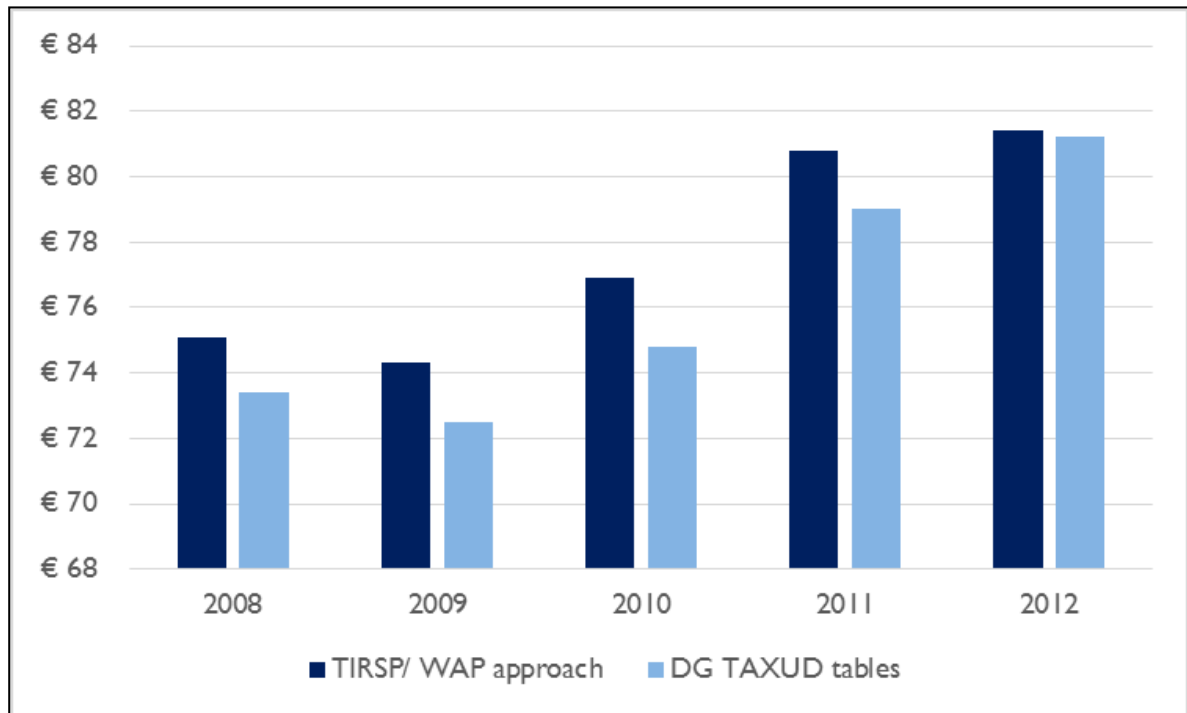
Table 6 Detailed calculation performed for different years

Year	Data available	Calculation
2008-2011 March	Specific excise duty in euros and as a percentage of TIRSP	TIRSP in euros per 1000 sticks = Specific excise duty in euros / Specific excise duty as a percentage of TIRSP
2008-2011 March	VAT and total tax burden (including VAT) as a percentage of TIRSP	Total excise duty excluding VAT as a percentage of TIRSP = (Total excise duty including VAT as a percentage of TIRSP) - (VAT as a percentage of TIRSP)
2008-2011 March		Total excise duty excluding VAT in euros/mn sticks = (TIRSP in euros) x (Total excise duty excluding VAT as a percentage of TIRSP)
2011 July - 2013	WAP, total excise duty including VAT as a percentage of WAP and specific excise duty in euros	Ad valorem excise + VAT in euros = WAP x Total excise duty including VAT as a percentage of WAP – specific excise duty in euros
2011 July - 2013	VAT as a percentage of TIRSP, Ad valorem excise + VAT as a percentage of TIRSP	VAT as a percentage of Ad valorem excise + VAT = (VAT as a percentage of TIRSP) / (Ad valorem excise + VAT as a percentage of TIRSP)
2011 July - 2013	Total excise duty (including VAT) in euros = WAP x Total excise duty including VAT as a percentage of WAP	Total excise duty excluding VAT in euros/mn sticks = Total excise duty in euros – (VAT as a percentage of Ad valorem excise + VAT) x (Ad valorem excise + VAT in euros)

Based on this analysis, the aggregate excise duty collected from cigarette sales in the EU has fluctuated between €72 billion (in 2008) and about €74 billion per annum between 2008 and 2013. These can be compared directly with the DG TAXUD data on cigarettes (at least from 2008 up to 2012) – these vary between €70.5 and €75 billion (but also include revenues from other tobacco products for some Member States, in some years).

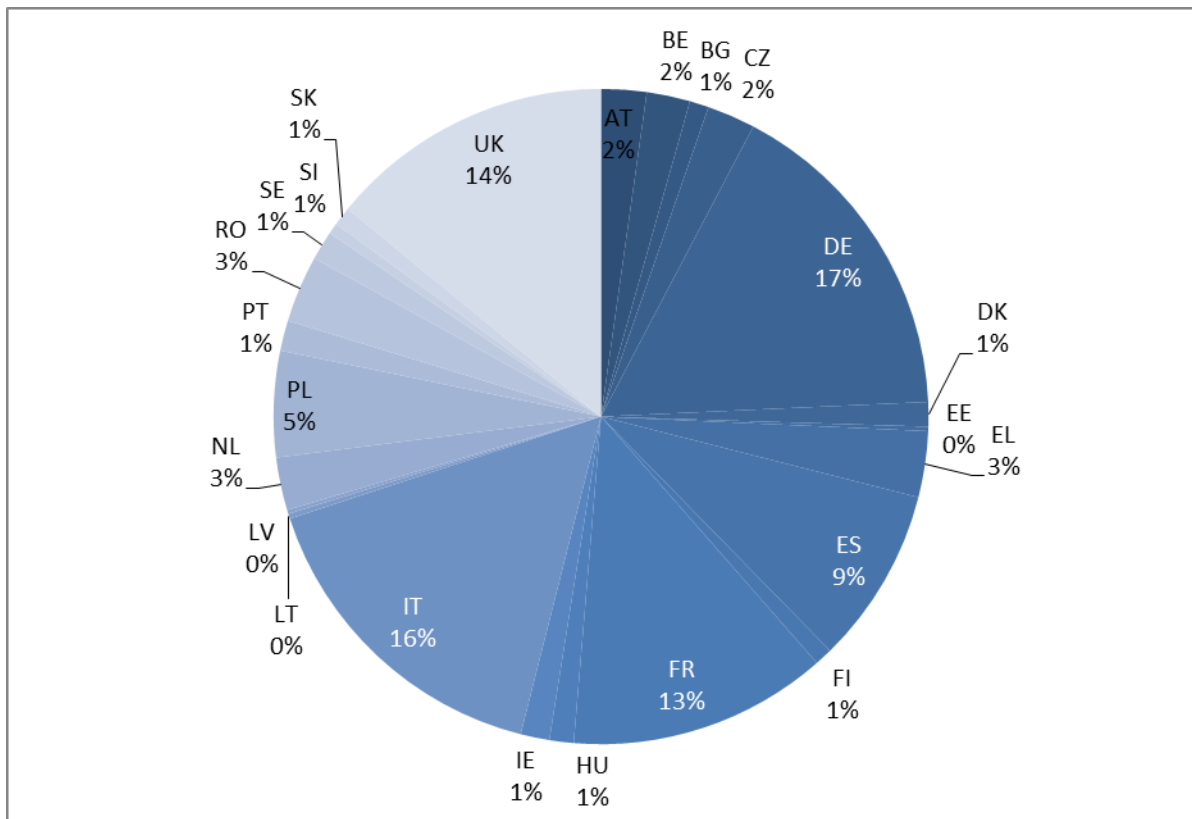
If we compare the overall tax take (excluding VAT) calculated in our analysis this aligns reasonably well with the DG TAXUD tables. For example, in 2012 the disaggregated analysis which we have prepared totals €81.4 billion in taxes (excl. VAT) across cigarettes and other tobacco products. The total from the DG TAXUD tables for this year is €81.2 billion. Previous years are slightly less well aligned – however the trend year to year is broadly similar (i.e. they increase or decrease at the same time). The change from TIRSP to WAP does not appear to be a particularly important factor. The comparison across all tobacco products is illustrated below.

Figure 3: Excise duty revenues from all tobacco products (€bn)



The graph below shows that the Member States with the highest tax revenue from cigarettes are Germany, Italy, the UK and France. Indeed, the tax from the largest four countries represents around 60 per cent of the total tax revenue.

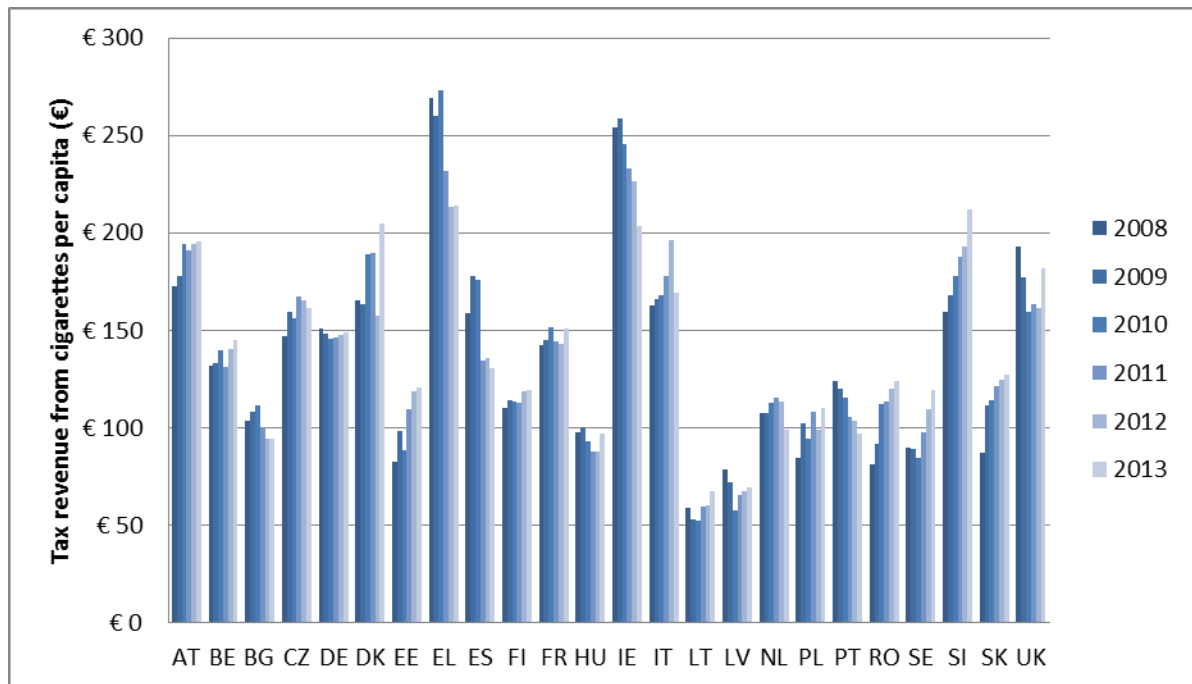
Figure 4: Excise duty revenue from cigarettes by Member State, 2012



Source: Europe Economics' analysis based on approach described in Table 6

It is clear that the countries with the greatest revenues from excise duty on cigarettes are those Member States with higher populations. To provide a clearer picture of the differences in excise duty on cigarettes between Member States we present below estimates of excise duty per capita. This chart shows that per capita excise duty revenues are relatively high in Greece and Ireland, although there has been a decrease over time in these countries (quite possible due to the poor economic performance of these countries in recent years).

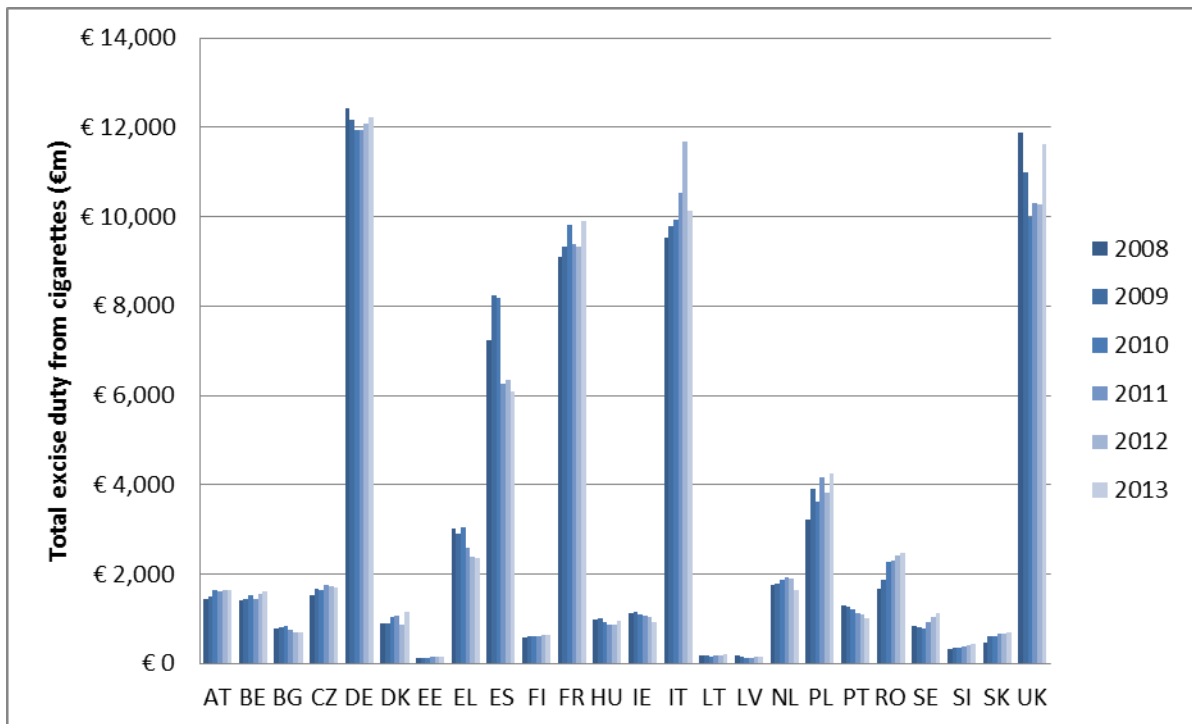
Figure 5: Excise duty revenue from cigarettes per capita, by Member State



Source: Europe Economics' analysis based on approach described in Table 6

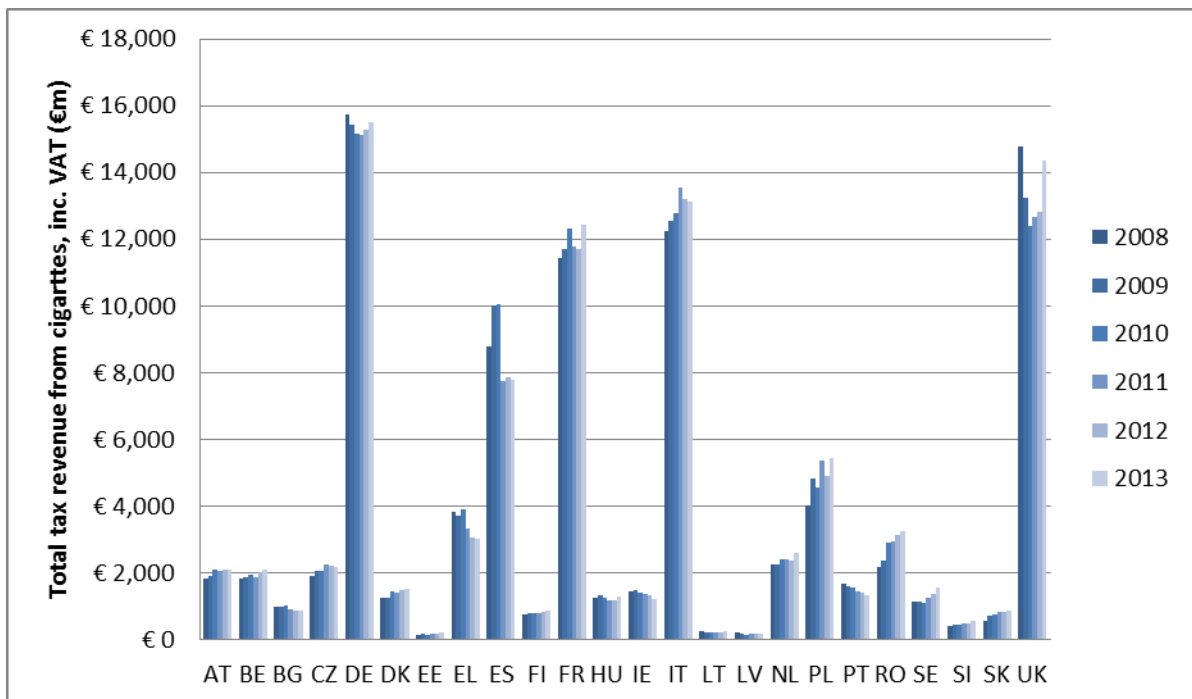
A comparison of the two figures below shows that the volatility of the total value of excise duty revenue from cigarettes is similar to that of all tax revenue from cigarettes, although the volatility of excise duties in Italy exceeds that of all tax revenue. This suggests that the root cause of changes in excise duty revenues is either changes in excise duty rates or cigarette sales: changes in VAT rates do not appear to have played a significant role in most Member States.

Figure 6 Total Excise Duty (excluding VAT) collected - Cigarettes 2008-2013



Source: Europe Economics' analysis based on approach described in Table 6

Figure 7 Total Tax revenue (including VAT) collected - Cigarettes 2008-2013



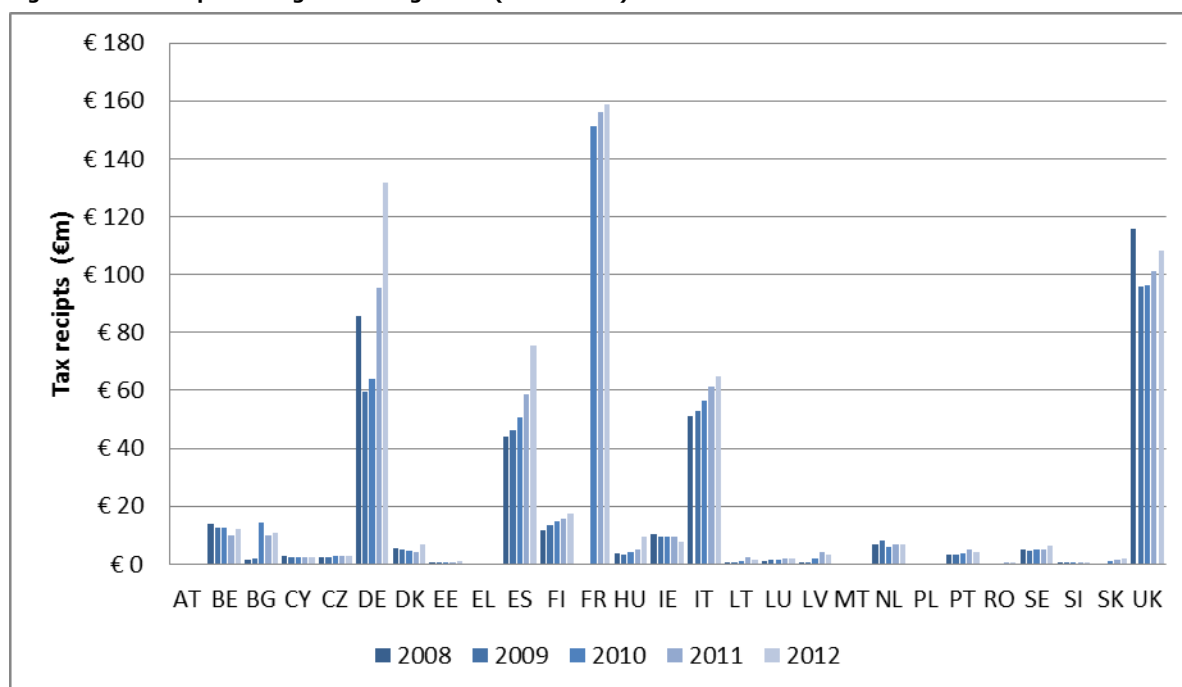
Source: Europe Economics' analysis based on approach described in Table 6

Total Excise Duty Collected – Cigars and Cigarillos

There were insufficient data to estimate the excise duty revenue on cigars and cigarillos separately.⁴³ In addition, more than half of the data on cigarillos provided by the DG TAXUD was aggregated within the tax revenues for cigars⁴⁴. As a result, we analyse these two together.

Similarly to cigarettes, the larger Member States collect more excise duty from cigars and cigarillos than do smaller countries. It should be noted, however, that on average the sums involved are less than two per cent of the revenue from cigarettes. In France, the total revenue collected from cigars and cigarillos is more than €140 million. This is followed by the UK, around €100 million. It is worth noting that Germany's tax receipts increased by approximately 50 per cent from 2010 to 2011, but its collections remain below those in France and the UK. This was primarily driven by an increase in the consumption of cigarillos during that period. Most Member States' tax revenue from cigars and cigarillos is less than €20 million.

Figure 8 Tax receipts for Cigars and Cigarillos (2008-2012)



Source: Europe Economics' analysis of DG TAXUD's tax receipts data

Note: 2012 is the most recent year of tax revenue data available in DG TAXUD's tables. Data are not available for AT, EL, MT and PL.

Total Excise Duty Collected – Other Smoking Tobacco

As with cigars and cigarillos, data on other smoking tobacco are also aggregated within other categories. This includes some of the larger Member States (e.g. France). The diagram below identifies only those countries where discrete data are available. Of those countries, Germany has the highest tax receipts in this category. The Netherlands also has a high value of tax receipts from this category of tobacco, significantly above levels seen in more populous countries (e.g. Italy).

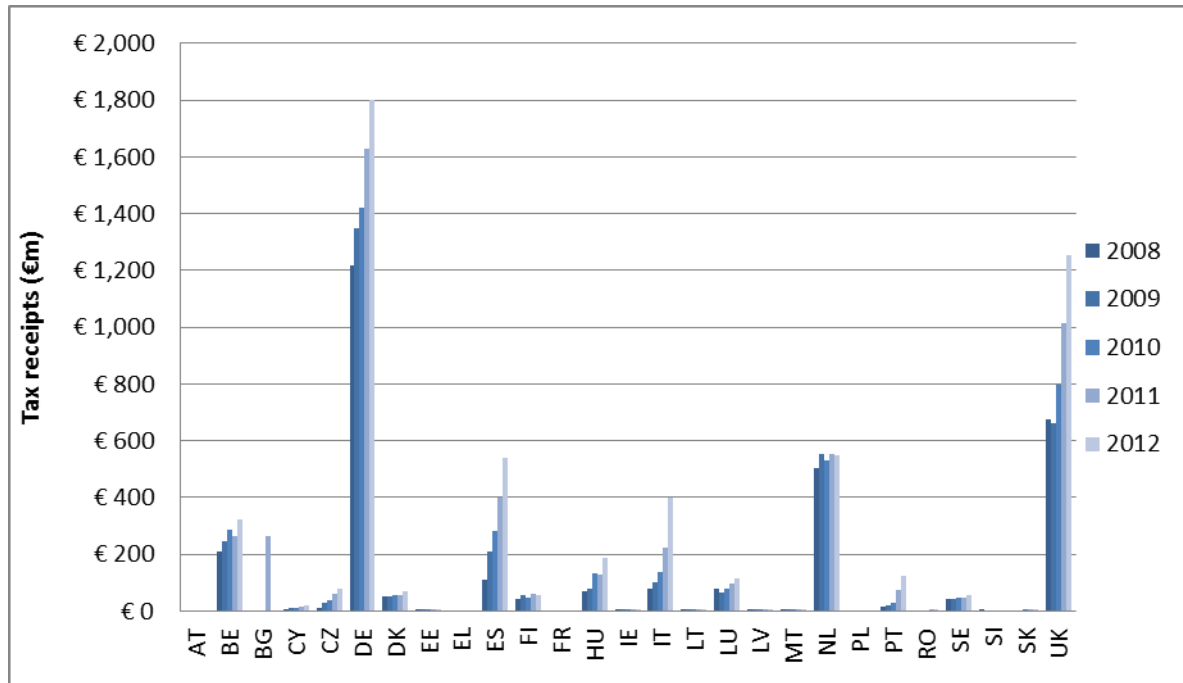
We also note that the tax receipts exhibit a marked upward trend in 2008-2012. The increase is most dramatic in Germany, Italy, Spain and the UK. In Spain and the UK

⁴³ They were provided as a percentage of TIRSP in the excise duty tables, and the TIRSP value itself cannot be derived from the data available.

⁴⁴ Some Member States aggregate the data together with cigarettes (e.g. in Austria and Poland). Others do so only for certain years (e.g. France only aggregates the data with cigarettes in 2008 and 2009).

this partially reflects increases in the duty rates applicable to other smoking tobacco while the VAT rate rose in Italy and the UK. The excise and VAT rates were unchanged in Germany and hence the trend in that country appears to be entirely driven by sales.

Figure 9 Tax Receipts: Other smoking tobaccos 2008-2012



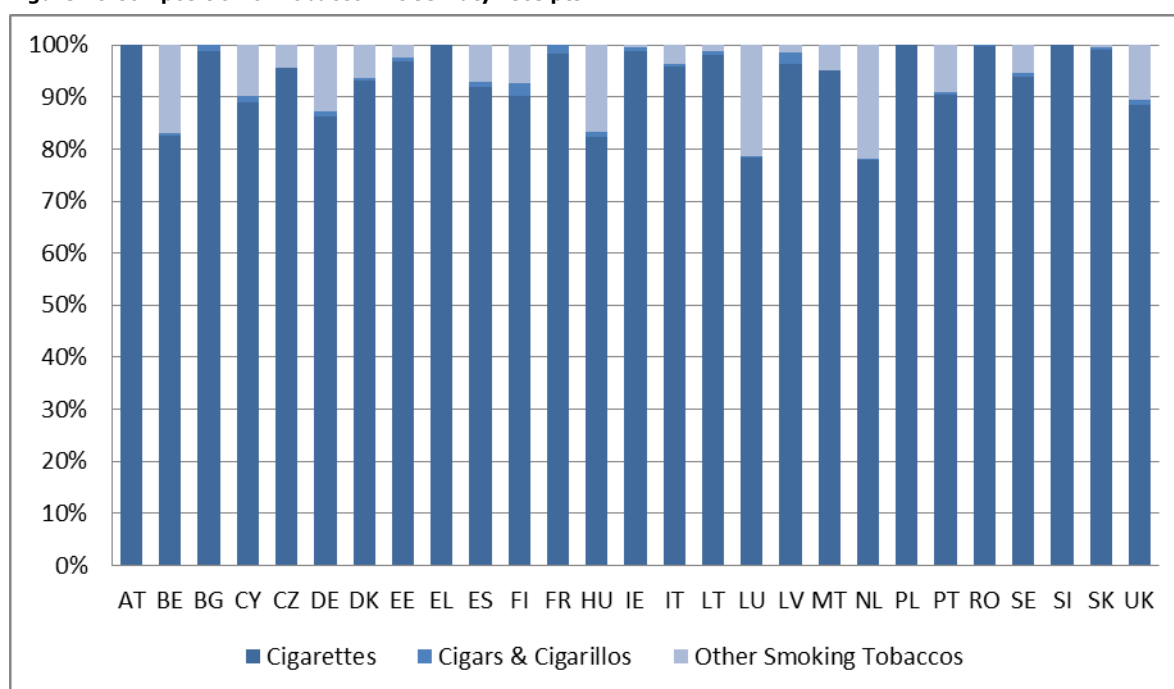
Source: Europe Economics' analysis of DG TAXUD's tax receipts data

Note: 2012 is the most recent year of tax revenue data available in DG TAXUD's tables. Data are not available for AT, EL, FR and PL.

Composition of tobacco excise duty receipts

As identified above, the sources (by tobacco product) of excise duty receipts vary significantly by Member State, although cigarette tax receipts make up more than 75 per cent of all tobacco tax receipts in every Member State where the split is available. The differences between Member States are illustrated in the chart below.

Figure 10 Composition of Tobacco Excise Duty receipts



Source: Europe Economics' analysis of DG TAXUD's excise duty tables

Illicit Trade

In this study, we estimate the magnitude of excise duty losses which arise from illicit trade only. While losses are likely to arise from other sources (e.g. from the abuse of tobacco product classifications), it is not possible to quantify these losses given the data available to us (e.g. there are no data available on the number of misclassified products). Therefore, the estimate presented in this section should be seen as a lower bound to the total value of tobacco excise duty losses.

Even with this narrower definition the assessment of the scale of illicit trade is far from straight-forward. This is unsurprising given its illegal nature. Joosens (2011) provides a good analysis of the different approaches used in its estimation and their pitfalls.⁴⁵

Given this caveat, one can calculate the value of excise duty losses in the case of cigarettes using the following formula:

$$\text{Excise duty losses} = \text{Total excise duty in euros per thousand sticks} * \text{Illicit Volume}$$

This calculation is based on the total excise duty (in euros) per thousand sticks to permit rate data from DG TAXUD's excise duty tables to be used. Euromonitor provides data on illicit penetration within cigarette consumption by Member State from 2008 to 2013.⁴⁶ These data have the advantages of a broadly comparable approach,

⁴⁵ European Commission, 2011, Pricing Policies and Control of Tobacco in Europe (PPACTE), Deliverable 5.2: Illicit tobacco trade in Europe: issues and solutions, Luk Joosens

⁴⁶ The dataset contains retail volume and illicit trade volume in million sticks. The data for 2013 is forecasted. Euromonitor states that "by its very nature illicit trade is a market that is difficult to quantify. Euromonitor sources for this include trade press, customs offices, interviews with manufacturers and retailers as well as local knowledge of the market – for example how porous borders are, how high unit prices are, whether a market is a conduit for cigarettes versus actual consumption (e.g. Russia is a significant exporter of illicit trade, but due to low unit prices of duty-paid cigarettes in the country, its actual consumption of illicit trade is low). Very often illicit trade will be expressed as a proportion of duty paid, legal sales (e.g. "illicit trade is 20% of duty paid") and is a ballpark figure that is quoted by the industry and one that Euromonitor corroborates via interviews with key industry players. Due to the market's contentious nature, vari-

coverage of nearly the whole EU28 (Croatia, Luxembourg, Malta and Cyprus are omitted) and annual data over several years such that dynamics can be considered.

Our analysis indicates that the total excise duty loss due to illicit consumption of cigarettes was €9.5 billion in 2012, i.e. about 13 per cent of excise duties collected, and €10.4 billion in 2013. (By way of contrast, KPMG's Project Star estimated the share of the illicit consumption of cigarettes at about 11.1 per cent in 2012).

As shown in the figure below, Denmark is estimated to have the lowest percentage loss of excise duty (one per cent) and Latvia has the highest proportion (more than 40 per cent). It is worth noting that the excise loss is not insignificant in large Member States such as France, Germany and the UK, at around 10 per cent of potential revenue. Those Central and East European countries which have a land border with a non-EU state tend to have greater losses, generally at more than 20 per cent of potential revenue. This is consistent with the observation that the drivers of illicit consumption include the opportunity to supply (e.g. from illicit production outside the EU – although there is also illicit production sourced from within the EU)⁴⁷ as well as the demand from consumers for cheaper cigarettes (due to the avoidance of duty) or products not otherwise available.

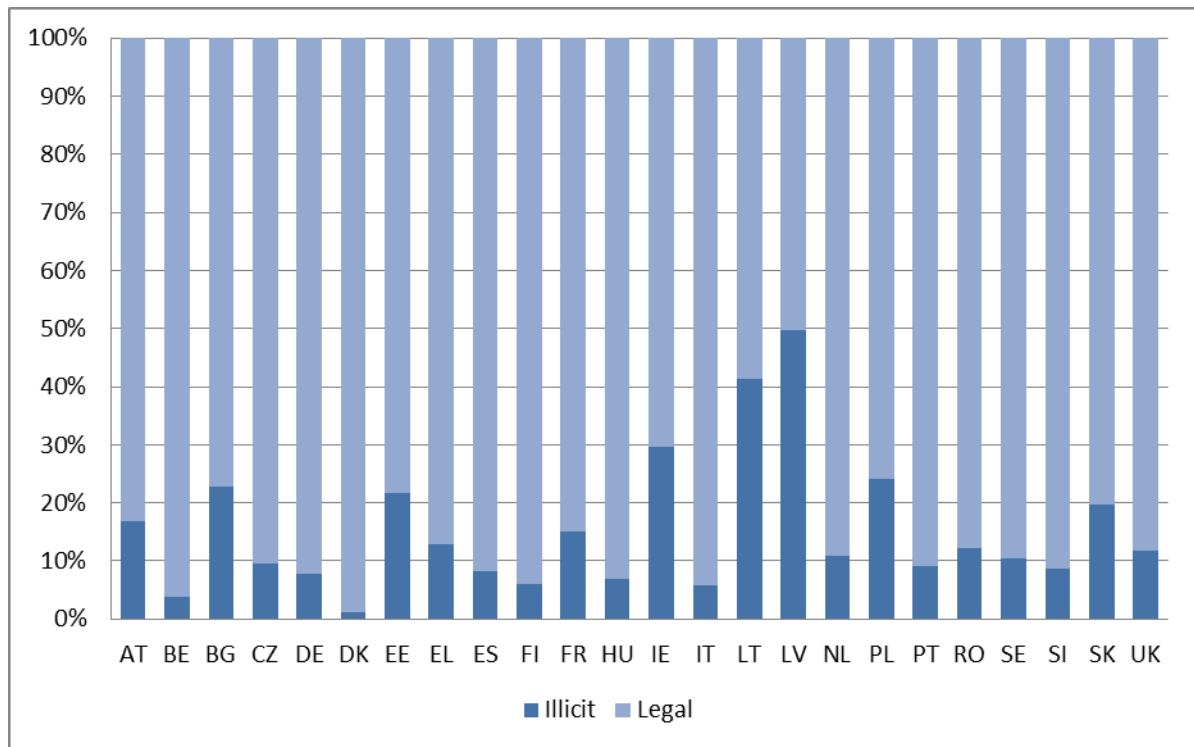
In the Euromonitor data Ireland also has notably high illicit penetration. Ireland does have high retail prices, although so does its immediate neighbor, the UK. On the other hand, other sources do not identify high penetration of illicit consumption in the Irish market.⁴⁸

ous parties have vested interests in either deflating or inflating illicit trade figures, though Euromonitor strives to present the most accepted and realistic estimate of the market. Euromonitor's illicit trade figures include both non-duty paid (NDP, also known as contraband) and counterfeit (fake)".

⁴⁷ This is confirmed by FRONTEX in its Eastern border Annual Overview, 2012, http://www.frontex.europa.eu/assets/Publications/Risk_Analysis/EB_AO.pdf

⁴⁸ For example, Pricing Policies and Control of Tobacco in Europe (PPACTE), 2010 estimated the illicit share at below five per cent

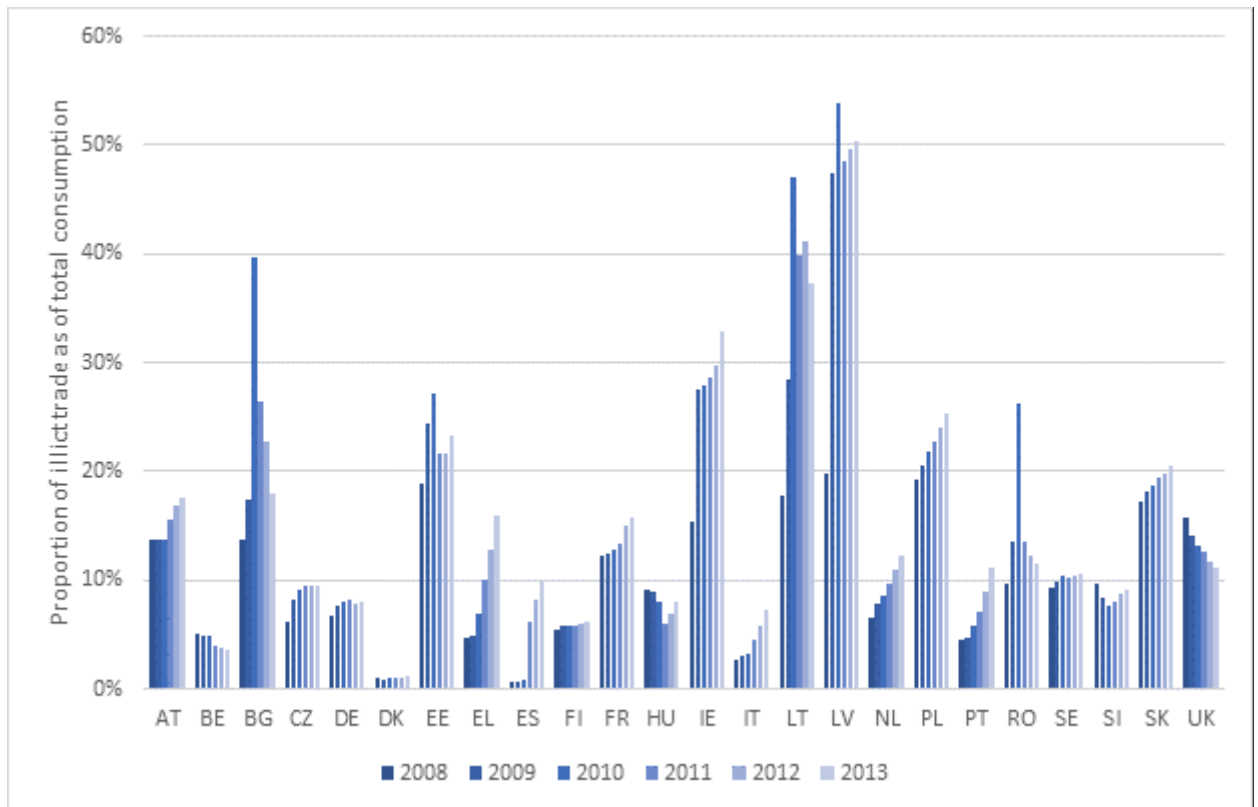
Figure 11 Excise Duty Gap of Cigarettes by Member State 2012



Source: Europe Economics' analysis of DG TAXUD and Euromonitor data

The penetration of illicit cigarette consumption varies by Member State. Denmark has the lowest penetration. Only two Member States, Belgium and the UK, show steady decrease in illicit trade over the entire period 2008–2013 (the penetration was lower in 2013 compared to 2008 in Hungary and Slovenia also).

Figure 12 Penetration of illicit consumption - Cigarettes 2008-2013

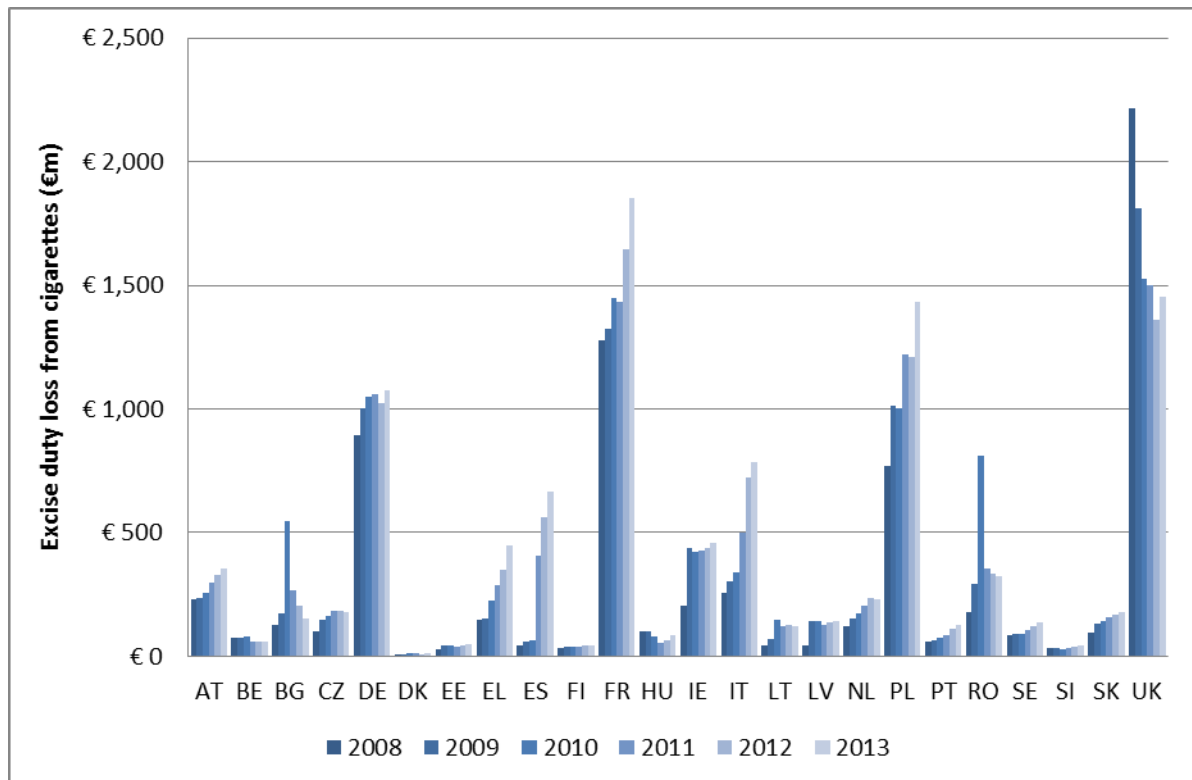


Source: Europe Economics' analysis of DG TAXUD and Euromonitor data (Croatia, Malta, Cyprus and Luxemburg not shown)

The implementation of the MED does not appear to have had an identifiable effect on the situation. In other words, there is no apparent break in national trends around this time (illicit consumption's share rose in some countries, and fell in others).

This translates into the estimated duty loss as below. Germany, France, Poland and the UK have excise losses in excess of €1 billion in at least one year. In general, there has been an upward trend in the value of excise duty losses, the UK being the most notable exception, although excise duty losses fell in absolute terms in Belgium and Hungary also.

Figure 13 Excise Duty Loss - Cigarettes 2008-2013



Source: Europe Economics' analysis of DG TAXUD and Euromonitor data

The European Commission has noted that cigarettes constitute by far the biggest part of seizures of tobacco products reported by Member States.⁴⁹ "Some significant seizures" of Hand-rolled tobacco (HRT) have been made, but other tobacco product types do not appear in significant numbers. We note that the (licit) cigarette market is significantly larger than that for HRT which is (generally) larger than that for, say, cigars. In that sense, these seizure data do not provide strong evidence that illicit consumption in any of these individual groups is significantly out of proportion with licit consumption.

With this in mind, while it is not possible to replicate this analysis for other types of tobacco due to a lack of data on illicit penetration, we can provide an indicative estimate of such losses. We assume that the penetration of illicit trade is the same for all types of tobacco. This may not be borne out in reality, e.g. illicit penetration may be relatively insignificant in some tobacco product categories – at least in some countries. However, it is not sufficiently clear whether the penetration of illicit trade of cigarettes is higher or lower than other forms of tobacco and hence we consider this assumption reasonable in the absence of clearer evidence to the contrary. We also note that since tax revenues from cigarettes are such a large proportion of the total the margin for error here is not likely to be material.

Under this approach, we simply adjust the estimated excise duty loss to reflect the composition of tobacco excise duties as shown in Figure 10. This approach means that the total loss of tobacco excise duties due to illicit trade in cigarettes, cigars and

⁴⁹ European Commission, "Stepping up the fight against cigarette smuggling and other forms of illicit trade in tobacco products - A comprehensive EU Strategy"; COM(2013) 324 final; 6th June 2013

other smoking tobacco was about €11.1 billion in 2013, against the €10.4 billion for cigarettes alone.⁵⁰

It is important to note that this calculation may overstate the true excise duty loss, both from cigarettes and from other tobacco. In particular, the calculation estimates the loss of excise duty given the current consumption of legal and illicit tobacco.

However, it is likely that the *total* consumption of tobacco would fall if illicit tobacco were eliminated. The prices of illicit tobacco products are typically lower than for their licit equivalents (we discuss the scale of the price difference further below). So this is equivalent to saying that the prices experienced by the current consumers of illicit cigarettes would rise, and hence overall consumption would fall (i.e. one unit of illicit tobacco would be substituted by less than one unit of legal tobacco, given that the price of legal tobacco is greater than that of illicit tobacco and that price elasticity estimates suggest that demand for tobacco falls as the price increases). This means that the above formula may overestimate the amount of revenue that should be considered 'lost' (i.e. the additional duty revenue that would be obtained if illicit consumption were eliminated) because not all of the illicit consumption would translate through to additional licit consumption, and hence additional duty collection.

Ideally one might use bespoke-price elasticity data to assess this change. Again, such data are lacking. However there have been numerous attempts in the literature to estimate the own-price elasticity of demand for cigarettes, in particular, and we consider this to be at the least a good proxy for the circumstances which we are seeking to model.

We highlight various recent estimates used in past studies (many of which are from the PACTE project) in the table below.

Table 7: Summary of own price elasticity estimates

Author	Country	Year	Overall
WHO	Developed countries	2011	-0.25 to -0.5, cluster around -0.4
Gallus, S.; Schiaffino, A.; La Vecchia, C.; Townsend, J.; Fernandez, E.	EU	2006	-0.46 vs -0.76 (local vs foreign brand)
Gallus S, Fernandez E, Townsend J.	IT	2003	-0.43
Fernandez E, Gallus S, Schiaffino A. et al	ES	2004	-0.19 to 1.25
HMRC	UK	2010	-1.17 and -0.92
Escario and Molina	AT	2001	-0.83
Escario and Molina	DE	2001	-0.42
Mindell and Whynes	NL	2000	-0.74 (1970-1980) and -0.54 (1985-1995)
Escario and Molina	NL	2001	-0.75
Escario and Molina	ES	2001	-2.28
Bask and Melkersson	SE	2004	-0.65 to -1.03 long run
Lien Nguyen, Rosenqvist, Pekurinen	FI	2012	-0.22 to -0.413 (short run) - 0.851 to -0.991(long run)
Lien Nguyen, Rosenqvist, Pekurinen	FR	2012	-0.067 to -0.499 (short run) -

⁵⁰ This scaling up relies on the proportions from 2012.

Author	Country	Year	Overall
			0.913 to -0.384 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	DE	2012	-0.672 to -0.788 (short run) - 1.098 to -1.284 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	ES	2012	-0.349 (short run) -0.214 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	IE	2012	-0.265 (short run) -0.59 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	IT	2012	-0.373 (short run) -0.372 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	PT	2012	-0.288 to -0.422 (short run) - 0.869 to -2.54 (long run)
Lien Nguyen, Rosenqvist, Pekurinen	SE	2012	-0.399 (short run) -0.229(long run)
Lien Nguyen, Rosenqvist, Pekurinen	UK	2012	-0.379 (short run) 1.485 (long run)

Overall, these represent a heterogeneous set of estimates, and we note that various studies have taken divergent steps towards controlling for changes in attitudes towards tobacco (e.g. due to health scares) and to tobacco control measures in making their elasticity estimates. Both of these are likely to matter given the time periods over which estimates are being made.

Given the set-up in this evaluation question, and that we are seeking to estimate the impact of eliminating illicit consumption, we would ideally wish to focus on the elasticity with respect to *total* consumption. Many of the studies above focus upon the impact on licit (specifically duty paid) consumption. These estimates could be biased – at least for the purposes being discussed here - due to substitution to, inter alia, illicit products, as well as down-trading to cheaper substitutes (such as RYO) as well as reduced overall consumption.⁵¹

In light of these concerns we have focused upon the WHO's estimates for developed countries. These are based upon the meta-analysis of a large number of studies and, whilst this does not mean the points raised above cease to be issues, it is an authoritative source. The WHO finding is that the typical range is -0.25 to -0.5, with clustering around -0.4. In our analysis, we adopt the range of -0.35 to -0.45 (i.e. around 0.4), implying that a rise in the price of cigarettes by 10 per cent leads to a reduction in consumption of between 3.5 and 4.5 per cent.

Of course, such elasticity estimates average out differences between different types of consumers. Typically, lower income and younger consumers are more sensitive to changes in price than are older and higher income consumers. Indeed the World Health Organization (WHO) has noted that the price elasticity of youths with respect to tobacco products lies in the range of -0.5 and -1.2 in high-income countries, which is substantially higher than the estimates for adults.⁵² It also notes that the responsiveness of tobacco demand to price increases is higher among the poor than the rich in

⁵¹ See for example the discussion by Padraic Reidy and Keith Walsh, *Economics of Tobacco: Modelling the Market for Cigarettes in Ireland*, February 2011. This paper discusses the potential role of changing demand for non-duty paid cigarettes in explaining their elasticity estimate of -3.6 (whereby a one per cent price increase results in a 3.6 decline in the quantity of duty-paid cigarettes consumed).

⁵² Anne-Marie Perucic, (February 2012), "The demand for cigarettes and other tobacco products", Presentation at Dublin TobTax Capacity Building Workshop, available at: www.who.int/tobacco/economics/meetings/dublin_demand_for_tob_feb2012.pdf

high-income countries, although no estimates of the magnitude of these price elasticities have been identified.

We can use these data to estimate the impact of an increase in the effective price experienced by the current consumers of illicit tobacco, and thereby refine our estimate of the tobacco excise duty gap.

If we suppose that illicit tobacco were to be eliminated (e.g. through highly effective enforcement action) this would mean that the only option for purchasing tobacco would be on the legal market. We note that a 2008 study on tobacco smuggling in the UK suggested that the price of illicit cigarettes was 50 per cent cheaper than legal cigarettes.⁵³

Therefore, the elimination of illicit trade would lead to an effective 100 per cent increase in the price of illicit cigarettes (which would equalize the price of the illicit and legal variants, assuming that the UK study is representative).

Given the estimated elasticity of -0.35 to -0.45, a doubling of the effective price experienced by consumers of illicit tobacco would reduce demand amongst those that previously purchased illicit products by between 35 and 45 per cent (i.e. the sales of legal tobacco products would rise by between 55 per cent and 65 per cent of the value of previous illicit consumption).

Therefore, if illicit trade were to be eliminated, excise duty revenues would increase by less than the estimated excise duty gap of €11.1 billion. Indeed, the revenues which would be captured would be between 55 and 65 per cent of this figure, i.e. by between €6.1 billion and €7.2 billion per annum.

Given that the concept of an excise duty gap should refer to the amount of money that tax administrations lose to illicit trade (i.e. the amount that could be recovered if illicit trade were eliminated), we consider that a reasonable estimate of the excise duty gap is €6.1 - €7.2 billion.

There are some caveats to this result which we wish to identify here:

- It is possible, however, that the size of the gap would be lower than this. As noted above, younger and poorer consumers are likely to have a higher price elasticity of demand than that of other consumers. Given the sensitivity to price of these consumers, we would expect such consumers to be more likely to participate in the illegal market than other consumers.⁵⁴ Therefore, the increase in legal sales following the elimination of the illicit market may be less than estimated above and hence the excise duty gap may be correspondingly higher. The mid-point of the range of price elasticity of youths with respect to tobacco products reported by the WHO is -0.85. This is notably greater price elasticity and if these are a disproportionate part of the illicit cigarette buying population then the above estimate of the duty gap would be reduced.
- The data on the price gap between illicit and licit consumption are particularly weak. The price gap may vary significantly from the one that we have used, e.g. if counterfeit products are the main category within illicit then the price gap experienced by consumers might well be less (indeed, a large price gap can act as

⁵³ West R, Townsend J, Joossens L, Arnott D, Lewis S. *Why combating tobacco smuggling is a priority. BMJ 2008; 337: 1028-1029*

⁵⁴ Evidence that illicit consumption is proportionately greater amongst heavy smokers – at least in Italy - is presented by Joossens et al. *Illicit cigarettes and hand-rolled tobacco in 18 European countries: a cross-sectional survey. Tob Control 2014;23:e17-e23*

a signal that a product is counterfeit). If the price differential (expressed as a % of the duty-paid price) was 25 per cent, then the realizable duty loss would be 85–88 per cent of the original figure – against 55–65 per cent with a price gap of 50 per cent.

- The elasticity data draw largely on licit experience only, as we have noted above. In addition, elasticities are typically non-linear, and as such the estimates upon which we have drawn may not reflect well the consumption shift that would result from such a large price move – nor, indeed, potentially for the lower initial price (i.e. price sensitivity is likely to be more at high relative prices than at low ones). Similarly the elasticity estimates do not account well for potential substitution effects, e.g. from illicit cigarette consumption to licit HRT consumption. These uncertainties mean that the estimate of realizable duty loss needs to be treated with appropriate caution.

On the other hand, as we have noted above, losses from other sources (e.g. from the abuse of tobacco product classifications) are omitted from this analysis due to lack of data.

Summary

Our analysis of the extent to which the current arrangements for tobacco excise duty on tobacco products safeguard Member States' budgetary objectives has found:

- total tax revenues have fluctuated over time both within individual member States and across the EU as a whole;
- 60 per cent of all EU tax revenues from cigarettes arose from four Member States in 2012 (France, Germany, Italy and the UK);
- excise duty losses on cigarettes fell between 2008 and 2013 in a few Member States but increased in most;
- the maximum estimated excise duty loss in 2013 was €11.1 billion per annum but this assumes that all consumers of illicit tobacco would continue to purchase the same amount of tobacco products in the event that illicit trade is eliminated; and;
- adjusting for possible reductions in tobacco consumption following the elimination of the illicit market suggests that the excise duty gap is likely to lie in the range of €6.1 billion to €7.2 billion per annum. However, if the licit cigarette-buying population is more price sensitive than the average population, then the gap could be lower than this. On the other hand, inclusion of other drivers of duty loss (e.g. misclassification) would drive the gap upwards.

An overall conclusion to the extent to which the Directive adequately safeguards budgetary objectives may only be given once a detailed analysis of the appropriateness of the arrangements is conducted. This is done in the sections below.

Q2.1 To what extent do the definitions of taxable products in Articles 2-5 of Directive 2011/64/EU allow for adequate (correct categories and rates) collection of the due excise duties for manufactured tobacco products?

The evaluation of the definitions contained in articles 2-5 of Directive 2011/64/EU and their **appropriateness in relation to safeguarding the budgetary interests** of the Member States has taken into account two different aspects:

(a) Products which are not explicitly defined as excisable tobacco products.

Specifically, the evaluation has looked into the potential impact on the budgetary revenues of four major product groups: (i) raw tobacco, (ii) water pipe tobacco, (iii) electronic cigarettes and (iv) expanded tobacco.

(b) Tobacco products which are difficult to classify or whose classification requires subjective interpretation of the law but which otherwise fall within one of the categories of tobacco products defined.

In relation to the latter, specific attention has been given to the distinctions between cigarettes and cigarillos and between fine-cut tobacco for the rolling of cigarettes and the other categories of excisable tobacco.

The findings have shown that budgetary interests are affected in different forms by each of the categories described above, hence in the section below each issue is described and analysed separately.

Q2.1 (a) The treatment for excise purposes of tobacco products not defined by the Directive?

(i) Treatment for excise purposes of raw tobacco

The current treatment of raw tobacco has a direct and an indirect impact on the budgetary objectives of Member States. The direct impact refers to situations where economic operators sell raw tobacco directly to consumers, allowing them to produce, on a small scale, tobacco products for their own consumption, avoiding the payment of the excise duty.

Member State authorities reported that there have been attempts by economic operators to sell non-excisable raw tobacco and, in some instances, place at the disposal of consumers' machines which cut the tobacco leaves, allowing consumers to roll their own cigarettes while avoiding excise duty.

As described in greater detail elsewhere in this report⁵⁵, in a majority of Member States, raw tobacco is not subject to any specific treatment from an excise duty perspective. This means that raw tobacco may circulate freely and could be sold to consumers in order for them to manufacture their own tobacco products.

In such systems, there would be legal uncertainty with respect to the existence of a legal basis for imposing excise duties, seize or confiscate raw tobacco even when there is a suspicion that it would be used for the manufacture of excisable tobacco products outside a tax warehouse.

⁵⁵ See answers to Q1.3 and Q2.3

In Ireland, quantities of unmanufactured tobacco have been detected in situations where it was evident that it was not for legal manufacture in a tax warehouse. To address this problem, a new legislative provision was introduced in Finance Act 2013 (Section 56) in relation to the use of unmanufactured tobacco in the illicit production of tobacco products.

"Where any unmanufactured tobacco is found in the State and where that unmanufactured tobacco is not shown to the satisfaction of the Commissioners to be kept, or to be in the course of delivery—

(i) under a customs procedure within the meaning of Council Regulation (EEC) No. 2913/92 of 12 October 1992

(ii) for use as raw material for the production of tobacco products in a tax warehouse,

(iii) for use as raw material for the production of any product or thing other than a tobacco product, or

(iv) for any other use that is not contrary to this section,

then it shall be presumed until the contrary is proved that the unmanufactured tobacco is prohibited goods".

In order to prevent such situations from occurring (or put an end to already established practices, some Member States have put in place provisions which regulate (to various degrees) the growing, processing and sale of raw tobacco⁵⁶. Even in situations where the Member States have inscribed in their regimes a legal basis allowing the imposition of excise duties on raw tobacco or the imposition of criminal fines if quantities were found to circulate outside the established system, a number of Member States authorities have reported that the amounts of raw tobacco diverted from the legal supply chain or being put up for retail sale have been growing.

In one particular Member State with a large internal production of raw tobacco, tobacco growers have to conclude contracts with first processors of raw tobacco, while first processors of raw tobacco have to be registered and may only sell to authorised warehouse keepers. Despite the fact that sanctions in relation with these obligations are not automatic and there are limited resources allocated for control, in 2013 365 Kg of blend tobacco (cut tobacco, where an initial processing took place) and 274 Kg of bulk tobacco has been confiscated.

The indirect impact is more significant and refers to the situations described in Q2.3 by which raw tobacco is diverted from the "legal" supply chain and used in the large and medium scale production of excisable tobacco products outside the premises of an authorised warehouse keeper, hence away from the control mechanisms of Member States.

In relation to the amounts of seizures of raw tobacco, even in the countries where a distinction between a "legal" and an "undeclared" circuit can be made⁵⁷, Member States reported that the legal uncertainty, coupled with the lack of effective monitoring and control measures on this part of the logistics chain precludes them from conducting targeted checks which may lead to more seizures, reflecting more appropriately the size of the problem.

⁵⁶ See answers to Q1.3

⁵⁷ I.e. those countries which regulate the market for raw tobacco

Despite the lack of mechanisms in place to adequately quantify the amounts of raw tobacco diverted into the illegal supply chain, the quantification of illicit trade, as included in the excise duty gap section of this report, includes “contraband” (i.e. fake) as well as non-duty-paid (NDP) products. Quantities of raw tobacco diverted from the legal circuit will serve as raw materials to the “contraband” part of illicit trade and are therefore included in the calculation of the excise duty gap.

(ii) Treatment for excise purposes of water-pipe tobacco

Even though water-pipe tobacco is not specifically defined by the Directive, it is considered to be an excisable product in all Member States (if containing tobacco) and treated, mainly, as other smoking tobacco.⁵⁸

The wide majority of countries reported that they had no problem in applying the definition of other smoking tobacco in order to apply excise duty on water-pipe tobacco.

From this perspective, it could be concluded that the lack of a specific definition for water-pipe tobacco under the current arrangements does not preclude Member States to levy excise duty on this product within the framework of Directive 2011/64 EU.

It should be said that the cross country analysis has shown that in a number of Member States, water pipe tobacco is taxed only if it contains tobacco, while other Member States apply excise duty regardless of whether the product is fully or partly made out of substances other than tobacco.

While the budgetary implications of this limitation⁵⁹ are negligible due to the very marginal consumption of those products in the countries where they are non-excisable, the inconsistent treatment may cause other problems if the products in question were to be subject of cross border movements while under suspension of excise duties.⁶⁰ When products of this type are imported from third countries, this problem remains a theoretical one, however this becomes an issue if the products are destined for consumption in a different country than the one of importation.

It is very important to mention that because the composition of water-pipe-tobacco contains sugars, molasses and other dense substances, its properties in terms of weight differs considerably from the other types of products which usually fall under the category of “other smoking tobacco”. Depending on the nature of the market in a particular Member State, a particular rate structure for this category may not be appropriate to apply to both water-pipe tobacco as well as the other products within “other smoking tobacco”. Being unable to find an appropriate balance between the consumption patterns and the rate structure may have significant implications on the budgetary revenues.

In conclusion, Member States budgets may be affected by the fact that a specific rate structure, which would take into account the consumption patterns and the specific properties of water-pipe tobacco cannot be separated from the rate structure applied to all products falling under the residual category of “other smoking tobacco”.

⁵⁸ In accordance with Art. 5(1) (a) Directive 2011/64/EU

⁵⁹ I.e. the fact that some countries consider water-pipe tobacco not containing tobacco as non-excisable

⁶⁰ Inconsistent treatment for excise duty purposes may also be caused by the fact that water-pipe tobacco is classified under CN code 24 03 11 00 according to the subheading note 1 of chapter 24. If the product, however is a tobacco-free product intended for smoking in a water-pipe it is classified under CN code 2403 99 90, a CN code which is usually not excisable. – The issue of dual classification is discussed thoroughly in Q2.2 of this report.

One Member State reported that the entire legal market of water-pipe tobacco disappeared (i.e. all sale of this type of product turned illicit) when the structure of the rate changed from a purely ad valorem to a purely specific one. As the consumption of water-pipe-tobacco in that MS is fairly common, the budget implications are estimated to be significant.

(iii) Treatment for excise purposes of electronic cigarettes

The wording of the definitions of Art 2-6 does not envision the application of excise duties on e-cigarettes within the general framework of Directive 2011/64/EU due to the fact they contain neither tobacco nor do they imply combustion (hence cannot be considered as being “intended to be smoked”).

At present the situation looks patchy with different Member States taking different stands.

Table 8 Treatment of e-cigarettes in the EU

Treatment	Member State:
Medical device/ product ⁶¹	AT, DE, DK, EE ⁶² , HU, SE ⁶³ , FI, PT, EL, LU and BE ⁶⁴
No specific Provisions / Consumer product (apart from general product safety legislation)	CY, DE, EE ⁶⁵ , HU ⁶⁶ , FI, CZ, MT, ES, IE, NL, LV, PL, RO, SI, SK and UK
Substitute for tobacco products	IT

In some countries, due to the nature of the authorisation requirements or the lack of implementing regulation for obtaining approval, e-cigarettes are effectively prohibited or banned. Some countries have reported that, even though they find themselves in such a situation, e-cigarettes are nevertheless present on the market.

A large number of Member States have expressed the need for clarity on the part of EU legislation with respect to the treatment of e-cigarettes from an excise duty perspective.

Some of the Member States have reported that they would welcome the application of excise duties on e-cigarettes, citing both the need for health protection as well as the attainment of budgetary objectives.

One large Member State with a considerable market for e-cigarettes expressed its concern that as more economic operators (including the established manufacturers of excisable tobacco products) become involved with e-cigarettes, a future shift of consumption towards e-cigarettes can be expected. As a result, the budgetary implications of not including e-cigarettes within the framework of the EU Directives may prove to be extremely significant.

The economic operators themselves raised concerns with respect to the competitive distortions caused by differentiated tax treatment between e-cigarettes and cigarettes and the inherent substitutability.

⁶¹ Subject to specific authorizations overseen by the respective health ministries.

⁶² If containing nicotine

⁶³ If containing nicotine

⁶⁴ In BE and LU, e-cigarettes are to be treated the same as tobacco cigarettes if they contain tobacco extract (if only containing nicotine, BE and LU treat e-cigarettes as a medical product)

⁶⁵ If it does not contain nicotine

⁶⁶ If it does not contain nicotine

As a result of the increased attention on e-cigarettes, additional research has been conducted on the subject, the results of which can be found in Appendix 6 – *Research note on e-cigarettes* (summarised in the text box below).

E-cigarettes

Definition

The e-cigarette, commonly referred to as e-cig, is a hand-held battery-powered device consisting of an atomizer, a battery and a disposable cartridge. This product is **intended to imitate ordinary cigarettes** in both the appearance and the use, i.e. reproducing the “hand-to-mouth” movement. They do not work through combustion, in fact they **use heat to vaporise the solution in the cartridge** and create an aerosol (or mist) that the “vaper” inhales¹. The nicotine content in the cartridge can range between 0 and 48 mg/ml. The liquid does not contain tobacco except for minuscule quantities either due to the tobacco flavouring or to the process of extraction of nicotine from tobacco leaves.

Market development

Since 2003 where e-cigarettes were first patented in China, the **market has grown exponentially**, registering a compound annual growth rate of 57% which stands at about USD 2 billion worldwide. The EU market alone is estimated worth between EUR 400 and EUR 500 million, and is characterised by a large number of distributors rather than manufacturers. Many of these are still SMEs, although the interest by large tobacco manufacturing companies is growing.

Classification in EU

The sudden boom registered by the e-cigarette market found governments, legislators and regulatory agencies around the world unprepared as the **legislation in place did not allow for classifying these products in a univocal way**.

In the EU, the legislation in place is not clear about what should be taxed. On the one hand, Article 2 Council Directive 2011/64/EU refers to the presence of tobacco as the discriminating factor. However, on the other hand, Article 3(1) of Council Directive 2001/37/EC, while not engaging directly with taxation, mentions other substances, i.e. tar, nicotine, and carbon dioxide. In the case of e-cigarettes this latter limit is only partially applicable as none of the papers consulted mentioned the presence of tar in e-cigarettes and only one reported very little concentrations of carbon monoxide. The only anchorage would be represented by nicotine which is present in virtually all e-cigarettes and refill liquids.

Health concerns

Just like the other tobacco products, e-cigarettes have propelled a heated policy debate which touches upon many different aspects such as classification, taxation, health issues, quality and safety. As for the **health effects** of “vaping”, contrasting conclusions are found in empirical research studies, making the case for imposing excise duties on e-cigarettes rest on weak foundations as it is not sure whether direct and indirect harm exist. Furthermore, at present there exist no international standard regulating the production of e-cigarettes, cartridges and refill liquids, which may represent a threat to consumers' safety.

(iv) Current treatment for excise purposes of expanded tobacco

Literature and national policymakers pointed towards a growing problem related to the increasing use of expanded tobacco and more specifically, **dried ice-expanded tobacco (DIET)** – the most commonly used manufacturing process that uses solid carbon dioxide (CO₂) in the making of expanded tobacco⁶⁷. Tobacco treated in the DIET

⁶⁷ Stevenson/Proctor, *The Secret and Soul of Marlboro*, *American Journal of Public Health* 2008, p. 1185.

process is reordered to a desired moisture content, and is then indistinguishable from untreated tobacco.

Characteristics of DIET tobacco (in detail)

Cut tobacco from a conventional primary process is fed to the CO₂ impregnation system in precisely weighed sub-batches, and impregnated with liquid CO₂ at pressures of 30 - 35 Bar. The impregnators are filled with liquid CO₂ before being drained, depressurised and the residual gaseous CO₂ removed and recovered by re-compression.

The frozen tobacco is now discharged from the impregnators, and passes through special opening doffers to a buffer silo. It is then fed at a controlled mass flow by means of a special low-temperature Weycon to the infeed of a specially designed air dryer in which the frozen tobacco is subject to a process gas stream consisting mainly of superheated steam. This causes the 'dry ice' or solid CO₂ contained within the tobacco cellular matrix to change state from the solid to the gaseous phase (sublimation). Due to the fact that the volume of gaseous CO₂ is vastly greater than the volume of dry ice, the tobacco is expanded, in some cases to double its original volume depending on the nature of the tobacco.

Following expansion, the product moisture is corrected to the desired final value if necessary, and unwanted heavy items (e.g. stems and other contaminants) removed by classification in an Elutriator (see other web page for more details of this product). The DIET material may then be filled into bins or boxes for onward storage and transportation, or may be conveyed to silos ready for Addback in the Primary process.

To levy comparable rates of excise on fine-cut tobacco for rolling cigarettes and on manufactured cigarettes, the weight of tobacco used to prepare hand-rolled cigarettes and manufactured cigarettes must be established. The current conversion rate suggests that 1 kg of fine-cut tobacco is equivalent to 1000 cigarettes (1g = 1 cigarette)⁶⁸; Some Member States, however, believe that this implied ratio is incorrect, particularly with the increasing use of dry ice-expanded tobacco manufacturing processes, which reduces the mass of tobacco in a manufactured cigarette. According to the ISO norm on measuring tar and nicotine in hand-rolled cigarettes (ISO15592-3:2008)⁶⁹ there are 0.4-0.75g of tobacco per hand-rolled cigarette. This suggests that 1333-2500 hand-rolled cigarettes can be made from 1 kg of fine-cut tobacco⁷⁰, rather than 1000.

In line with the apparent evidence suggested by the ISO norm, a few Member States have pointed out that, as a result of the increasing use of expanded tobacco in the production of fine-cut-tobacco, the resulting increase in volume essentially allows consumers to make a higher number of hand-rolled cigarettes, with the same weight of product, while paying the same amount of excise tax. This statement is partially disputed by economic operators, which argue that, given its properties, expanded tobacco burns more quickly than normal tobacco hence consumers would simply roll more cigarettes in order to compensate, thereby negating the potential excise duty loss.

⁶⁸ The conversion rate is implicit, assumed from the rate structure which levies excise duties per 1000 sticks in the case of cigarettes and per kg in the case of fine-cut tobacco. This conversion rate, however, is not made explicit or legally established as a basis for calculation.

⁶⁹ ISO15592-3:2008: Fine-cut tobacco and smoking articles made from it -- Methods of sampling, conditioning and analysis -- Part 3: Determination of total particulate matter of smoking articles using a routine analytical smoking machine, preparation for the determination of water and nicotine, and calculation of nicotine-free dry particulate matter.

⁷⁰ Fine-cut-tobacco in which expanded tobacco may account for 0 to 100% of the blend

According to reported figures, in Germany, expanded tobacco accounted for 28,8% of the market for fine cut-tobacco in 2012, which translates into 8140 tons of expanded roll-your-own. The German tax authorities, based on their own experiences in dealing with expanded tobacco assumed that a consumer would use 0.75g of normal roll-your-own tobacco but only 0.6g of expanded tobacco for each cigarette. As a result of the weight assumptions made by the German authorities; 10 175 tons of tobacco instead of 8140 would have been consumed.

At a tax level of 63,04 EUR/1kg, the budgetary impact would be 128 286 400 EUR.

As the current wording of the Directive makes no distinction between regular tobacco and expanded tobacco for excise duty purposes, which may have an effect on the budgetary objectives of Member States, this present evaluation has further investigated the issue of expanded tobacco, its use and treatment across the MS.

From a budgetary objective perspective, the use of expanded tobacco plays a role only when it is being used in the production of excisable tobacco products which are taxed according to their weight (through the mechanisms explained above). The use of expanded tobacco in the manufacturing of cigarettes has no impact on the revenues of Member States.

The inconsistent treatment of expanded tobacco caused by unclear definitions or dual coding of tobacco products can have an impact on the control mechanisms and the administrative and compliance costs. Such aspects are discussed at length in Q2.2, Q4.1 and Q4.2 respectively.

The use of expanded tobacco in the EU

From the perspective of excise duties, Member States do not seem to give much consideration to expanded tobacco and have not investigated or researched the volumes and uses of expanded tobacco. Only two countries (DE⁷¹ and HU⁷²) are aware of the volumes of expanded tobacco present in their markets.

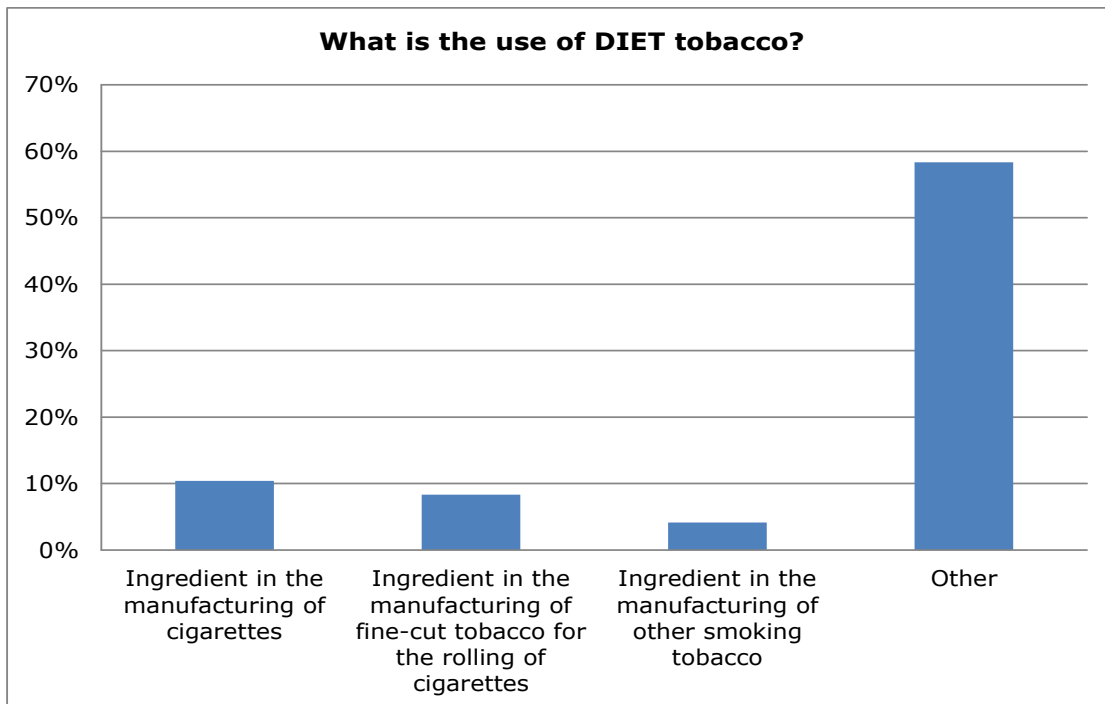
In order to complement this lack of data, economic operators were asked to report on the use of expanded tobacco in the manufacturing of excisable tobacco products.

It showed that a very wide majority of respondents (94%) use DIET or another kind of expanded tobacco in the tobacco production, while only 6% do not use it. Figure 14, below shows how DIET tobacco is used in the manufacturing of excisable tobacco products.

⁷¹ Germany estimates that, in 2012 approximately 8000 tonnes of expanded tobacco was released for consumption and sold as fine-cut tobacco.

⁷² On the basis of voluntarily reported data from economic operators, the Hungarian authorities were able to estimate that 2830 tonnes of expanded tobacco, accounting for 40% of the market for fine-cut-tobacco was released for consumption in 2012.

Figure 14 Use of DIET tobacco in manufacturing tobacco production (N=36)



As shown by the graph, the majority of respondents use it for “other” purposes than the ones they were presented for in the survey questionnaire. The reasons for the over representation of the option “other” is that expanded tobacco is used in the production of all types of excisable products and not just one in particular.

Respondents explained that DIET tobacco becomes part of the so-called dry blend recipe, which is used together with other components such as raw tobacco, tobacco stem or homogenised tobacco in the production of all types of manufactured products.

The inclusion level of expanded vs non expanded tobacco in the products ranges from 0% to 100% depending on the taste, strength and delivery of smoke ingredients.

According to one respondent, expanded tobacco is moreover assumed to lower the yield of tar, nicotine and carbon monoxide, therefore assisting to meet the EU requirement laid down by Directive 90/239/EEC.

It should be regarded that, from the analysis of the answers of economic operators and those of Member States, the use of expanded tobacco is much more widespread than previously thought, as it serves as an essential ingredient in the production of tobacco products. As a result, particular attention should be given with respect to the treatment of this type of product not only from a budgetary perspective, but from the perspective of the control and monitoring mechanisms.

The treatment of expanded tobacco by Member States

With respect to the finished product, as mentioned above, Member States make no distinction of whether the fine-cut-tobacco released for consumption consists in whole or in part of expanded tobacco; as such, any expanded tobacco that otherwise fits the criteria of fine-cut-tobacco will be treated as such in all Member States.

A particular important aspect to take into account in this respect is that it is very difficult to distinguish between expanded and non-expanded tobacco, especially if the blend of tobacco is comprised of both expanded as well as non-expanded tobacco.

Customs laboratories consulted in the course of this evaluation mentioned that there is currently no method by which they may ascertain the inclusion level of expanded tobacco in a particular tobacco blend; hence any differentiated treatment of fine-cut tobacco on the basis of whether it contains expanded tobacco or not would be technically impossible unless an intermediary table which would establish reference values for different blend percentages and their equivalent flotation⁷³ degrees) (i.e. a tobacco blend which contains x% expanded tobacco has a floatability degree of y%) was established and made legally binding.

The method prescribed in the Annex I of Commission Regulation 3311/86⁷⁴ is not suitable for distinguishing between expanded or non-expanded fine-cut tobacco as it only serves to classify cut expanded tobacco in what is now CN code 2403 99 90 (non-excisable).

With respect to the treatment of expanded tobacco as an intermediary product, this evaluation has found evidence of inconsistent treatment for excise purposes as a result of the application of subjective definitions of excisable tobacco products and of the dual coding system. However, subject to the explanations given in the present section, it has found no evidence of a direct impact on the budgetary revenues of Member States.

It should be noted, on the other hand that, as the inconsistent treatment has significant implications with respect to monitoring and control functions, administrative and compliance costs, it is treated thoroughly in Q2.2, Q4.1 and Q4.2 respectively.

(v) Other

Directive 2011/64/EU does not define smoke free tobacco as excisable, mostly due to the fact that Directive 37/2001/EC bans the sale of tobacco for oral use in most EU countries⁷⁵.

As a result of this, the consumption of smokeless tobacco (e.g. chewing tobacco, oral and nasal snuff) across the EU is limited and, according to responses for MS authorities, mostly concentrated in very few countries (e.g. Denmark, Sweden, Finland, Estonia and Italy.)

In the context of this evaluation, on the basis of responses from Member States, the impact on the budgetary objectives of the non-inclusion of smokeless tobacco as excisable tobacco products at EU level is considered to be marginal, especially due to the fact that Member States in which consumption of these types of products takes place have enacted national consumption taxes with similar functions as an excise duty.

The volumes and treatment of these products are summarised in Table 9 below.

⁷³ As expanded cut tobacco differs from non-expanded cut tobacco in that it is less dense, it is necessary to determine methods by which customs laboratories may decide at what difference in the level of density it can be established that a particular tobacco blend is expanded, and to what extent.

⁷⁴ Commission Regulation (EEC) No 3311/86 of 29 October 1986 on the tariff classification of goods

⁷⁵ Art 8, Directive 37/2001/EC

Table 9 The volumes and treatment of certain types of smokeless tobacco in MS where they are present

Product and Country	Treatment	Taxed Volume
Snuff – DK	Subject to a national excise duty	25.500 kg
All types of smoke free tobacco (chewing tobacco, Kar-dusskrå and snus) - DK	Subject to a national excise duty	9000 Kg
Chewing tobacco - EE	Subject to a national excise duty	n/a
All types of smoke free tobacco products (chewing tobacco and oral snuff) - FI	Subject to a national excise duty	2010 - 1400 kg, 2011 - 10 kg 2012 - 15 kg ⁷⁶
Moist snuff - SE	Subject to a national excise duty	11 500 Kg
All types of smoke free tobacco products not banned by Directive 37/2001/EC - FI	Subject to a national consumption tax similar to excise duty	17 000 kg

Q2.1 (b) Reported instances of tobacco products which are difficult to classify or whose classification requires subjective interpretation of the law (borderline products)

In order to assess the appropriateness of current definitions, from a budgetary perspective, this evaluation question is concerned with whether products which are difficult to classify or whose classification requires subjective interpretation of the law (borderline products) are subjected to **fair** (correct categories) and **uniform** (consistent treatment across Member States) taxation.

Particular emphasis is given to the distinction between cigarettes and cigars/cigarillos, however, where relevant, any other identified cases will be included and analysed.

In order to complete the analysis regarding “borderline” products, the report presents the findings of the evaluation in four distinct parts:

- Two individual sections summarise the current situation as reported by Member States and economic operators⁷⁷.
- The third section contains a detailed analysis of the sources and underlying drivers which lead to or have exacerbated the disputes or difficulties in classification.
- Finally, the last part looks at the evidence that can be drawn from a quantitative analysis of the extent of the problem.

Reported difficulties in interpretation by Member States

Fourteen Member States (FI, DE, LT, LV, SK, HU, NL, GR, PT, CZ, ES, IT, PL, SE) have reported that they have had experience with products which, in their opinion, were potentially attempting to abuse the definitions of Directive 2011/64/EU with the purpose of obtaining preferential tax treatment.

These countries have expressed significant concern that the preferential rate structure of cigars / cigarillos creates substantial incentives for economic operators to market products which are, in essence, cigarette substitutes (with respect to their size, appearance, smoking time, production methods, etc.) but which otherwise fulfil the minimum requirements of the definitions in order to be classified as cigars / cigarillos.

⁷⁶ All volume regards quantities brought by consumers from Sweden (the drop in taxed amounts corresponds to a ban on acquiring snus via internet).

⁷⁷ The reported statements are qualified through cross-country analysis to identify trends and underlying drivers.

The rest of Member States have reported that they have had no practical experience with any products on their market which were attempting to abuse the definitions in search for a better tax treatment. These Member States considered that no such problems arose, despite the potential risk of abuse being present as a result of two possible reasons:

- The rates between the different types of excisable tobacco products are more or less aligned, either through a rate structure similar to that of the higher taxed product, or through a rate structure which is appropriate in light of taxing both the expensive, high-end cigars as well as cheap cigarillos (e.g. through the imposition of a purely ad-valorem rate structure, with a minimum tax floor (MED) imposed at the same level as the MED applied for cigarettes). The Member States concerned report that, as a result of the rate structure, the incentive of trying to market "borderline" products does not exist.
- There is no real demand on the market for "borderline" products as consumers are generally loyal to the traditional cigarette brands.

As it is beyond the remit of this evaluation to pass individual judgement on the correct classification in an excise tax category of products whose classification proved difficult or has caused disputes, administrative cases or judicial proceedings, the analysis is limited to presenting the cases which have been reported by tax administration to have caused difficulties. The analysis includes the nature and legislative source of the dispute, outcomes of the dispute and on the treatment of the product in other MS where it is present. Our findings are summarised in Appendix 7 – *Analysis of products whose classification requires subjective interpretation of the law*.

Any impacts that the subjective interpretation and the ensuing dispute has had on the costs of administrations and economic operators involved is discussed as part of Q4.1 and Q4.2.

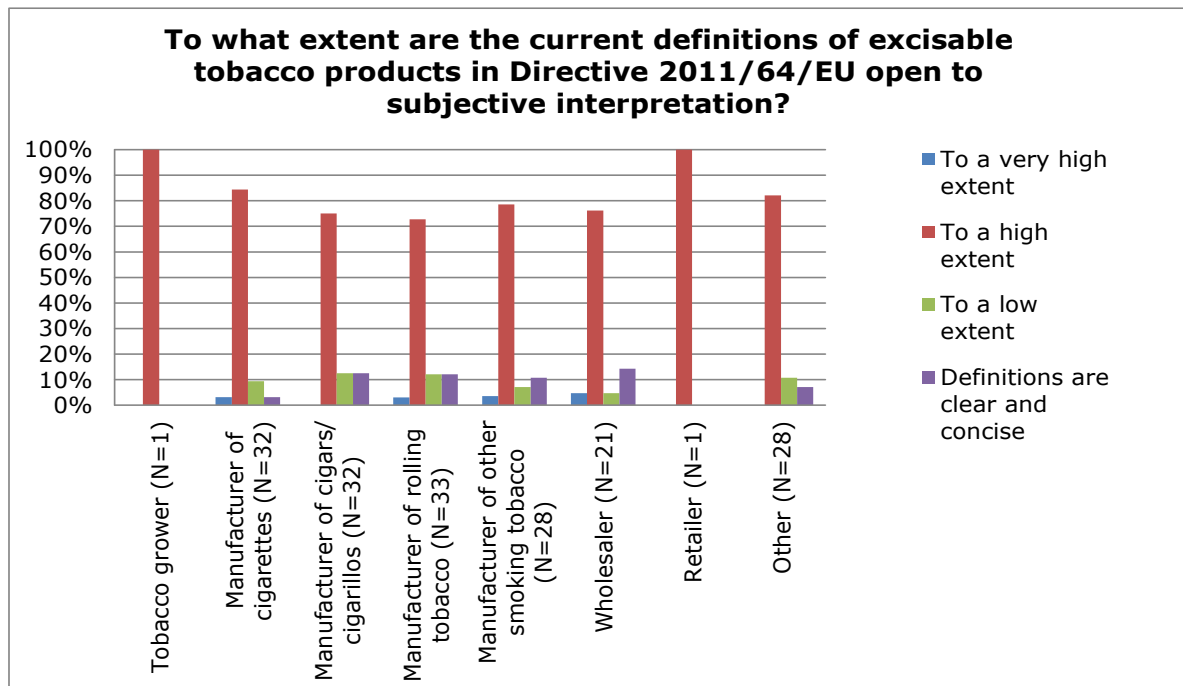
It must be noted that a number of countries appear disproportionately among the examples where disputes have taken place, the reason behind this over-representation (in addition for the existence of a higher incentives due to the rate structure) is that in those countries, national processes of "classification" are performed systematically, as opposed to other systems in which "classification" is based purely on self-reporting by manufacturers and consignors. As a result of this, it is our assessment that the lack of disputes (hence the lack of reported 'borderline' products in the remaining countries may also result from the lack of systematic classification procedures⁷⁸ and does not exclude the possibility of similar products being present on the market of some of the countries which did not report having had experience or disputes with 'borderline' products.

Reported difficulties by economic operators

When asked about the extent with which definitions of excisable tobacco products in Directive 2011/64/EU are open to subjective interpretation, the majority of economic operators consider them to be subjective to a high extent (66%), while this aspect seems to be less of an issue for those 17% of respondents who answer "to a low extent" and the 15% of respondents who consider the definitions to be clear and concise. Figure 15, below depicts the responses by operator type.

⁷⁸ This is further explained in Q2.2(a).

Figure 15 Definitions of excisable tobacco products and subjective interpretation, by economic operator type

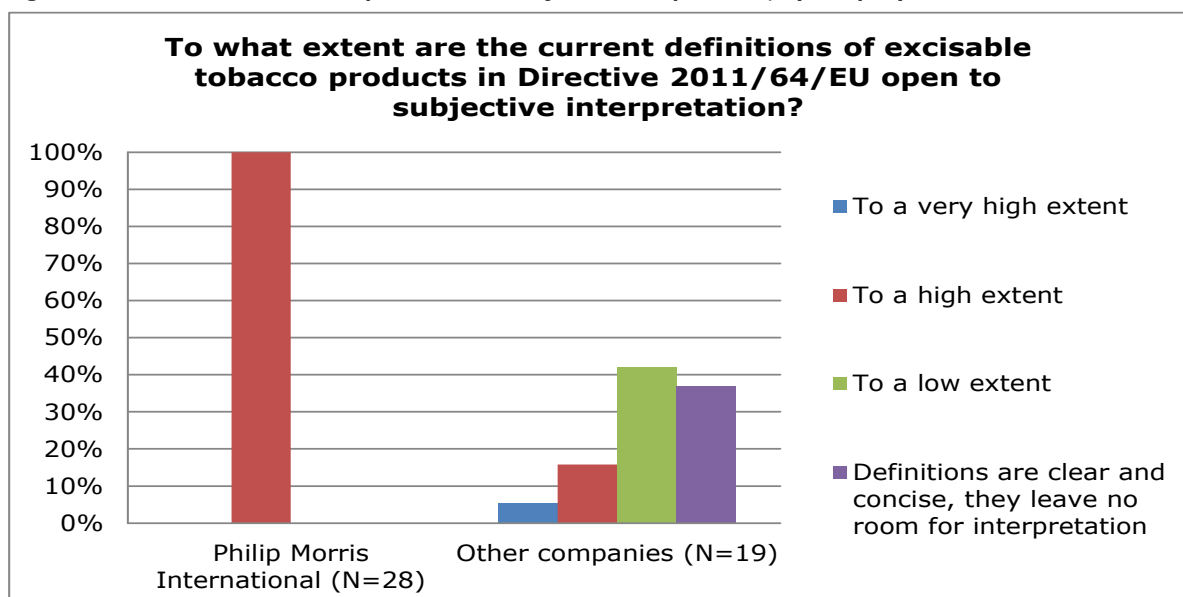


Note: Numbers and percentages do not sum up to 47 responses/100%, as respondents were given the possibility to provide answers for more than one Member State. There is only one reply representing tobacco growers and retailers, respectively.

As depicted by the graph, the issue of subjective interpretation seems to be rather equally distributed across operator types when taking the number of respondents into account (there is only one reply representing tobacco growers and retailers, respectively which explains the 100% response rate for "a high extent").

However, when accounting for the relatively large share of respondents representing Philip Morris International we receive a slightly different picture, as depicted in Figure 16.

Figure 16 Definitions of excisable products and subjective interpretation, by company cluster



The graph shows that all respondents representing PMI answered the same way (“to a high extent”), while the share of those who consider definitions particularly subjective is considerably lower among respondents from other companies (16%). 42% within the latter group think that definitions are subjective only to a low extent, while well over a third considers them to be clear and concise.

A number of the most recent disputes involved PMI’s own products; hence PMI may have been affected by the legal uncertainty to a higher extent than its peers.

When accounting for the over-representation of PMI⁷⁹, the results of the survey to economic operators would conclude that, overall, economic operators tend to believe that definitions are clear or open to subjective interpretation to a low extent. An important percentage (approx. 20%) of economic operators, however, tend to believe that definitions are open to interpretation to a high or very high extent.

In the subsequent open question the respondents elaborate on their replies. The respondent describe, while the definitions are clear for most products, some elements of the definitions are subject to interpretation. The definitions mentioned (by several respondents) regard the definition of Art 4(1):

- “Normal consumer expectation”
- “Exclusively intended to be smoked as they are”

The large majority of answers considering the definitions to be subjective had specific regard to the distinction between cigarillos and cigarettes.

A number of respondents mentioned that in some markets (e.g. Spain, Portugal, Latvia, Lithuania) “little cigars” or cigarillos are marketed as cigars, with a lower excise duty, while the product, according to some of the respondents, actually should be considered as cigarettes for excise duty purposes as the products are considered a substitute for cigarettes. The lower excise duty of cigarillos results in a lower retail price for the product and this is thought to distort competition with cigarettes.

One respondent suggests that the definition of Art 4 should be amended along the lines of “*a type of cigar or cigarillo which is similar in many respects to a cigarette is treated as a cigarette for excise purposes*” or to differentiate in the directive between manufacturing process i.e. “*machine-made similar to that for cigarettes*” and “*hand-made with the labour intensive production*”.

Detailed analysis of the disputed provisions

The cases presented in Appendix 7 – *Analysis of products whose classification requires subjective interpretation of the law* as well as the responses from economic operators indicate there are *some* aspects of the definitions of excisable tobacco products of Directive 2011/64/EU which merit closer inspection and review. These are (in the order in which they appear in the Directive):

- Art 4 (1) “given their properties and normal consumer expectations is exclusively intended to be smoked as it is”.
Although this provision is useful for arguing against the abusive classification of certain products seeking the preferential tax treatment of cigars/cigarillos (e.g. Gulliver’s, Partner, Break cigars), due to the fact that this is a subjective, interpretable argument, it is a source of disputes and legal uncertainty.

⁷⁹ on the principle of one economic grouping = one vote

- To be more specific, Member States are of the opinion that this provision can be interpreted in two ways: on the one hand that they are intended to be smoked like a cigar, so not like a cigarette, or on the other hand: that there needs to be no other action (e.g. cutting, reprocessing of ingredients, using the filling to make more cigarettes, etc.) before being smoked. This provision should be revised to ensure legal clarity and eliminate legal uncertainty and costly disputes.
- Art 4(1) (a) “rolls of tobacco with an outer wrapper of natural tobacco”.
With respect to this provision, this evaluation has identified two problems. First, products in this category are subjected to diverging classification for customs and excise purposes on the basis of whether the filter is covered by the wrapper or not, a problem that does lead to additional costs for administrations and operators. As will be substantiated in subsequent questions, the two definitions should be harmonised in order to reduce unnecessary costs and eliminate legal uncertainty of treatment. It is our assessment, however, that this inconsistency is not the main driver behind the increasing number of disputes.

The second problem is more substantial and concerns the risk that products are being designed to objectively fit this definition while otherwise presenting a subjective similarity to cigarettes (see problem regarding Art 4 (1)). As a result of the evidence collected in the context of this evaluation, it cannot be excluded that manufacturers introduce products which fit the legal definition of cigars/cigarillos but otherwise have similar characteristics to cigarettes (in terms of size, smoking time, production means, and consumer expectations), especially in light of the substantial number of reported cases from Member States. This problem revolves around the principle of “fair taxation” by which products that exhibit very similar properties should be considered equally from a taxation point of view. In order to overcome this problem, two non-mutually exclusive solutions are possible:
 - The first solution requires the redesign of the logic behind the preferential tax treatment of cigarillos and an overhaul of the definition to correctly reflect this logic. It would be necessary to establish the subjective elements which distinguish, from an excise tax perspective, cigars/cigarillos from cigarettes? (These can be, for example, the production methods (more labour intensive), smoking time, the fact that smoke is not inhaled, the fact that cigars are consumed in smaller quantities and with less frequency than cigarettes?)
 - The second solution involves maintaining the current definition but eliminating the incentive to market these “borderline” products through the application of carefully designed rate structures. The objective of these structures would be to tax products which are subjectively⁸⁰ similar to cigarettes with a comparable rate to that of cigarettes while not disproportionately affecting the taxation of other products within the cigar/cigarillo category. Potential rate structures which may serve this purpose are: (i) High ad-valorem with an MED for cigars/cigarillos equal to the MED (or the excise tax applicable at the level of the WAP) for cigarettes; or (ii) High specific rate
- Art 5(1) (a) “capable of being smoked without further industrial processing”.
This provision, which reduces the administrative burden on legitimate economic operators, creates legal uncertainty with respect to the treatment of partially processed tobacco put up for sale with the intention of being smoked. – Addi-

⁸⁰ These products will generally have a small per unit price because they would usually be mass produced. They are sold in relatively larger quantities (e.g. in packs of 19 or 20) because their smoking time is low

tional clarification with respect to the meaning of “industrial processing” or a revision of the provision (e.g. to read “without further processing *in a tax warehouse*”) is required eliminate this uncertainty. This solution, however, will not be sufficient to overcome the negative impact of this delimitation in scope on the monitoring and control function (discussed in Q2.2). – Should this provision change to say “capable of being smoked,” a smoking test is necessary to define a legally binding objective method which can determine what can be smoked.

- Art 5(1) (b) “put up for retail sale and which can be smoked”.
In the current form of this provision, the treatment of bulk tobacco refuse put up for sale is unclear. In order to remove this legal uncertainty, the provision can be made less ambiguous by removing the word “retail”. A smoking test will still be required.

Q2.1 (c) Volume / quantity of products whose treatment was reported to be problematic

In order to get a quantitative indicator in terms of *hypothetical* budgetary impact relevant to the issues discussed above, this evaluation proposed to gather data on the volumes / quantities released for consumption in the countries where the product was reported to be involved in a dispute related to its classification.

Unfortunately, Member States were not in position to offer data broken down at such level of detail (in most cases, data was not available).

As an alternative, the evaluation has quantitatively analysed the consumption patterns of cigarettes, cigars, cigarillos⁸¹ and roll-your-own tobacco in order to assess the extent to which the risk expressed by Member States (that certain types of cigarillos, are abusing the definitions in order to gain a preferential tax treatment) can be substantiated with quantitative data.

Assuming the premise that the products concerned are subjectively similar to cigarettes, they would be seen as direct substitutes and a tax induced increase of consumption of cigarillos in the detriment of cigarettes will be observed, especially in the context of growing excise duties on cigarettes.

Before presenting the results of such an analysis, it is necessary to mention that it is rather difficult to identify the impact of excise duties on the consumption of a product. More specifically, the only way in which excise duties can affect consumption decisions is via an impact on retail prices. If manufacturers absorbed all duty increases or took the profits afforded to them by a preferential tax treatment such that the retail price remained unchanged (or similar to those of cigarettes), there would be no impact of excise duties on consumption, as consumers respond to retail price changes, not excise duty changes.

This fact makes the analysis somewhat complex as there are many factors other than excise duties that affect retail prices. In addition, there are many influences on consumption behaviour other than retail prices (e.g. real household incomes).

That said, the data included in our report do seem to show evidence of down-trading by consumers. The clearest example of this is the fact that cigarette sales have generally fallen over time as prices have risen while RYO tobacco sales have generally

⁸¹ In the available dataset, cigarillos are defined as miniature cigars weighing less than 3 grams each, with a ring gauge of <29.

risen (particularly in countries where the economy has performed poorly in recent years such as Spain, Portugal and Greece).

With respect to whether “borderline” cigarillos are in fact trying to abuse a preferential tax treatment, it is interesting to note that sales of cigars have generally fallen over time despite relatively flat prices, whereas sales of cigarillos have increased in some Member States. An interesting case here is Spain, where sales of cigarillos rose during the same period as prices of cigarettes rose and sales fell. The case of Latvia (described below) is equally interesting.

Latvia, which reported that the emergence of borderline cigarillos has been problematic, shared consumption data that indicates a decline of cigarette sale of 22% coupled with a 2089% increase in the consumption of cigars and cigarillos.

Cigarettes (in thousands of units) (-22.83% change, or 523 830 thousand units)

- 2,294,348 (2009)

- 1,770,518 (2010)

Cigars and cigarillos (in thousands of units) (+2089% increase, or 127 187 thousand units)

- 6088 (2009)

- 133,275 (2010)

The dramatic increase can almost entirely be attributed to Partner Cigarillos, as 125 526 thousand pieces (2010) and 116 375 thousand pieces (2011) were released for consumption. They were not present on the market in 2009.

Table 10 contains consumption data for cigarillos (in million units) in the most recent years, for which complete data is available.⁸²

As can be seen in the table, in many EU countries, predominately in the countries which have reported no problematic issues, the consumption of cigarillos represents only a fraction of the market for excisable tobacco products. While it can be argued that the disputed cases which have been reported are limited to only a number of countries, and that at EU level the extent of the problem is relatively marginal compared to the overall consumption of excisable tobacco products, the *hypothetical* budgetary implication on some of the individual countries which have reported problems (e.g. LV; NL; DE; EL) may be significant.

Table 10 Consumption of cigarillos (in million units) in the EU in 2011 and 2012

Country	2011	2012
Bulgaria	5.0	5.0
Croatia	1.6	1.6
Czech Republic	12.1	12.3
Estonia	4.0	4.4
Hungary ⁸³	11.8	14.2

⁸² In this dataset, cigarillos are defined as miniature cigars weighing less than 3 grams each, with a ring gauge of <29.

⁸³ As a result of the expiry on December 31st 2014 of the derogation given to Hungary and Germany in the application of the definitions for cigars/cigarillos (Art 4(2)) it is expected that a proportion of the products which are shown to be cigarillos in this dataset to be re-classified as cigarettes for excise purposes.

Country	2011	2012
Latvia	122.4	93.0
Lithuania	55.2	57.1
Poland	8.7	9.5
Romania	6.2	6.4
Slovakia	2.5	2.6
Slovenia	1.1	1.3
Austria	86.2	90.2
Belgium	240.5	242.7
Cyprus	0.2	0.2
Denmark	35.7	35.6
Finland	115.8	120.5
France	1,290.8	1,280.0
Germany ⁸⁴	3,943.2	3,884.6
Greece	60.0	55.2
Ireland	4.8	4.9
Italy	335.7	338.8
Luxembourg	18.5	18.8
Malta	0.7	0.7
Netherlands	305.5	306.6
Portugal	74.0	69.1
Spain	1,469.6	1,769.4
Sweden	36.8	36.2
United Kingdom	305.7	292.1

Summary

Our analysis of the extent to which definitions of taxable products in Articles 2-5 of Directive 2011/64/EU allow for adequate (correct categories and rates) collection of the due excise duties for manufactured tobacco products provides the following key findings:

- In light of the growing consumption of e-cigarettes, as a substitute to excisable tobacco products, the long-term budgetary implications of not including e-cigarettes within the framework of harmonised excise duties may prove to be significant.
- Differences in the level of taxation between excise duty categories are being credited by Member States as a driving factor for the emergence of “borderline” products, particularly those seeking to take advantage of the lower levels of taxation of cigars/cigarillos.
- The current definitions of Art 4(1) lead to increasingly disputed classifications of certain tobacco products as cigars/cigarillos. The nature of the disputes pertain to both the risk that this category is being abused to circumvent the high excise duties imposed on cigarettes as well as to issues resulting from the application of divergent criteria for customs and excise purposes.

⁸⁴ *Ibid.* 83

- Even though the size of the cigarillos market (of which 'borderline' products are a subset) is relatively small when compared to the total market of excisable tobacco products, the *hypothetical* budgetary implication of misclassification on some of the individual countries which have reported problems (e.g. LV; NL; DE; EL) may be significant.
- The current treatment of raw tobacco has a direct and an indirect impact on the budgetary objectives of Member States. The direct impact refers to situations where economic operators sell raw tobacco directly to consumers, allowing them to produce, on a small scale, tobacco products for their own consumption, avoiding the payment of the excise duty. The indirect impact is more significant and refers to the situations described in Q2.3 by which raw tobacco is diverted from the "legal" supply chain and used in the large and medium scale production of excisable tobacco products outside the premises of an authorised warehouse keeper, hence away from the control mechanisms of Member States
- There is evidence that raw tobacco, partially processed tobacco, dried leaves and other types of tobacco are being sold directly to consumers, however, in the absence of measures of monitoring and control, it is not possible to adequately quantify the resulting revenue impact. Despite the lack of mechanisms in place to adequately quantify the amounts of raw tobacco diverted into the illegal supply chain, the quantification of illicit trade, as included in the excise duty gap section of this report, includes "contraband" (i.e. fake) as well as non-duty-paid (NDP) products. Quantities of raw tobacco diverted from the legal circuit will serve as raw materials to the "contraband" part of illicit trade and are included in the calculation of the excise duty gap
- The current definition of Art 5(1) (a) and specifically, the wording of "*without further industrial processing*", appears not to be appropriate in light of giving sufficient legal clarity for the inclusion of a number of products which arguably can be smoked as smoking tobacco.
- The current definition of Art 5(1) (a) enables Member States to apply excise duties on water-pipe tobacco, irrespective of whether it contains tobacco or not. However, the characteristics of this kind of tobacco product are significantly different than those of other types of tobacco which are usually found within this category, and as such a single rate structure is not always appropriate.
- In the current definition of Art 5(1) (b) "put up for retail sale and which can be smoked", the treatment of bulk tobacco refuse put up for sale is unclear. In order to remove this legal uncertainty it has been suggested to remove the wording "retail" from the definition.
- As there is currently no method by which the inclusion level of expanded tobacco in a particular tobacco blend can be legally ascertained by customs laboratories, any differentiated treatment of fine-cut tobacco on the basis of whether it contains expanded tobacco or not would be technically impossible to impose in practice.

With the exceptions of the aspects presented above, this evaluation concludes that, overall, the Definitions of Art 2-5 Directive 2011/64/EU have proven to be effective and are generally, appropriate for enabling adequate (correct categories and rates) collection of excise duties for the large majority of manufactured tobacco products

Q2.2 To what extent are the definitions of taxable products in Articles 2-5 of Directive 2011/64/EU appropriate to enable monitoring, verification and authentication, and identify illicit trade, evasion and abuse in the Internal Market?

Question 2.2 examines the capacity of the Member States to utilize the existing definitions of Directive 2011/64/EU in order to perform monitoring of trade/ logistics of taxable tobacco products, identify illicit trade, evasion and abuse in the Internal Market.

It must be stressed that, the appropriateness of the definitions of taxable products in terms of the efficient and effective realisation of the monitoring and control functions has two distinct dimensions:

- The first is substantive in nature and relates to the scope of applicability of excise duty legislation (i.e. whether a product can be considered an excisable tobacco product, as defined by Art 2-5 of Directive 2011/64/EU). This dimension explores, in particular, the non-inclusion of raw tobacco within the scope of excisable tobacco products.
- The second dimension is process-related, and refers to the concrete means by which the authorities of Member States code, classify, treat and monitor products which fall under the scope defined by the European legislation.

As the substantive aspect has been thoroughly discussed as part of Q2.1 and Q2.3, it will be treated in this section only from the perspective of the monitoring and control function.

In order to facilitate reading and gradually build the narrative of the evaluation, the section will present the procedural aspect and its impact on the functioning of the system, with a particular focus on the dual treatment of tobacco products for excise and customs purposes.

Q2.2 (a) The extent with which dual coding and classification of tobacco products for customs or excise duties purposes affect the capacity of the Member States to fight against avoidance or fraud

The process of classification in excise duty categories

In order to analyse the potential implications of the dual treatment of tobacco products for customs and excise purposes, an understanding on the processes of classification at Member States level is necessary. This aspect has been researched on the basis of the sample of case study countries.

The classification of tobacco products in their respective excise categories is performed in various ways across Member States. Additionally, processes may vary according to whether the product is imported from a third country or manufactured in the Member State itself or another EU country.

Importation from 3rd countries

At importation, a customs declaration has to be done for each consignment; the importers will be asked to declare, on their own responsibility, the CN code and excise code applicable, if customs officials are involved, classification on the basis of CN codes and CNEN descriptions will be performed. In this situation, they will also be in a position to recommend the excise duty treatment on the basis of nationally established equivalence tables, implemented as administrative guidelines, hence the link between CN codes and excise duty categories may be important in this scenario. It is at this stage that laboratory testing may be implicated (only when necessary).

Products manufactured in the EU

There are two general approaches possible:

The first approach relies mostly on self-regulation, in which a new product (product type, brand) does not automatically undergo classification with the tax administration and there is no systematic approach that allows the tax administration to identify new products or have a say in their classification as one or another excise tax category.

These systems rely on reports, or other ad-hoc operations such as inspections to come across products which would potentially raise doubts with respect to their correct classification. If such doubts are raised, the products would be re-classified on the basis of a visual inspection or sent to the customs laboratory which would be in position to make recommendations for the correct CN and excise duty treatment. Economic operators would be allowed to appeal against the re-classification.

The second type of system involves tax administrations (to various degrees) in the initial classification of products which are manufactured in the tax territory of the MS. This process often takes place when manufacturers request an authorization and are obliged to declare their products. At the moment the request is received, information regarding the characteristics of the product has to be provided. The custom classification is achieved first, followed by the excise tax treatment.

A particular unique case is that of Greece, where in addition to a CN code and an excise code, a unique national tax code is necessary for all excisable tobacco products placed on the market in Greece, this code is unique not only on product level, but the same products released for consumption at different price levels will have to be given a distinct code. This process entails the declaration by the operator of a description of the product, its name, packaging and retail selling price. The operators are required to refrain from releasing the product for consumption for 15 days. It is through this process that the Greek authorities inter alia have an opportunity to verify the compliance of the products marketed in Greece with the requirements of each excise category and identify potentially abusive products.

It is clear from the analysis that, despite the fact that, from a legal perspective, the treatment of tobacco products for excise purposes is not bound by the treatment of the product for customs purposes, due to the various processes of classification and monitoring, and indirect link between the two exists *de facto*.

To what extent are CN codes and the explanatory notes thereof consistent with the definitions of tobacco products in Article 2-6 of the Directive?

The answers to the survey to Member States revealed divergent opinions with respect to whether the definitions of Directive 2011/64/EU and the CN codes (and associated explanatory notes) are consistent with one another.

Fourteen Member States expressed their opinion that the two coding systems are largely consistent with each other.

Nevertheless, a number of inconsistencies and problems were reported by the other Member States. The reported inconsistencies were then analysed to verify whether they are caused by a unique situation or whether they are the result of a systemic problem. The latter category (and their real-life impact) is summarised below:

Table 11 Reported inconsistencies of the CN codes with the Definitions of Directive 2011/64/EU

Inconsistency	Outcome
Tobacco free water pipe tobacco, is not present in chapter 24 of the CN classification	Even though tax law may treat tobacco free water-pipe tobacco as excisable, the customs officials will often overlook this fact. Since the customs processes have the CN codes as their basis, products not falling under chapter 24 will not be subject to increased scrutiny and additional control.
Cigars, cheroots, and cigarillos (CN 2402 10 00) is not consistent with definitions of Art 4(1) (a)	Cigars covered by an outer wrapper of natural tobacco (not including the tip) will have to be included in another category (most likely in 2402 20 90). However, since, for excise purposes the product can still be a cigar, this may result in errors and difficulties in using EMCS, as the technical specifications do not always allow the combination of 2402 20 90 with T300.
Articles 3(b) and (c) of the Directive are not reproduced or adapted into the explanatory notes at CN codes 2402 20 10, 2402 20 90 or 2402 90 00 (cigarettes)	It is unclear what CN codes will correspond to the definitions of Art 3 (b) and (c) One possibility is that CN 2403 10 10 can be treated as T200 under certain conditions; however, it is unclear whether other categories would also correspond.
Fine cut tobacco (Art 5 (2)) has no equivalent in the CN codes	CN 2403 10 10 can be treated, according to the particularities of the product as both smoking tobacco (T500) as well as fine-cut tobacco (T400) for excise purposes
Article 4(2) is included in the explanatory notes (CN 2402 10 00)	The derogation that applies to Germany and Hungary is due to expire at 31/12/14, hence a potential inconsistency is due to take place after that date
The subjective criteria of "normal consumer expectations" of Art 4(1) is not reflected in the CN codes (CN 2402 10 00)	In essence, this inconsistency makes the subjective criteria even harder to apply from a practical point of view, as all ensuing disputes will eventually take the CN classification in account for delivering an opinion on the treatment of the product.
Expanded tobacco falls under 2403 99 90	As this category usually contains non-excisable products, treating expanded tobacco as excisable is made difficult, with potentially negative consequences for adequate monitoring, control and budgetary objectives
Article 5(1) can be linked to wider number of CN codes, not just one.	Article 5(1) has been designed as a residual category in order to capture products which may otherwise escape taxation. Moreover, this category is used by Member States to enlarge the scope of the monitoring and control function to cover products which could be intended for smoking, without it being obvious from their CN classification.
CN 2403 10 10 has been brought in line with Art 5(1) (b) to be limited to "retail" sale, but is now not in line with CN 2401 30 00	CN 2401 30 00 excludes waste prepared for sale as smoking tobacco or chewing tobacco, assuming it would be suitable for CN 2403 10 10. The treatment of waste prepared for sale as smoking tobacco <i>in bulk</i> will be unclear both from a tariff classification as well as from an excise perspective
CN code 2402 90 00 can include a variety of products, not all of which finding direct equivalents in the Directive	Depending on certain circumstances, this category may lead to excise classification as T200, T400 or T500, or even contain products which are not excisable.

Member States have reported that a number of attempts to modify CN codes to more adequately reflect the reality of the products concerned were attempted in the context of the Customs Code Committee (CCC). The attempts in question however were not finalised, due to fears that they may cause additional inconsistencies with the Directive.

With respect to the fact that CN code 2402 10 00 does not reflect the “normal consumer expectations” of Art 4(1), during the 106th and 119th meeting of the CCC, an amendment to the CNEN to subheading 2402 10 00 "Cigars, cheroots and cigarillos, containing tobacco" was discussed in order to include products being advertised and sold as cigarettes, but taxed as cigarillos.

Most Member States felt that the amendment of the CNEN should be done taking into account the current text of Directive 2011/64/EU and not go beyond that objective in order to avoid discrepancies between the CN and Directive 2011/64/EU.

Regarding the classification of tobacco refuse presented in bulk and suited for smoking (119th meeting CCC). A round of the table indicated that the majority of Member States represented abstained from giving an opinion on the issue as this was not in line with definitions of the tobacco Directive 2011/64/EU.

Some Member States pointed out that, in the current framework, CN codes can be amended in relatively short timeframes to eliminate inconsistencies with the Directive, but amendments to the Directive were only possible at large time intervals and following a much more difficult process.

Even though it was not specifically asked in the survey, several Member States specifically recommended that CN codes⁸⁵ would be better suited as the basis for excise duty.

The customs tariff includes the CN and TARIC (Art 20/1 CC). The tariff consists of 11 positions. The first 6 positions are part of the HS, which is administered by the WCO. The following 2 positions (7 and 8) are part of the CN: This is a systematic inventory of all goods on the basis of the HS managed by the EU with further subdivisions of the EU for tariff purposes (common customs tariff). The following 2 positions (9 and 10) are part of the TARIC, which governs Community measures such as anti-dumping regulations, tariff suspensions or quotas. This part is managed by the European Commission itself. The last point is purely national and affects the determination of sales and excise tax rates, but not the classification of the taxable goods.

Regarding alcohol and mineral oil, the Directive exclusively links to the CN, however in the field of tobacco taxation there is no general link to the CN.

On the other hand, a substantial number of Member States expressed concerns over the same possibility. The countries holding this view argued that use of CN codes for excise duty purposes could cause difficulties such as a reduced flexibility for Member States' evaluation of products, and even increased potential for abuse (as reported to be occurring for some energy products). They also mentioned that the sovereignty of the Member States in taxing goods would be unduly impeded by the qualified majority requirement in the customs area as compared to the unanimity requirement in the tax area (Art. 113 TFEU). The later argument, however, appears not to be fully substantiated, as any changes of the objects of excise taxation have to be decided unanimously, whether or not referencing the CN.

One Member State pointed out that the recent attempts to regulate tax issues⁸⁶ through the area of customs and tariff legislation (e.g. the modification of the CNEN of

⁸⁵ N.b Customs tariff positions 7 and 8

⁸⁶ I.e. to attempt to reduce the legal uncertainty with respect to excise tax treatment of certain tobacco products

cigars/cigarillos and tobacco refuse without the corresponding change in the text of the Directive) have not had the effectiveness sought and cause a series of unintended consequences. The assessment of this evaluation is that reducing legal uncertainty was not achieved in these particular cases due to the fact that the change to one system was not reflected in the other.

In the opinion of another country in this category, dual coding, in fact, actually has a positive impact if regarded as an additional “check” against negligent conduct by customs officers who fail to identify incorrect or fraudulent customs declarations. An additional layer of supervision could ensure the correct excise classification of products, in accordance with the purposes and objectives of the Directive. This scenario, however, is possible only in countries where a “classification procedure” takes place with the involvement of tax authorities.⁸⁷

How does the dual coding of tobacco products affect the operations of Member States?

In the context of the evaluation, significant efforts were conducted to isolate the impact of the differentiated treatment of tobacco products for fiscal and customs purposes on the basis of differentiated definitions on the operations of Member States.

As many as fourteen Member States responded to the survey that there is no (or no significant) impact deriving from the need to apply a dual classification system, while an additional three mentioned that, although they imagine the potential of problems surfacing, they have had no experience in this respect. One Member State reportedly sorted out potential inconsistencies in this respect by signing an unambiguous agreement on dual categorizations of the product sold on the market with all economic operators operating in the country.

Only four countries reported that the dual coding affected their operations in various ways: the most cited effect being the emergence of legal uncertainty as a result of inconsistencies. Other effects included increased administrative costs and decrease of the effectiveness of IT systems.

On the basis of a thorough analysis of the potential impacts reported, this evaluation concludes that the problems reported by Member States (legal uncertainty, decrease of effectiveness of IT systems, and increased administrative tasks) are not attributed directly to the dual treatment of tobacco products. It appears that the inconsistent treatment of tobacco products, as a result of interpretable definitions has a stronger contribution to these effects than the dual classification itself. The existing practical links between customs and excise classification, however, tend to exacerbate the problem, reducing the possibilities for an unambiguous classification for certain tobacco products, in particular those belonging to a CN code with contains both excisable as well as non-excisable tobacco products.

The impact of the dual coding practice on the capacity of Member States to adequately perform monitoring and logistics and find illicit trade is impacted only to the extent to which it contributes to the inconsistent treatment of certain products as excisable or non-excisable tobacco products.⁸⁸

⁸⁷ See section Q2.2 (a)

⁸⁸ See Q2.2(b) and Q2.2 (c)

Q2.2 (b) To what extent current definition rules and implementation thereof are detrimental to other rules and mechanisms in application at EU level?

Integrability of the current classification system with existing IT technologies

In this section we have chosen to briefly describe the most important elements on the impact of the Directive on the functioning of the EMCS, a detailed description of the IT systems commonly used by Tax administrations in support of imposing excise duties can be found in Appendix 5 – *Question 1: Background Information*, and more specifically, as a result of the answers to Q1.5.

All responding tax authorities stated that EMCS has improved their operations by reducing the risk of fraud and by making inspections more targeted. It also allowed for improving the efficiency with respect to the paper-based system.

Member States appreciate that data that can be extracted by the EMCS allow for having a real-time overview of the movements, create risk profiles, feed risk-analysis systems and perform data mining.

The direct impact of the EMCS on illicit trade from third countries however, is not evident.

With respect to the specific impact of the dual classification on the functioning of IT systems (e.g. the EMCS) Member States have mentioned that, where there is an inconsistency between the CN codes and the excise treatment of the Directive, errors might arise,⁸⁹ but these errors stem from a shortcoming of the technical specifications (which should be kept up to date and reflect the evolving nature of the market) and not from the systemic failure of the excise system.

The proper functioning of the rules on administrative cooperation and exchange of information

To a great extent, Member States regard administrative cooperation and exchange of information as one of the most important tools available to fight against tax fraud in the scope of excisable products which, by nature, is a cross-border phenomenon.

Indeed, the illegal trade of tobacco products is a transnational infringement, and detections and seizures of illegal tobacco products in a Member State involves criminal activities carried out in another Member State and/or third countries. So, cooperation and exchange of information at EU and international level are essential to develop the abilities of Member State administrations and increase efficient performance in this field.

Some Member States pointed out that most of the detections, seizures and investigations carried out require the participation and coordination with other Member States.

With respect to suggestions for improvement, Member States suggested the following areas:

- To increase the systematic collection on the movements of raw tobacco
- To have periodic exchange of information about movement of risk tobacco products such as tobacco leaves and raw tobacco
- To improve the response times of Member States following specific requests for information

⁸⁹ E.g. when the combination between a correct CN classification and a correct excise duty classification is not allowed by the EMCS specifications.

With respect to the impact of the current definitions on the functioning of the system for admin cooperation, the majority of countries (14) do not think that the current definitions create a problem.

A number of countries however raised concerns with respect to situations where definitions are not harmonised (raw tobacco) or the application of existing ones is inconsistent (e.g. the treatment of a particular tobacco as excisable in one Member State and non-excisable in another).

One Member State expressed its opinion that, since the EU Directive 2011/64/EU does not define raw tobacco as an excisable good, the lack of common definition and treatment is damaging for the functioning of administrative cooperation and information exchange.

Example: A Polish economic operator dispatches raw tobacco to a competitor located in a different EU Member State. Authorities responsible for the inspection of the Polish dispatcher approach the EU Member State of the economic competitor that had acquired raw tobacco in order to verify the transaction, meaning the acquisition of raw tobacco by the economic competitor. The administration of the EU Member State of the economic competitor informs the Polish administration that the transaction cannot be reviewed in cooperation with the economic competitor since the delivered good is not excisable on the territory of that EU Member State.

In this respect, Member States mentioned that clarifications of what products should be considered excisable or non-excisable would be welcome.

Furthermore, Member States argued that a major negative consequence of the lack of harmonized definitions at EU level is that it is not possible to use administrative cooperation of the Council Regulation (EU) 389/2012 for products not monitored via EMCS.

With respect to the appropriateness of the definitions in Directive 2011/64/EU to ensure effective and efficient functioning of other mechanisms (such as the EMCS and administrative cooperation and information exchange), this evaluation has found that the inconsistent treatment of certain tobacco products⁹⁰ and the lack of a harmonised definition for raw tobacco negatively influence administrative cooperation between Member States.

Q2.2 (c) The extent to which the non-inclusion of certain tobacco products within the framework of excisable tobacco products affects the monitoring and control function?

The impact on the costs for tobacco growers, processors and other economic operators involved in the logistics of raw tobacco as well as on the capacity of the EMCS systems to handle the increased data traffic would have to be investigated.

In addition to raw tobacco, this section presents the potential negative effects of the lack of harmonised (unequivocal) definitions for other products in terms of the ability to monitor trade and logistics of excisable tobacco products resulting from inconsistent treatment.

The inconsistent treatment of such products (and others) may, additionally, have an impact on budgetary revenues, on administrative costs for Member States and compliance costs for economic operators. Such impacts are discussed at length in Q2.1; Q4.1 and Q4.2 respectively.

⁹⁰ See Q2.2 (c)

Water-pipe tobacco containing tobacco – CN 2403 11 00

The evaluation has found no inconsistent treatment of water-pipe tobacco containing tobacco across Member States. There is no evidence that the lack of specific definitions in the Directive for water-pipe tobacco negatively impacts the ability of Member States to perform monitoring of trade/ logistics of taxable tobacco products.

Water-pipe tobacco not containing tobacco – (not in chapter 24 of the CN classification)

The evaluation has found evidence of potential inconsistent treatment of this type of product. The product is treated as excisable in some countries and as non-excisable in other countries. As a result of this inconsistency, monitoring in some situations (such as cross border movements under the EMCS or duty paid cross border movements) can theoretically be affected. However, as this kind of product is usually imported from third countries and is consumed in very marginal quantities, this evaluation has not found any concrete evidence of water-pipe tobacco not containing tobacco being moved within the EU without proper documentation.

Homogenized (reconstructed tobacco) – CN 2403 91 00

Evidence of inconsistent treatment with respect to this type of tobacco has been found. Given the use of this product in the tobacco blends and the manufacturing of excisable tobacco products, failing to transport this type of product under the cover of an e-AD, for transports originating in countries which deem this product to be non-excisable can have an impact in the ability of Member States to monitor the logistics of excisable tobacco products.

Tobacco refuse - CN 2401 30 00 or CN 2403 10 10

Tobacco refuse (CN code 2401 30 00) requires substantive clarification: if tobacco waste can be smoked but is not “put up for retail sale”, it would in effect not be considered an excisable product and hence will not be monitored within the EMCS. This would have consequences on the ability of MS to perform effective monitoring or control.

Expanded tobacco – CN 2403 99 90

According to existing classifications, the treatment of expanded tobacco, even when it is ready cut, and destined for the rolling of cigarettes would be unclear.⁹¹ Failing to include this type of product as an excisable product when it has been cut or otherwise split and is capable of being smoked has a negative effect on the monitoring and control function.

Bulk bland tobacco – CN 2403 19 90

In certain special cases when national decisions need to be taken on the treatment of a certain product, there is a risk that different Member States could have different interpretations regarding the adequate classification and/or excise treatment, leading to inconsistent application of the rules and to problems regarding the functioning of the EMCS.

This evaluation has found significant evidence⁹² to support the hypothesis that the lack of a harmonised definition of raw tobacco as an excisable tobacco product, and the resulting effect of its lack of inclusion as a product under the monitoring of the EMCS

⁹¹ According to Commission Regulation (EEC) no 3311/86 of 29 October 1986 on the tariff classification of goods falling under subheading 24.02 E of the Common customs tariff, expanded tobacco is to be considered to be not suitable for smoking without further industrial processing and goes further to describe a test, which determined whether or not tobacco has been expanded

⁹² See section Q2.3 for a detailed breakdown of arguments and evidence

has a strong negative impact on the ability of Member States to monitor the logistics of excisable tobacco products.

Some Member States have suggested, within the context of this evaluation, that in order to improve the collection and exchange of information on the logistics of raw tobacco, it should be included in the scope of excise duty legislation as an excisable product with a zero duty rate.

However, a thorough analysis of the current treatment of raw tobacco across the EU (see section on Q2.3) indicates that the implementation of such a system will imply significant costs for some Member States, especially in those where the legislative framework and control measures would have to be designed from zero.

Summary

Our analysis of the extent to which the definitions of taxable products in Articles 2-5 of Directive 2011/64/EU are appropriate to enable monitoring, verification and authentication, and identify illicit trade, evasion and abuse in the Internal Market reaches the following conclusions:

- All the responding tax authorities stated that EMCS has improved their operations by reducing the risk of fraud and by making inspections more targeted. It also allowed for improving the efficiency with respect to the paper-based system.
- Member States regard administrative cooperation and exchange of information as one of the most important tools available to fight against tax fraud in the scope of excisable products.
- The non-inclusion (or inconsistent inclusion) of a number of tobacco raw materials, intermediaries or by-products within the scope of the EMCS and the administrative cooperation, negatively affect the capacity of Member States to monitor and control the logistics of excisable tobacco products and fight illicit fraud.
- A major negative consequence of the lack of harmonized definitions is that it is not possible to use administrative cooperation of the Council Regulation (EU) 389/2012 for products not monitored via EMCS.
- The dual classification of tobacco products does not necessarily have a direct negative impact on the capacity of MS to perform effective monitoring. However, it exacerbates the legal uncertainty around the treatment of certain products whose classification as excisable products is contested.
- The dual classification of products, may, in certain cases exacerbate the problem of legal uncertainty with respect to the excise treatment of certain tobacco products; this effect is mostly present with respect to products belonging to CN classifications which include both excisable as well as non-excisable tobacco products. In certain cases, it also regards products whose tariff classification (and accompanying explanatory notes) is inconsistent with the definitions of the Directive.

Summing up, as currently formulated, the definitions of Art 2-5 of Directive 2011/64/EU are not fully appropriate for enabling effective and efficient monitoring of excisable tobacco products.

Q2.3 How does the treatment of products not defined by the Directive impact the ability to perform monitoring of trade/ logistics of taxable tobacco products?

As the protection of budgetary objectives critically depends on the **ability of Member States to monitor and control the production and sale of excisable tobacco products**, Question 2.3 looks closely at whether the non-inclusion of certain products within the scope of Directive 2011/64/EU has any negative effects. This section gives particular importance to raw tobacco as an essential link in the tobacco trade and logistics system.

The evaluation has found that the inconsistent treatment resulting from the non-inclusion of raw tobacco as an excisable product has a strong negative effect on the ability of Member States to systematically collect data on the raw materials used in the making of excisable tobacco products, fight illicit trade and ensure the collection of tax revenue.

The Fiscal Treatment of raw tobacco

Raw tobacco is not covered by Directive 2011/64/EU and for this reason there is no *harmonised* definition of raw tobacco for fiscal purposes, the national systems for control in force at national level may make reference to either established international definitions, (such as the CN codes) or may be constructed individually at national level.

As the treatment and the conditions for the purchase and sale of raw tobacco are seemingly subject to differentiated rules in the Member States, the present section also briefly summarises the current national measures of controlling and monitoring the flow of raw tobacco before analysing their effects.

A mapping of the applicable definitions of raw tobacco, as well as its fiscal treatment in the Member States, has been conducted in the context of this study.

Out of 24 tax administrations that provided answers to the question in the survey, nine (FI, LT, HU, HR, NL, CY, PL, RO, LUX) stated that there is a national definition of "raw tobacco" in place either for fiscal purposes (e.g. in the fiscal law) or for other purposes (e.g. tobacco law) but which is used for fiscal purposes too.

15 of the 24 tax administrations responded that there is no explicit definition of raw tobacco in their national legislation. Meanwhile, the Common Nomenclature and the related explanatory notes may be used to define raw tobacco, when required.

From a legal point of view, the manner in which raw tobacco is defined, appears to be very fragmented across the EU: the different definitions and fiscal treatment, as reported by the tax administrations in the context of the survey, are summarised in Appendix 8 – *Overview of national definitions and treatment of raw tobacco*.

Q2.3 (a) The extent to which information on the logistics of raw tobacco is being generated in the context of the current systems?

Within the current arrangements,⁹³ data on raw tobacco can be generated from three potential sources:

⁹³ At national as well as at EU or international level

- (i) Customs information on importation from third countries; In the context of the Customs Information System (CIS) information on the amounts of raw tobacco imported and released within free circulation in the EU can be made available

This happens, for example, in Malta, where whenever raw tobacco is received at customs (mainly coming from third countries) it is put in free circulation and the excise authority is informed. Daily updates on the stocks of raw tobacco in the customs warehouses are sent to excise administration.

- (ii) Data on the amounts of raw tobacco acquired, used and disposed of by authorised warehouse keepers.

Information on raw tobacco becomes available and relevant to the control and monitoring of the production of excisable tobacco products at the level of authorised manufacturers who are required to maintain accounts of all unmanufactured tobacco received, used, disposed of or resulting in the manufacture of tobacco products.

However, this type of information can only be used in the control of established manufacturers who already function within the legal system. Even in systems which require that raw tobacco be sold only to registered warehouse keepers, this data collection system cannot account for raw tobacco which has been previously diverted to the illicit market.

- (iii) Data generated in the context of national measures for the control and monitoring of the logistics of raw tobacco

As detailed in Q1.3 and Q2.3, in a majority of Member States, there are no specific licensing, authorisations or other obligations imposed on operators involved in the logistics of raw tobacco. However, in the countries that have enacted legislation, there are several measures which have been implemented for the purpose of controlling and monitoring the logistics of raw tobacco.

There are significant variances between the choices made by each MS. Nevertheless, the systems usually entail the application of one or more of the following measures:

- The registration of one or more of the following types of operators trading in raw tobacco: tobacco growers; first processors or importers (e.g. DK, HU, HR, NL, CY, RO, PL)
- The obligation that raw tobacco may only be sold to or bought by registered first processors or authorised warehouse keepers (e.g. DK, HR, CY, RO, PL)
- The obligations for importers of raw tobacco to declare the final destination and use of the amounts imported (e.g. UK)
- The obligation that movements of raw tobacco are accompanied by a paper based commercial document, detailing the origin and destination of the goods transported and/or the name and authorisation number of the economic operators involved. (e.g. FI, NL, RO)
- The obligation to keep records of tobacco raw material for all persons trading in raw tobacco (SK)
- Obligation to declare the amounts produced and their destination (e.g. GR, BE)
- Marking of raw tobacco with tax marking and wrapping it in closed boxes (PL)

In countries where a system is in place, excise duties or criminal fines may be imposed for raw tobacco found to be in non-compliance with the obligations (e.g. IE, FI, RO, PL, NL, HU).

With respect to this last point, the systems described above, while potentially able to generate some data on the logistics of raw tobacco, have not been designed with this purpose in mind and are generally unable to generate real-time data in electronic format; as such they are not suitable for use in risk assessments and the targeting of control measures in a cost-effective manner.

Q2.3 (b) To what extent do Member States systematically collect and use monitoring data on raw tobacco

In Slovakia, the flows of the raw tobacco on the tax territory as well as imports from third countries and receipts from other MS are monitored. Persons involved in the logistics (growing, drying, fermenting, receiving, storing and dispatching) of raw tobacco must register at custom office.

The trader is then required to keep records of tobacco raw material (received or dispatched, irrespective of destination).

The trader is also required, no later than two working days prior to any receipt or dispatch of such tobacco raw material to notify the customs office of:

- identification data of the trader;
- the quantity, brand name and the respective code of the combined nomenclature of tobacco raw material;
- identification data of the supplier or purchaser of tobacco raw material;
- identification data of a person to/from whom it sells/purchases tobacco raw material;
- the place of delivery of tobacco raw material.

In Hungary, the importation, storage and supply of cured and fermented tobacco is subject to prior registration and notification requirements

Within the system, tobacco producers, fermentation facilities, importers, traders (tobacco supplier), and tax warehouses used for the storage and warehousing of cured and fermented tobacco are subject to registration requirements.

Tobacco importers and suppliers shall keep accurate trade records, and shall notify all tobacco shipments to the customs authority broken down per consignments, at the latest by the time of the commencement of the given import and trade transaction.

Notification obligations shall be satisfied by electronic means and must contain the quantity of the tobacco, the starting point and the destination of the movement, the time of the departure and the supposed arrival, the name of the consignee and the plate number of the transport vehicle.

Only two countries (Slovakia and Hungary) collect systematic data on raw tobacco. Most systems described in section 2.3 (a) are not designed to generate real-time information, but rather to facilitate checks and permit the application of excise duty on raw tobacco suspect of being taken out of the "legal circuit".

The reasons for not systematically collecting data on raw tobacco are categorised below:

▪ **Raw tobacco not treated as an excisable product:**

The main reason cited by Member States for not systematically collecting data is that raw tobacco is not an excisable tobacco product; therefore no information concerning its circulation exists. Several countries have mentioned that even though some data (on importation, growing, etc.) may be available, as a non-excisable product, once import formalities are achieved, the product is not monitored and no follow-up is carried out. The EMCS is not helpful in the case of raw tobacco as it does not fall within the products followed by the system.

▪ **No manufacturing or production facilities in the Member State:**

Some Member States have mentioned that as they do not have any manufacturing or production facilities on their territory, they do not find it necessary to collect any systematic data on raw tobacco.

▪ **Too many variables to make a good connection between import of raw tobacco and the excisable tobacco product:**

Several Member States have also mentioned that in the current system, a number of variables are outside of their control, hence effective monitoring is not possible. Despite having in place licensing systems of operators and measures of control of importation, raw tobacco released in free circulation in another Member States is very difficult to monitor, hence it would not be accurately reflected in any potential data analysis.

▪ **Mechanisms in place are not suitable:**

Finally, the Member States argued that, even though they have systems in place for controlling the logistics of raw tobacco, they are unsuitable for collecting systematic, real-time data, as they have been designed as a tool to facilitate only verification and checks, and not real-time monitoring. Such is the case for most systems which require only registration, record keeping or paper-based accompanying documents and do not impose any information obligations on operators other than authorised warehouse keepers.

Whereas the majority of Member States do not keep information related to the production and importation of raw tobacco, some Member States do use the information on raw tobacco to some extent. For example, it is not uncommon for information related to the importation and trade with raw tobacco to be used by the investigating authorities to get indications on the illegal production of excisable goods.

Q2.3 (c) To what extent do Member States consider that the current measures for controlling the logistics of raw tobacco impact their ability to monitor excisable tobacco products

Member State opinions seem to be split in three groups as to whether the current (lack of) measures impact the ability of the tax authorities to monitor excisable tobacco products.

(a) Satisfied with the current arrangements: ten Member States: (EE, BE, NL, LU, SI, CY, IE, MT, PL and RO) find the current measures for controlling raw tobacco sufficient and not having a negative impact on tax authorities' ability to monitor excisable products. The reasons for this opinion can be categorised in the following clusters:

- Countries with no production of raw tobacco and no manufacturing of excisable products (e.g. EE and SI)
 - Countries largely satisfied with the amount of data collected by the national measures currently in place (e.g. CY, IE, MT, PL and RO)
- (b) Not fully satisfied with the current arrangements: seven Member States (DK, FI, ES, PT, CZ, IT, SE) indicated that the current measures were not fully sufficient and can have a negative, albeit minor, impact. These countries considered that there is room for improvement. The reasons cited for this balanced opinion were:
- Low quantities of raw tobacco imported or grown (e.g. DK, FI, ES)
 - Based on assessments and available data, the apparent risk of raw tobacco being diverted to illegal production is low, but the risk of tobacco being sold to consumers exists (PT)
 - Despite national measures being in place allowing the monitoring of operators dealing with raw tobacco and taking action if suspicion of illicit behaviour exists, the scope and reach of information could be improved (CZ)
 - While recognising the potential benefits of having more data on raw tobacco, the benefits would have to be weighed against the costs of generating the required data on both economic operators as well as the administration. (IT)
- (c) Not satisfied with the current measures: Nine Member States indicated that the current measures negatively impact their ability to monitor excisable tobacco products; countries in this category have advocated the improvement of control and monitoring measures at EU level. The reasons cited for this positions were:
- The most effective way of combatting illegal production would be through the improvement of information on the movement of raw materials for the production of tobacco goods, better information on the flow and movements of these materials would assist the activities of Member States to pursue and dismantle criminal organisations involved in the illicit production of tobacco products. (DE, LT, LV, SK, HU, AT, HR, UK)
 - As growers report an increasing number of thefts from fields and the drop in revenue is declining faster than the “quitting” rate, it looks probable that the increase of the size of the illicit market can be linked with the illegal production and/or sale of raw tobacco. (HU)
 - Information which currently exists on the movements of raw tobacco⁹⁴ is insufficient for effective monitoring and conducting targeted checks. (DE, UK)
 - The capacity to monitor excisable tobacco products (produced legally and illegally) would improve if raw tobacco would be included within the scope of the EMCS). (SK)
 - In the context of the single EU market, national measures would not be fully effective, in the absence of an EU wide system the monitoring of goods crossing borders would not be fully possible.
 - More clarity with respect to the treatment of raw tobacco would help with enforcing measures aimed at preventing the sale of raw tobacco to consumers (see answers to Q2.1). (EL)

Member States advocating for stronger measures admit that any potential increase in the scope of data collected from operators will impose administrative and compliance

⁹⁴ See answers to Q2.3 (a)

costs, hence any step in the area should balance the legitimate interests of both economic operators as well as the need to tackle illicit trade.

Summary

Our analysis of the extent to which the treatment of products not defined by the Directive impacts the ability to perform monitoring of trade/ logistics of taxable tobacco products suggests the following conclusions:

- Only two countries (SK and HU) reported that they collect systematic, real-time data on the production, movement and overall logistics of raw tobacco.
- Systematic, real-time data and information on the logistics of raw tobacco would increase the ability of Member States to fight illicit trade and increase their capacity to fight against criminal organizations involved in the illicit production of excisable tobacco products.
- The current arrangements for regulating the movements and logistics of raw tobacco applicable at national, EU or international level are unable to generate systematic, real-time data in electronic format, as such they are not suitable for the use in risk assessments and the targeting of control measures in a cost-effective manner.
- The absence of systematic, real-time monitoring of raw tobacco across the EU has a strong negative impact on the ability of Member States to perform monitoring of the logistics of excisable tobacco products and fight against illicit production and trade.
- Any systematic monitoring of raw tobacco across the EU is not possible in the absence of a unified definition of what constitutes raw tobacco for the purpose of attaining the objectives of excise duty legislation.

Overall conclusions

- With the exceptions of the aspects summarised in Q2.1, this evaluation concludes that, overall, the Definitions of Art 2-5 Directive 2011/64/EU have proven to be effective and are generally, appropriate for enabling adequate (correct categories and rates) collection of excise duties for the large majority of manufactured tobacco products.
- As currently formulated, the Definitions of Art 2-5 of Directive 2011/64/EU are not appropriate in light of enabling effective and efficient monitoring of excisable tobacco products.
- The absence of systematic, real-time monitoring of raw tobacco across the EU has a strong negative impact on the ability of Member States to perform monitoring of the logistics of excisable tobacco products and fight against illicit production and trade.

Question 3: To what extent do the current arrangements for excise duty on tobacco products ensure the proper functioning of the Internal Market and avoid distortions in competition?

In this chapter we report our analysis of the economic impact of tobacco excise duties. This work is based on information and data gathered from various sources, including purchased data on the tobacco industries, responses to our surveys of Member States and economic operators and prior studies on tobacco excise duties and illicit trade.

A key challenge that is common to all aspects of the analysis is that of identifying the specific impact of Directive 2011/64/EU ('the 2011 Directive') given that relatively little time has elapsed since transposition of the Directive and data are typically published with a lag. This means that only one year of post-Directive data are available and so robustly identifying the impact of the Directive, as distinct from general trends, is difficult. Nonetheless, we describe the potential impact of the 2011 Directive wherever possible.

A complete descriptive overview of the current arrangements with respect to the structure of the excise duties can be found in Appendix 5 – *Question 1: Background Information*.

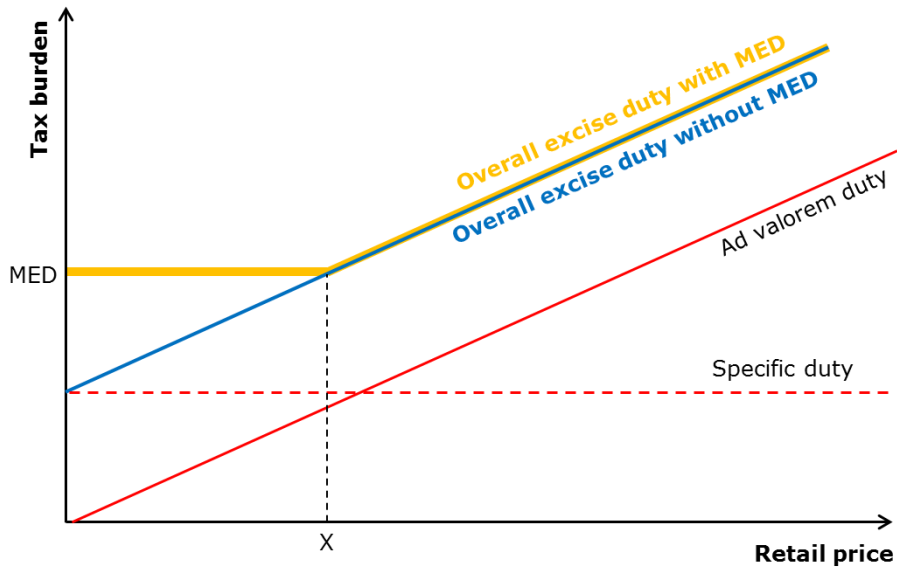
Q3.1 To what extent do the current rules on MED (Minimum Excise Duty) allow for neutral conditions of competition and the proper functioning of the internal market (avoiding distortion of competition or trade)?

Article 7 (4) of Directive 2011/64/EU provides that "where necessary, the excise duty on cigarettes may include a minimum tax component, provided that the mixed structure of taxation and the band of the specific component of the excise duty as laid down in Article 8 is strictly respected." Article 8 (3) of the same Directive states that "until 31 December 2013, the specific component of the excise duty shall not be less than 5 % and shall not be more than 76.5% of the amount of the total tax burden". From 1 January 2014, these limits are set at 7.5% and 76.5% respectively.

When applied, the MED serves as a minimum floor for the taxation of cigarettes. The illustration below shows that the effect of imposing an MED⁹⁵ would be to raise the minimum taxation on cheaper brands such that all the products lying on the left of X would be taxed at the level of the MED, while all the others would be subject to the mixed tax structure featuring the specific and ad valorem components.

⁹⁵ Here the MED is assumed to be a specific component (i.e. a fixed amount per unit of the product).

Figure 17 Excise duty structure with the MED

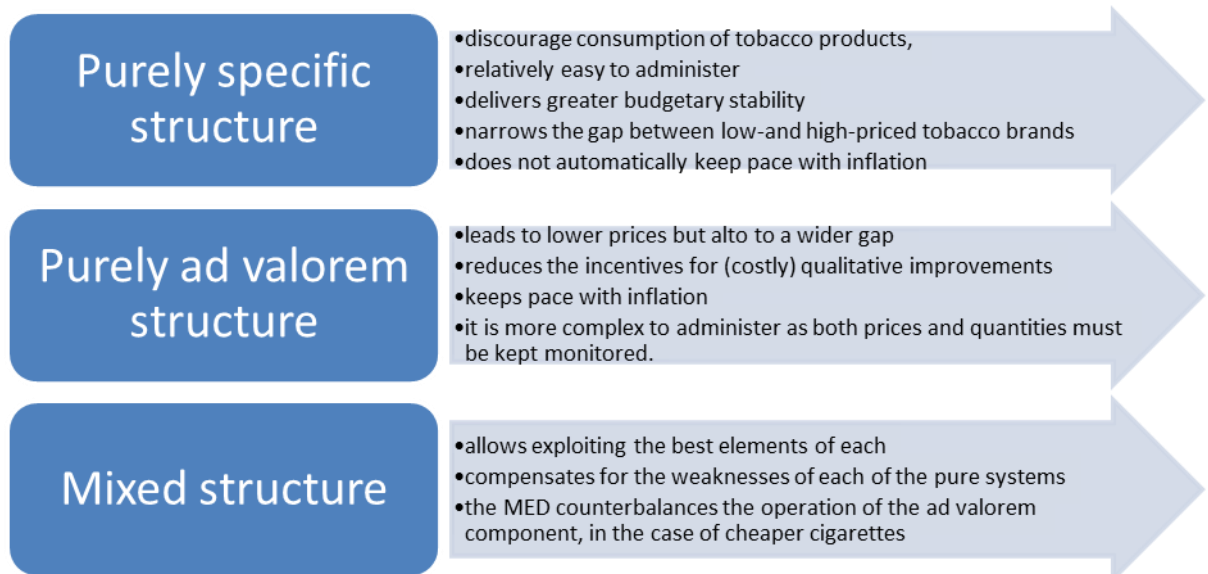


On the diagram above, there is no difference between the level of tax for cigarettes with a retail price below X, but the level of tax paid by those cigarettes with a retail price above X increases in line with the price. The MED therefore separates the structure of taxes in the cigarette market:

- low-cost cigarettes face a pure per-unit tax; and
- higher cost cigarettes face a combination of a per-unit and percentage tax.

Economic theory suggests that the impacts of these tax structures on the market may differ significantly, though both are distortionary. These differences are illustrated in the figure below.

Figure 18 Economic characteristics of tax structures



According to our interviews with Member States, there are a range of interpretations of the MED. For example, Denmark considers that as the MED replaces both the specific and ad valorem components of excise duty (for those cigarettes where it is bind-

ing) and was calculated as a fixed amount, it should be regarded as a specific component. In contrast, Slovakia does not consider the MED as a specific component, while the Netherlands considers that the MED contains both an ad valorem and a specific component, based on the WAP. While Finland tends to regard the MED as specific, it is not completely clear about how it should be classified even following a request for clarification to the Commission. A more detailed description of these views is provided in the table below.

Table 12 Interpretation of MED rules

Country	Interpretation of MED
Denmark	As the MED replaced both the specific and ad valorem component and was calculated as a fixed amount, it is regarded as a specific component. However, it has never been Danish practice to calculate an MED and "specific duty" as a total. Nevertheless, the limits (5-76.5%) were considered to be applicable to the MED.
Germany and Malta	Consider the MED to be a specific component of the excise duty structure.
Slovakia	Slovakia does not consider the MED to be a specific component
Slovenia	According to national law the MED is equal to total excise duty, which is the taxation of cigarettes at the WAP.
Finland	The categorization of the MED is not clear: Finland asked the Commission clarification to, but the issue remains unclear. They tend to regard it as specific.
Italy	The excise system is considered to be divided into two: an "ordinary regime" whereby cigarettes are taxed according to an excise duty featuring two components [minimum plus specific]; and a "special regime" with the MED. The criteria applicable to the specific and ad-valorem component are not regarded as valid references for the MED.
Netherlands	The MED is considered to contain an ad valorem and a specific component, based on the WAP. There is considered to be a similarity between the MED and the specific component: the former works as a specific component. If the retail selling price is below the WAP, the product is taxed at the MED. In this case the MED results in a fixed amount, just like the specific component. The calculation of the MED is said to be in accordance with the Directive. The present ad valorem rate for cigarettes is 2.36%. If this ad valorem rate were increased, the MED would also rise. So although the MED is a fixed amount for cigarettes with a price below the WAP, the MED is influenced by changes in the ad valorem rate.

With respect to setting the level of the MED and the actions taken by Member States to ensure compliance of the MED with the legislation, interviewees provided divergent responses:

- One Member State stated that a structure of high ad valorem duties and a high MED is used to ensure that both cheap and expensive cigarettes pay a high excise tax. It considers that a rate structure of high specific and a low ad valorem would allow manufacturers of expensive cigarettes to have high profits. The Member State reported that a high MED helps reduce price competition, ensures more budget stability and helps increase the ability to produce forecasts because profits are kept low.
- Another Member State stated that it uses the MED to decrease the price range of cigarettes.
- Some countries apply a mathematical equation to calculate the MED which is usually linked to the total tax burden at the WAP (or MPPC). For example, following the introduction of Directive 2010/12/EC, the Italian tax administration decided that the MED should amount to 115 per cent of the tax burden calculated at the MPPC. However, the administrative court (TAR del Lazio) suspended

the decision as being in breach of EU principles and so the level of the MED was brought back to 100 per cent. The decision of the administrative court has been appealed and handed over to the Consiglio di Stato which, in turn, passed it onto the European Court of Justice.

- Some countries (Germany, Slovakia, Luxembourg, Spain and Cyprus) agree that when the MED is set at a level equal to/lower than the total excise applied at the WAP, the mixed structure requirement is certainly fulfilled.
- Latvia thinks that the MED should be lower than "excise yield" at WAP. In Romania, at the price level where the MED becomes applicable (RON 10.6; EUR 2.3), the specific excise corresponds to 55.83% of total tax burden. Ireland sets the MED at 100% of the excise duty charged at the WAP (EUR 275.62, which represents the current specific rate of excise of EUR 241.83 per 1,000 cigarettes, plus the ad valorem rate of 8.72% of the retail selling price, applied to a notional retail selling price of EUR 7.75), however they think that it might be in principle higher even though they recognize that the Directive is not clear on this point.
- Similarly, each year Cyprus calculates the total excise duty burden at the WAP (based on previous year's data) and sets the MED to be equal to that amount. By means of calculations it is checked that the MED is compliant with the limits set by the directive. This is considered sufficient to claim that the mixed structure requirement is fulfilled.
- Uncertainties arise when the MED is higher. Austria levies an MED equal to 98% of total tobacco tax burden at WAP and considers this to be in line with the requirements. Some countries levy a MED higher than 100% of the excise duty at WAP but still consider to be compliant with the mixed structure requirement. In Portugal, the MED is obtained by applying a fixed percentage (104%) over the excise resulting from MPPC: this is deemed to be in compliance with the mixed structure requirement, because in the excise resulting from MPPC, the two components (specific and ad valorem) are present. In Poland, the MED equals 100% of excise paid at the WAP for cigarettes. The Netherlands, similarly to Italy, maintains that the mixed structure requirements are separate from the MED.
- The Czech Republic and Germany claim that compliance with the mixed structure requirements is safeguarded even though the MED is higher than the excise duty at WAP.
- Lithuania claims that since it reports to the Commission twice a year, its tax structure is fully compliant with the mixed structure requirements.
- Other countries (Slovakia, Latvia, Czech Republic, and Greece) maintain that as long as at least part of the market is taxed with an ad valorem and specific component, the requirements are fulfilled. Representatives of the Greek tax administration reported that some economic operators claim that the application of the MED in Greece violates the mixed structure requirement, in that most of the market is subject to the MED. However, the Greek administration believes that there is no agreed threshold in the Directive to back the economic operators' claim.
- According to an informal reply by the Commission to Finland, it is not possible to provide advice of the percentage of cigarettes which can be taxed according to the MED. They interpreted it as follows: "As long as the most of the cigarettes are taxed according to a specific and an ad valorem tax component (in 2012 in Finland 53.1 per cent), the MED is not too high, the mixed structure requirement is fulfilled". Given this interpretation, each year Finland performs a test to verify

that at least 50 per cent of the market is subject to a specific plus ad valorem tax.

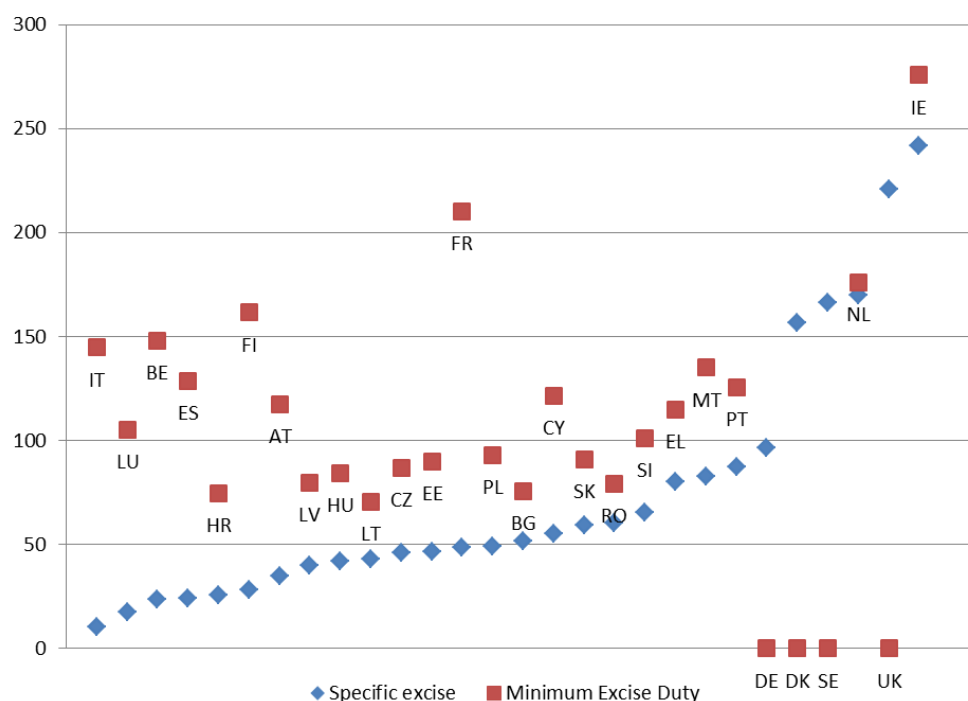
Moreover, Finland pointed out that the biggest challenge lies with the calculation of the WAP: when a major tax/price increase occurs, the structure would not be in line with WAP calculated using the old (pre tax increase) prices. The bigger the tax increase, the more problematic is the WAP calculated from releases to consumption in the previous year. The directive should be clearer in this regard (it is only mentioned very briefly in the end of Art 8(5)). This goes for both the MED and a specific tax.

The discussion in this section suggests that there is a lack of clear understanding of the MED provisions amongst the tax authorities of several EU Member States, which may lead some countries to be unwittingly non-compliant with the Directive. For example, it appears that some countries focus on the mixed structure requirements but pay little attention to the requirement for the specific component to be between 7.5 per cent (5 per cent prior to January 2014) and 76.5 per cent of the total tax burden.

Quantitative analysis

All but four countries (UK, Denmark,⁹⁶ Sweden and Germany) apply a MED as of 1 January 2014 with values ranging from €275.62 (per 1,000 items) in Ireland to €70.76 in Lithuania. As shown in Figure 19, there is no straightforward relationship between the specific component and the MED such that, for instance, countries with a high specific component also charge a high MED. Finland, Italy and Belgium are such examples of countries with a low specific component and a relatively high MED.

Figure 19 Excise duty structure: Specific component and MED



The DG TAXUD Tobacco Excise Duty Tables for Manufactured Tobacco contain sufficient information with which to construct an approximate test of Member States' past compliance with the MED provisions in the Directive. In particular, the data provided

⁹⁶ Denmark did apply an MED until July 2013.

in those tables allow for the calculation of the MED as a proportion of the total tax burden for cigarettes in those Member States for which an MED has been specified.

The tables provide the WAP in euros per 1000 cigarettes for each Member State⁹⁷. While the total tax burden is not included as a monetary value, it is possible to calculate the tax that would apply to 1000 cigarettes priced at the WAP.⁹⁸ Using these figures, we calculated the MED as a percentage of the total tax burden, with the results shown in the table below.

These calculations suggest that the majority of Member States slightly exceeded the upper limit of the allowable range for the MED as a percentage of the total tax burden. However, it must be noted that the WAP is calculated by DG TAXUD using data on the releases for consumption made in the preceding calendar year. Therefore, the observation of minor non-compliance may simply reflect some inaccuracy in the estimated WAP for the relevant calendar year rather than the failure of a Member State to comply.

While the results show numerous cases in which the MED as a percentage of the total tax burden exceeded 76.5%, it is not clear that this reflects non-compliance rather than inaccurate calculations due to the base year for the WAP differing from the calculation year.

Table 13 MED as Percentage of Total Tax Burden

MS	MED as % Total Tax Burden				
	01/01/2012	01/07/2012	01/01/2013	01/07/2013	01/01/2014
AT	76.8%	76.6%	76.6%	76.5%	76.5%
BE	73.5%	73.2%	75.1%	75.0%	78.4%
BG	79.4%	79.4%	76.9%	76.9%	76.6%
CY	77.8%	76.3%	80.3%	80.3%	77.4%
CZ	79.7%	79.7%	80.9%	80.9%	80.9%
DE	NA	NA	NA	NA	NA
DK	72.7%	75.2%	75.2%	NA	NA
EE	78.0%	78.0%	77.0%	77.0%	76.3%
EL	77.7%	77.7%	80.1%	80.1%	80.1%
ES	78.7%	77.4%	73.9%	79.3%	75.6%
FI	80.4%	80.4%	79.7%	74.1%	79.7%
FR	79.6%	79.6%	79.3%	78.8%	79.4%
HR	-	-	-	77.4%	72.4%
HU	74.9%	72.7%	75.6%	72.5%	69.7%
IE	0.0%	76.5%	76.8%	75.5%	75.7%
IT	87.1%	89.1%	83.9%	83.9%	83.9%
LT	76.2%	76.2%	76.2%	75.8%	75.8%
LU	76.5%	76.5%	78.0%	76.8%	76.8%

⁹⁷ Column 12 of DG TAXUD excise duty tables

⁹⁸ By multiplying the "total tax (incl. VAT) as % WAP" variable in column 8 by the WAP. This is our preferred method by which the total tax burden can be consistently estimated using the DG TAXUD Excise Duty tables given that the tables themselves contain some percentages estimated on the basis of TIRSP (e.g. column 6) and others based on the WAP (e.g. column 15).

MS	MED as % Total Tax Burden				
	01/01/2012	01/07/2012	01/01/2013	01/07/2013	01/01/2014
LV	76.2%	76.6%	76.6%	73.4%	75.2%
MT	79.6%	79.6%	79.6%	82.1%	82.1%
NL	80.5%	79.6%	80.1%	79.3%	79.3%
PL	77.8%	77.8%	77.9%	77.9%	78.0%
PT	79.7%	79.7%	79.6%	79.6%	80.0%
RO	74.2%	73.3%	73.6%	73.6%	69.1%
SE	NA	NA	NA	NA	NA
SI	78.5%	79.1%	74.0%	78.5%	77.4%
SK	79.0%	79.0%	80.3%	78.1%	78.1%
UK	NA	NA	NA	NA	NA

To understand the extent to which the MED has affected cigarette sales in EU Member States, it is necessary to both review stakeholders' perspectives on the matter and to assess market data before and after the 2011 Directive.

To understand the views of stakeholders concerning the MED rules, we included a number of relevant questions in our semi-structured interviews with economic operators and Member States.

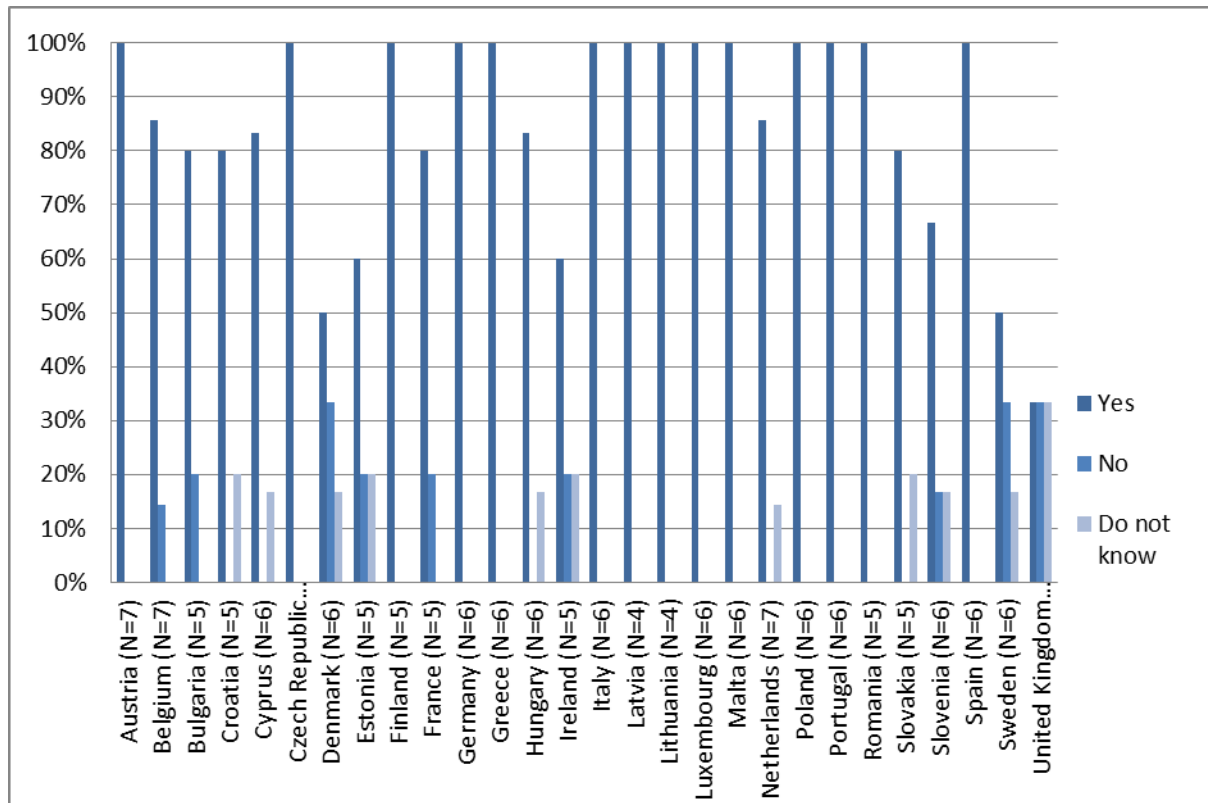
In some countries, such as Ireland and Romania, a very small proportion of cigarettes are taxed at the MED because the combined ad valorem and specific components of duty result in a tax level that exceeds the MED for almost all cigarettes. Therefore, it can be said that the MED has very little impact on the retail price of cigarettes in those countries and so has relatively little impact on the cigarette markets of those Member States. By contrast, a very significant proportion of cigarettes are taxed at the MED in countries such as Portugal and the Czech Republic. This means that the level of tax exceeds that which would apply in the absence of the MED and so, assuming that the difference in tax is passed through to consumers, the retail price of cigarettes taxed at the MED is higher than if the MED did not exist. In such cases, the MED distorts the cigarette markets of some Member States by raising the price of relatively low price cigarettes while leaving the price of more expensive cigarettes unaffected.

To provide further evidence on the relevance of the MED, we asked economic operators to report the extent to which MED rules have affected sales of tobacco products. The figure below shows that, overall, just 8% of respondents stated that sales of their products had not been affected by MED rules and 8% stated that they did not know how their product sales had been affected. However, this average masks interesting differences between countries:

- 33% of respondents (two from six in each case) with operations in Denmark, Sweden and the United Kingdom stated that the MED had not affected sales in those countries; but
- in half of all Member States, 100% of representatives stated that the MED had affected sales. It is noteworthy that this group includes Romania where the tax authority has indicated that a negligible portion of the market is affected by the MED. This may possibly be explained by cross-border trade and excise duty shopping giving effect to a price transmission mechanism.

This finding suggests that the MED has affected the proper functioning of the Internal Market. In particular, the findings that the proportion of cigarettes taxed at the MED differs between countries, combined with the perceptions of economic operators that the sales impacts of the MED have been greater in some countries than in others, suggests that the MED has affected relative prices in different Member States and so has had an adverse impact on the functioning of the Internal Market.

Figure 20 Have the sales of any of your products been affected by the national Minimum Excise Duty (MED) provisions?



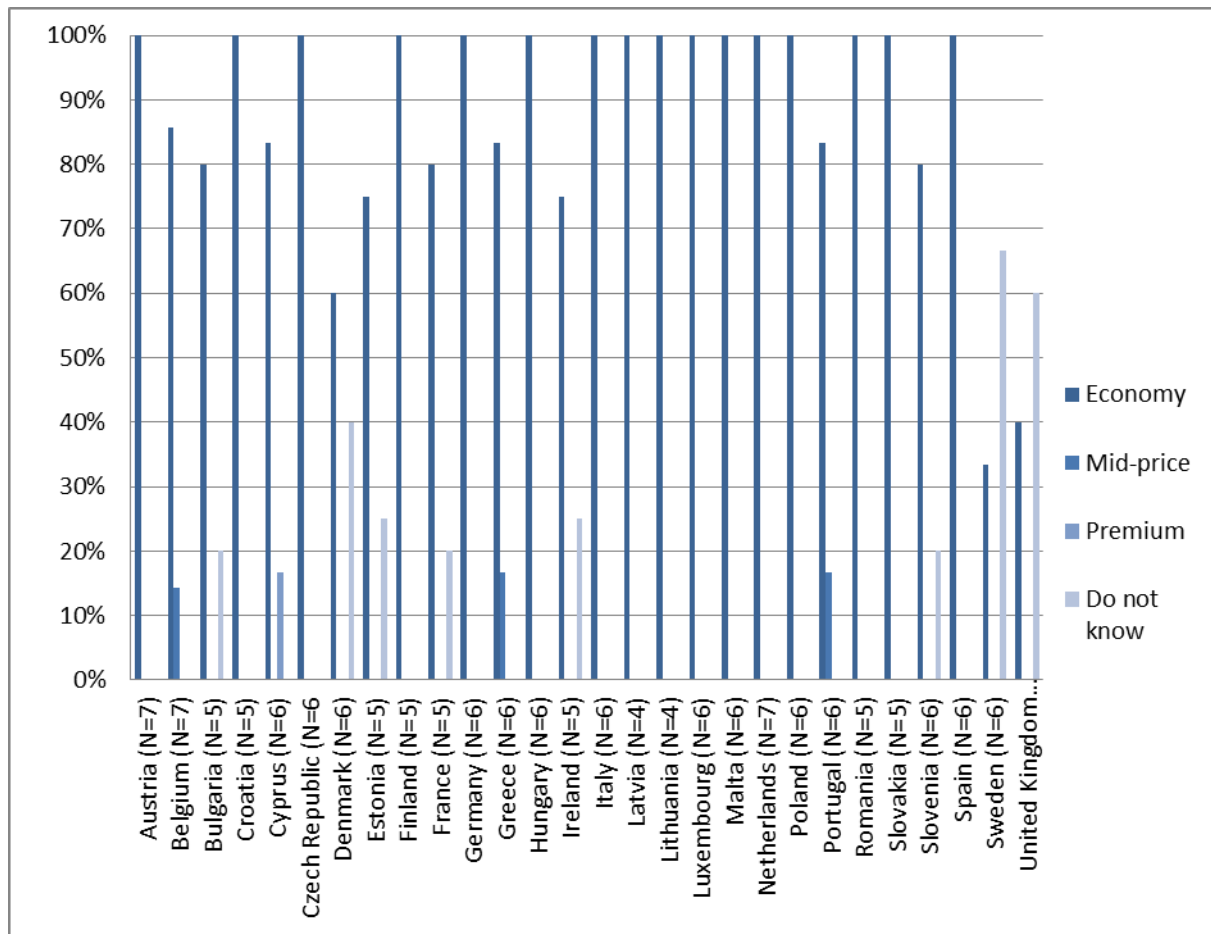
Source: Analysis of survey responses

Given that the MED’s function is to counterbalance the operation of the ad valorem component, in the case of cheaper cigarettes, one would expect that the impact on sales would be greatest for economy brands of cigarettes.

The rationale for this hypothesis is that the MED raises the total tax burden of each cheap cigarette and, assuming that tax is passed through to consumers, leads to higher prices than would apply in the absence of the MED. More expensive cigarettes are not affected by the MED and hence the tax burden of those products is determined by the country-specific ad valorem and specific elements alone.

According to the economic operators surveyed as part of this study, the products most affected by the MED are indeed economy varieties. Indeed, as shown in the figure below, only one country (Cyprus) mentioned premium products being affected by the MED and just three countries (Belgium, Greece, and Portugal) claim that mid-price products have been affected. Such a finding suggests that the MED has affected neutral conditions of competition by distorting relative prices of different types of cigarettes (in particular by closing the retail price gap between premium and economy brands).

Figure 21 Which types of products were most affected?



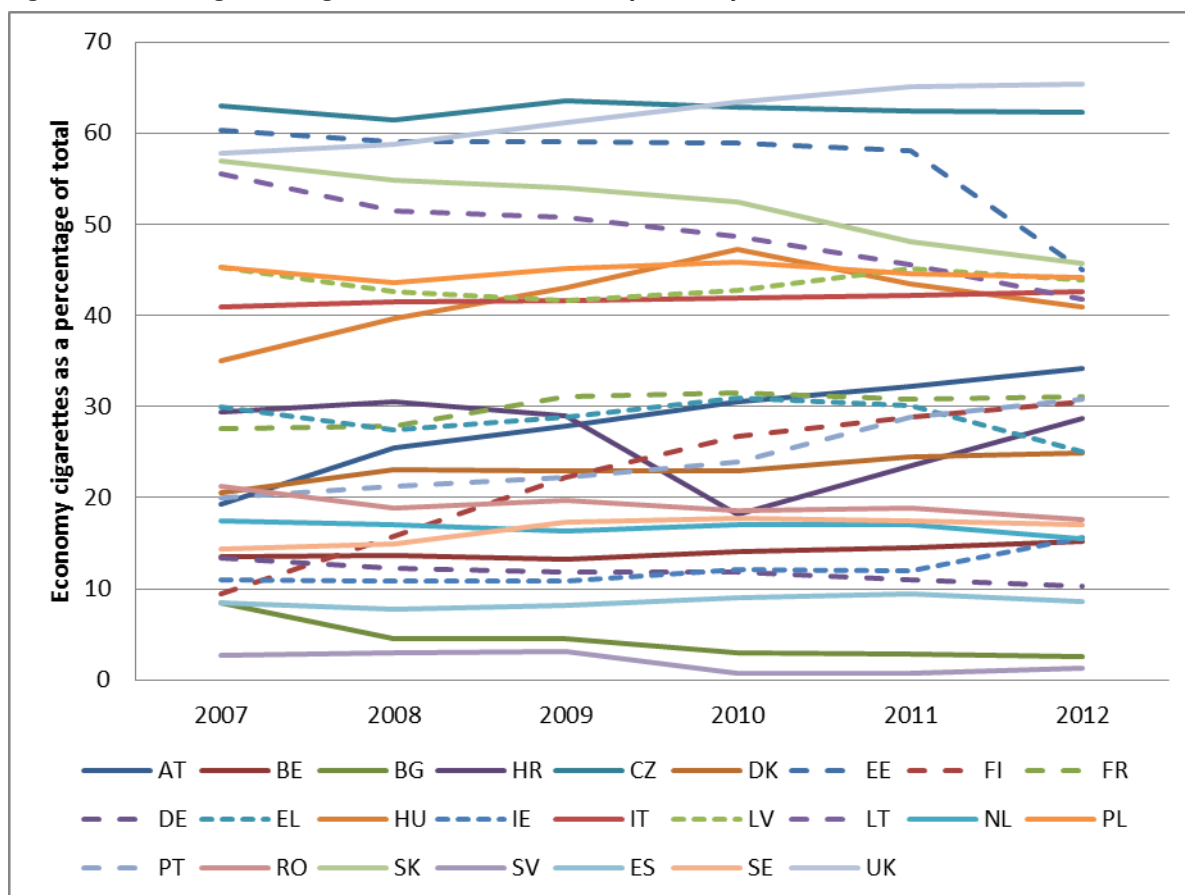
Source: Analysis of survey responses

Based on the above findings, it is clear that economic operators consider the MED to have affected the price and sales of economy cigarettes in all EU Member States, including those where an MED has not been in force (which may possibly be explained by cross-border trade and excise duty shopping giving effect to a price transmission mechanism).

However, the above analysis does not provide any information on the scale of the reported impact. To assess the extent to which the MED may have affected the sales of economy cigarettes, we present the proportion of all cigarette sales that are accounted for by economy brands in the figure below.⁹⁹

⁹⁹ The definitions of 'economy', mid-range and premium brands used in our analysis are specified by Euro-
monitor, Euro-
monitor states that there are no uniform, cross-country price bands set for tobacco, largely
because of the large variations in unit prices of cigarettes makes such a standardised definition impossible.
Therefore, each country sets its own definitions, based on in-country store checks. The detailed country-
level definitions are available in Euro-
monitor reports and are available to subscribers on its website.

Figure 22 Percentage of all cigarette sales accounted for by Economy brands



Source: Europe Economics' analysis of Euromonitor data

The chart shows that there was a significant drop in the proportion of economy sales in Estonia and Greece between 2011 and 2012. This may indicate that the MED had a particularly significant impact in these countries following the implementation of the 2011 Directive. The MED as a percentage of the total tax burden was approximately 78% in both countries during 2012 (see Table 13); this is relatively high albeit not exceptionally so.

It is interesting to note, however, that a decline in the proportion of all cigarette sales accounted for by economy brands commenced prior to the implementation of the 2011 Directive in several countries. For example, economy cigarettes became less popular in Lithuania and Slovakia each year between 2007 and 2012 while sales of economy cigarettes peaked in Hungary in 2010 and declined thereafter.

It is also notable that in other countries, the proportion of sales accounted for by economy brands has increased over time, including between 2011 and 2012. Indeed, the market share of economy cigarettes in Finland trebled between 2007 and 2012 while sales in Ireland increased sharply between 2011 and 2012, having been relatively flat previously. Across the EU as a whole, the market share of economy cigarettes increased slightly from 28.9 per cent in 2007 to 30.4 per cent in 2012.

These observations suggest that while the MED is perceived to have adversely affected the sales of cheaper cigarettes, it is by no means the only influence and does not appear to be the most important driver of sales. Indeed, positive influences on sales of economy cigarettes (e.g. down-trading from more expensive cigarettes due to declin-

ing real incomes in recent years) have outweighed the negative influence of the MED in some cases, and neutralised the effect in others.

Nonetheless, sales of economy cigarettes may still be lower than in the absence of the MED: the market share of economy cigarettes in the EU may have increased more significantly in the absence of the MED. Such a hypothesis is supported by the findings of our survey but it is not possible to test it using market data on sales alone without relying on some critical assumptions. In particular, it is necessary to make an assumption concerning the price elasticities of different premium, mid-range and economy cigarettes, together with the typical retail price of those categories.

With respect to price elasticities, we assume that the own-price elasticity of demand is -0.4 (i.e. the value around which the WHO observed clustering, see also the discussion at Q2 above)¹⁰⁰. For modelling simplicity, we further assume that there would be no upwards substitution (i.e. we assume that a rise in the price of economy cigarettes only would not affect demand for premium cigarettes. Finally, we assume that the cross-price elasticity between neighbouring categories (i.e. premium / mid-range and mid-range / economy) exceeds that between premium and economy cigarettes. These elasticities are set to 0.2 and 0.1, respectively.

Given these assumptions, we have assessed the impact of eliminating the MED in five EU countries.¹⁰¹ Given that the abolition of the MED can affect more than one price category simultaneously, and given that cross-price elasticities rely on the assumption that the price of one category changes while all else remains equal, our analysis of the impact of abolishing the MED relies solely on own-price elasticities. This approach is particularly appropriate given our assumption of no upwards substitution. The results of this with respect to demand and excise duty revenue are shown in the tables below.

Table 14 Demand impacts of abolishing the MED

	Italy	Portugal	Ireland	Sweden	Bulgaria
Change in demand: premium (million sticks)	0.0	0.2	0.0	0.0	0.0
Change in demand: mid-price (million sticks)	29.2	1.8	0.0	0.0	0.0
Change in demand: economy (million sticks)	85.8	3.1	0.1	0.0	0.1
Total change in demand (million sticks)	115.0	5.1	0.1	0.0	0.1

¹⁰⁰ We consider that this elasticity assumption is appropriate because our analysis explores the impact of changing the manner in which excise duties are collected. We do not examine significant increases in the retail price of tobacco products and so we consider it unlikely that the changes would lead consumers to seek illicit products.

¹⁰¹ Before settling on this approach, we had considered an alternative of estimating what would have happened if the 2011 Directive had not come into force, using 2011 data. The weakness with that approach is that it would require an assumption that all observed subsequent tax changes would have been identical in the absence of the MED. We do not consider such an assumption to be credible: Member States are likely to have implemented an MED rather than changing one or more elements of the mixed structure.

Table 15 Revenue impacts of abolishing the MED

	Italy	Portugal	Ireland	Sweden	Bulgaria
Change in total excise duty revenue: premium (€m)	0	-2	0	0	0
Change in total excise duty revenue: mid-price (€m)	-321	-17	0	0	0
Change in total excise duty revenue: economy (€m)	-801	-26	-1	0	-0.4
Total change in total excise duty revenue (€m)	-1,122	-45	-1	0	-0.4

These results show that the greatest adverse revenue impact of abolishing the MED would occur in Italy while Ireland and Bulgaria would be little affected (Sweden does not apply an MED). Given that a significant proportion of cigarettes are taxed at the MED in Italy while very few are taxed at this level in Ireland, these results are not entirely surprising. However, they do illustrate the significant differences in the impact of the MED on excise duty revenues in the selected Member States.

Given that member states would presumably seek to recoup some of the lost excise duties that would result from the abolition of the MED, we then explored the potential impact of changing the structure of excise duties in these Member States. In particular, we assessed the impacts that would arise if each of the tax administrations were to both abolish the MED and instead raise taxes on premium cigarettes. Our analysis included both direct effects (via own-price elasticities) and indirect effects (i.e. due to changes in the relative price of premium products and consequent down-trading, assessed via cross-price elasticities). Two different options were explored: a 20 per cent increase in the level of the specific tax; and a 20 per cent increase in the level of the ad valorem tax.

Revenue results for the former of these are presented in the first table below while results for the latter are presented in the second table.

Table 16 Revenue impacts of abolishing the MED and raising the specific duty on premium by 20 per cent

	Italy	Portugal	Ireland	Sweden	Bulgaria
Change in total excise duty revenue: premium (€m)	71	47.8	103.4	166.8	38.2
Change in total excise duty revenue: mid-price (€m)	-321	-17.0	0.3	0.1	0.3
Change in total excise duty revenue: economy (€m)	-801	-26.0	-0.8	0.0	-0.3
Total change in total excise duty revenue (€m)	-1,052	4.8	103	166.9	38.2

Table 17 Revenue impacts of abolishing the MED and raising the *ad valorem* rate on premium by 20 per cent

	Italy	Portugal	Ireland	Sweden	Bulgaria
Change in total excise duty revenue: premium (€m)	1009	17.9	18.9	3.3	22.5
Change in total excise duty revenue: mid-price (€m)	-318	-17.2	0.0	0.0	0.2
Change in total excise duty revenue: economy (€m)	-800	-26.1	-0.9	0.0	-0.3
Total change in total excise duty revenue (€m)	-109	-25.4	18.0	3.3	22.3

These results show rather significant differences in the budgetary implications for Member States under the two options. In particular, Italy currently has a low specific excise duty and so a rise of 20% for premium cigarettes has relatively little impact on its revenue. By contrast, the specific duty in Sweden is relatively high and hence a rise in that duty on premium cigarettes would have a substantial, positive, revenue impact. Conversely, raising the *ad valorem* rate by 20% would have a significant impact in Italy and would substantially limit the loss from abolishing the MED while this approach would have limited impact on revenues in Sweden.

Summary

Our analysis on the current arrangements of the MED suggests the following key findings:

- given the various interpretations given by Member States with respect to the limitations of the MED, the nature of the MED and the applicable rules regarding its use do not seem to be clear, despite the Commission having answered a request for clarification;
- possibly as a result of this, there is some evidence of non-compliance with the rules concerning the level at which the MED on cigarettes may be set;
- the MED is considered to have affected only economy cigarettes and only in certain countries;

As a result, there is some evidence that the implementation of the MED has affected neutral conditions of competition (by distorting relative prices of different types of cigarettes) and the proper functioning of the internal market (by affecting some countries to a greater extent than others); however, because the market share of economy cigarettes in the EU has increased over time, it appears that the negative influence of the MED is offset by other factors.

Q3.2 To what extent have changes in trade patterns been induced by changes in the tobacco excise duty levels?

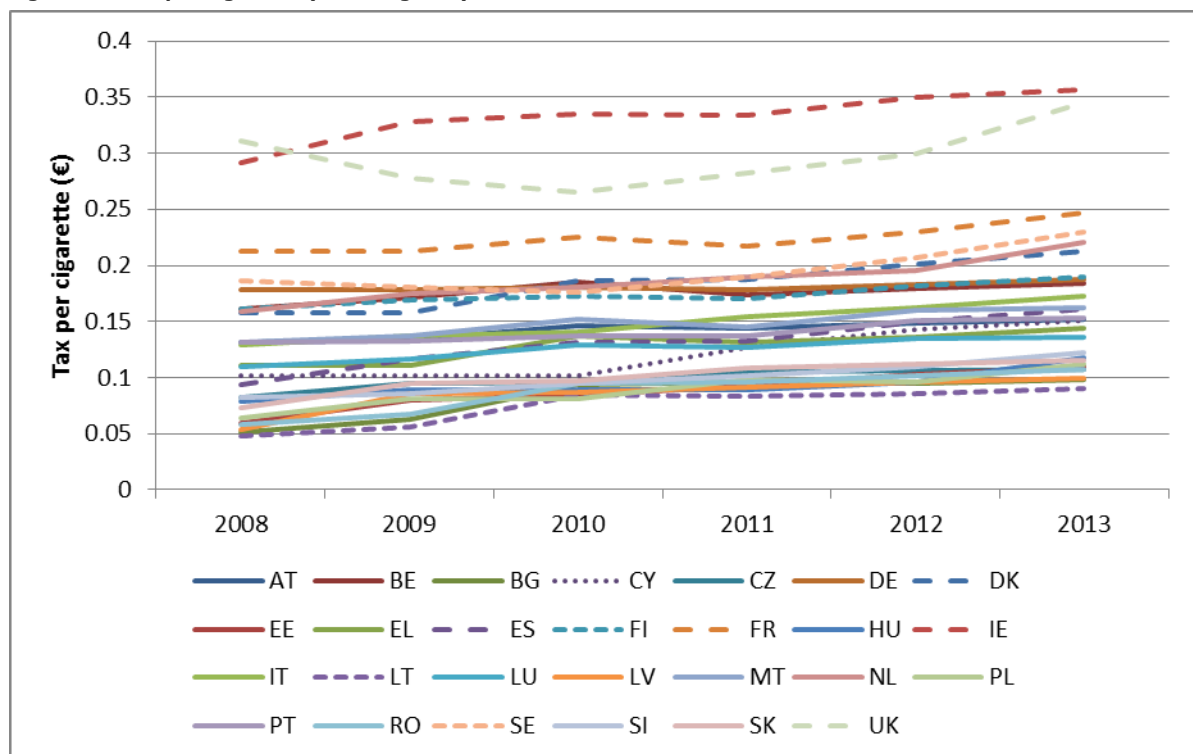
As for any form of taxation, excise duty differences between countries may create incentives for businesses and/or consumers to make certain choices or amend choices that had previously been made. With respect to trade, differences in the level of tobacco excise duty between countries, and differences in the rate of duty changes between countries, can provide incentives for manufacturers to relocate production and/or for consumers to engage in cross-border shopping.

To assess the extent to which changes in trade patterns have been induced by changes in the tobacco excise duty levels, we first examine changes in duty rates over time. As shown in the figure below, there was a fairly consistent upward progression

in the level of tax on cigarettes between 2008 and 2013 in the majority of EU Member States.

The greatest percentage increase in tobacco taxation between 2008 and 2013 occurred in Lithuania (87 per cent) and Bulgaria (91 per cent). By contrast, the level of tobacco taxation in Germany increased by only five per cent over the same period. Such a disparity in tax changes may provide incentives for tobacco excise duty shopping (i.e. the purchase of tobacco products in a different Member State to take advantage of the lower prices that are the result of lower taxation) but the incentive would depend on the relative market price of cigarettes between countries (e.g. a 91 per cent rise in excise duties in Bulgaria may still result in cheaper cigarettes than in Germany even if the rise there was only five per cent). Where excise duty changes amplify retail price differences between countries, excise duty changes would reinforce the incentive for cross-border shopping that arises from other influence on tobacco retail price differences, such as differences in the cost of living between countries.

Figure 23 Tax per cigarette (including VAT)



Source: Europe Economics' analysis of DG TAXUD data

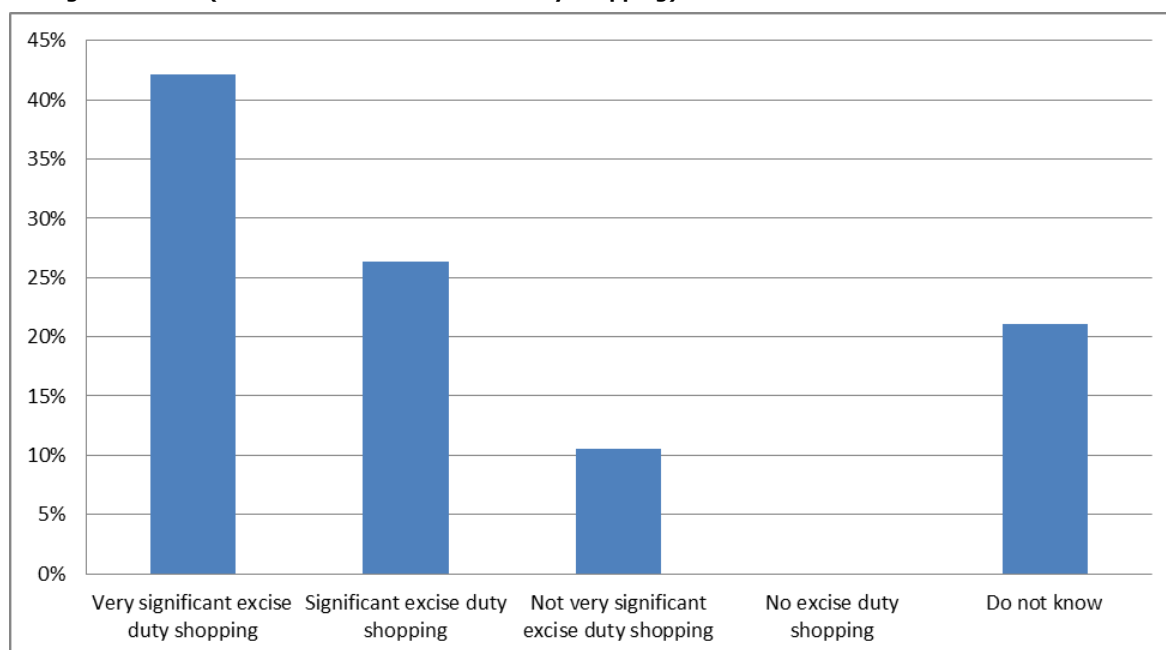
Consumers are only concerned about tobacco excise duties to the extent that they are reflected in the retail price: if an increase in excise duty was fully absorbed by the tobacco industry, i.e. leaving the retail price unchanged, there would be no reason to believe that consumers would change their behaviour. Put simply, consumers respond to changes in retail prices, not changes in excise duties.

Therefore, to understand the extent to which consumers respond to changes in excise duties one needs to assess the extent to which changes in excise duties are passed through to retail prices. Our survey of economic operators found that, in the vast majority of cases, their view is that increases in tax are fully passed through to consumers. This would mean that any change in excise duties has a direct impact on the retail price of tobacco in the relevant country and hence has the potential to affect trade be-

tween Member States. However, it is worth noting that some economic operators reported that costs are not always passed through immediately but rather are absorbed by the manufacturer for a certain period of time. The rationale for this decision would be to gain a short-term price advantage over competitors in the hope that this will breed brand loyalty in the longer term. Further, manufacturers can choose not to pass on 100 per cent of tax, making this choice for competitive reasons, rather than because of rules or regulations.

The chart below examines the extent to which economic operators perceive that consumers take advantage of differences in excise duties between EU Member States (this survey question specifically asked about the implications of differences in *excise duties* on cross-border shopping as compared to other influences on cross-border shopping via the retail price). It is clear that economic operators believe differences in excise duties to be an important driver of cross-border shopping by consumers. Indeed, 42 per cent of respondents reported that the extent of excise duty shopping by consumers is very significant and 26 per cent reported a significant effect. Just 11 per cent of respondents consider that the extent of excise duty shopping is not very significant and no respondent said that there is no impact of excise duties on cross-border purchasing.¹⁰²

Figure 24 To what extent do the consumers take advantage of the differences in the level of excise duties throughout the EU (cross-border tobacco excise duty shopping)?



Source: Analysis of survey responses

In qualitative responses to this question, most respondents agreed that different levels of excise duties have led to an increase in cross-border shopping, with one respondent claiming that this affects 20 per cent of all tobacco consumption. There is recognition that this is not only the case with tobacco products, but that consumers are generally price-conscious. However, stakeholders informed us that differences in excise taxes do not affect cross-border shopping in cigars.

¹⁰² In order to correct for over-representativeness of certain operators which have answered this question multiple times, this graph depicts the views of operators, taking into account one response for each economic grouping

There is also a perception that not only has there been legal cross-border shopping, there has also been illegal cross-border trade, due to the excise tax levels in different countries. Such illegal trade may be:

- smuggling (i.e. the illegal transportation of large consignments of tobacco products across borders);
- bootlegging (i.e. the illegal transportation of small consignments of tobacco products across borders); and /or
- counterfeiting / illegal manufacturing (i.e. production of cigarettes contrary to law).

The vast majority of our interviews with the tax authorities of Member States confirmed the views of economic operators, reporting that differences in excise duty levels throughout EU prompt cross-border excise duty shopping, which may be both legal and illegal.

However, there is recognition from some tax authorities that the implications of changes in excise duties for cross-border shopping depend very much on geography. For example, countries with borders that are external borders for the EU experience high levels of cross-border shopping, as non-EU countries (e.g. Turkey, Belarus, and Ukraine) have prices below EU levels. The main types of cross-border shopping here are illicit trade and smuggling.

More generally, cross border shopping appears to be most significant in border regions and the scale of such activities depends, among other factors, on the magnitude of the retail price difference (including both tax and non-tax drivers of such differences). Specific instances of excise duty shopping highlighted in our interviews with tax administrations include:

- consumers from PT going shopping to ES (because rates are lower in the latter);
- from IT to SI (recent increases in prices reduced the price gap and the size of the problem);
- from IE to most EU countries (especially smuggling);
- from UK to BE (the UK has liaison officers in BE to cooperate with local authorities but cross-border shopping is considered to be difficult to curb as it is legal if goods are imported in limited quantities for personal use); and
- from FR to IT; from DE and AT to CZ; and from CZ to PL.

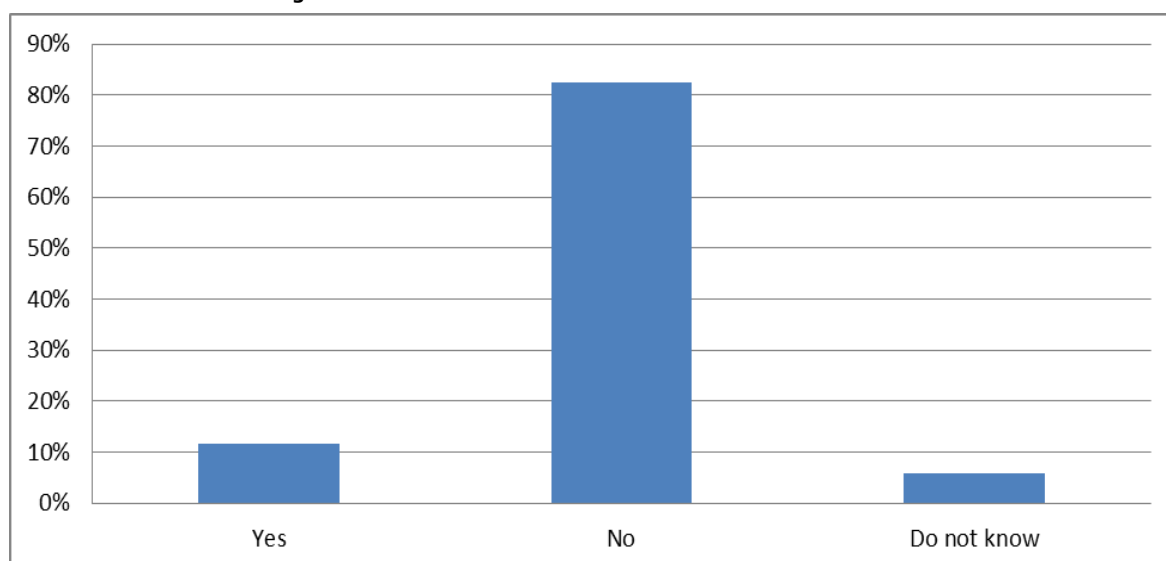
Despite the awareness of particular instances of cross-border excise duty shopping, in general very little data are available. Of those respondents that were able to provide quantitative estimates, one administration (Slovenia) claims that cross-border shopping affects 15 per cent of the national market. Statistics compiled by the Italian administration showed that the consumption of cigarettes in regions close to Slovenia (e.g. Friuli Venezia Giulia, Veneto, Trentino), displayed divergent consumption patterns from the national trend with a lower per capita consumption based on sales of tobacco products within Italy. This is likely to be due to cross-border shopping by Italian consumers taking advantage of the lower retail prices that are available in Slovenia.

While the existence of cross-border excise duty shopping is clear, approaches to tackling the problem are not. Indeed, one Member State claimed that until a fully-fledged harmonization is reached (far in the future) nothing can be done: but for now the choice on the level of the duties is a national matter. Other countries were somewhat

more positive, however, and suggested options such as target controls in border regions and, with respect to fighting against illicit trade from non-EU countries, increasing controls.

In contrast to the impact of excise duties on cross-border purchasing of tobacco products, the figure below shows that differences in excise duties have very little impact on the production location decisions of tobacco manufacturers.¹⁰³ Indeed, 82 per cent of respondents to this question stated that they had not considered relocating tobacco production due to differences in excise duties in the EU. 12 per cent of respondents stated that they had considered relocation but it is not clear whether these considerations resulted in a final decision to relocate.

Figure 25 Has your organisation ever considered relocating the production of tobacco due to differences in the level of excise duties throughout the EU?



Source: Analysis of survey responses

In qualitative responses to this question, economic operators explained that the main reason for this is that the level of the excise duty is not dependent on the location of the manufacturing facilities. Rather, the excise duty is based on the country of consumption. Other reasons for not moving facilities include that it would breach corporate philosophy with some manufacturers having a long standing history with a particular location.

However, it was noted that to maintain a manufacturing site anywhere requires a certain local demand. If nearly all manufactured volume has to be shipped to other markets, there would be time and cost pressure on the supplier to move production to those markets of consumption. Due to excise increases and lower legal manufacturing volumes some countries may undermine their attractiveness as manufacturing location as they do not qualify for a sufficient volume. However, this is a general problem of small countries and the level of excise does not add any significant risk.

These findings were supported by the results of our interviews with the tax authorities of Member States. Almost all respondents stated that differences in excise duties do not have the potential to prompt relocation of business as by their very nature excise duties become chargeable at consumption: products can be moved under duty sus-

¹⁰³ In order to correct for over-representativeness of certain operators which have answered this question multiple times, this graph depicts the views of operators, taking into account one response for each economic grouping

pension. While certain countries pointed out that they know of / received threats from manufacturers of relocating following an increase in the excise duties, they stated that these are considered to be empty threats.

Nonetheless, some countries mentioned that the level of excise duties might be one of the elements inducing relocation but it would have nothing more than a minor influence. More important drivers of relocation decisions include the cost of labour, quality of raw materials and general business conditions.

Interestingly, one country considers that production decisions may be influenced by excise duties indirectly as an increase in excise duties relative to those that apply in neighbouring countries creates favourable conditions for the development of the illegal market and for the reduction of the legal market. This may lead to a reduction in the profitability of legal manufacturers and thereby raise a question on the preservation of a particular factory in a specific country.

Legal cross-border trade

The above analysis has demonstrated that stakeholders perceive cross-border shopping by consumers to be significantly influenced by excise duty policies but that manufacturing decisions are relatively unaffected. To understand how excise duty policies can affect trade in a bit more detail, it is necessary to assess the incentives that exist for cross-border trade, and how these have changed over time.

Our approach to this analysis is to assess the extent to which differences in retail selling prices between Member States outweigh differences in the cost of transporting goods between EU countries. This approach provides evidence on whether there exists an incentive for cross-border shopping (in addition to cases where the consumer is in another Member State for other reasons). A key assumption in our analysis is that the incentive for cross-border shopping is proportional to the difference in price between countries, net of transportation costs.¹⁰⁴

To complete this analysis, two key pieces of data are required:

- estimates of cross-border shipping costs; and
- estimates of retail price differences between countries.

The table below presents evidence of cross-border shipping costs, as reported in a study completed for the European Commission.¹⁰⁵ Given this, and an assumption that the average number of cigarettes per kilogram lies in the range of 650 – 800, we also report the minimum price difference between countries that would be required for there to be any incentive for cross-border purchasing.¹⁰⁶

We note that under Directive 2008/118/EC, individuals may only avoid paying excise duties in their home country where the goods are acquired and transported across borders by the individual himself and where the goods are for his own personal consumption. Ideally, therefore, we would have data on the cost of transporting goods across borders, particularly with respect to specific border regions, which are the most likely to experience cross-border trade.

¹⁰⁴ Merriman et al (1995) made a similar assumption with respect to bootlegging

¹⁰⁵ FTI Consulting (2011), "Intra-Community cross-border parcel delivery"

¹⁰⁶ The minimum required price difference per cigarette is calculated using the following formula: Minimum price difference = cost 1kg parcel / number cigarettes per kg

In the absence of such data, we must instead use an alternative indicator of transportation costs as a proxy for individual transport costs. While our approach does not present a comprehensive picture of incentives for trade we consider that, given the data available, it gives an indication of the extent to which tobacco prices outweigh differences in transportation costs.

Table 18 Transport costs (1kg package) and implied price differences

Member State	The weighted average cross-border price of sending a 1kg parcel (EUR)	Required price difference per cigarette if 650 cigarettes per kg (EUR)	Required price difference per cigarette if 800 cigarettes per kg (EUR)
Austria	13.24	0.020	0.017
Belgium	18.56	0.029	0.023
Bulgaria	11.93	0.018	0.015
Cyprus	16.99	0.026	0.021
Czech Republic	17.38	0.027	0.022
Denmark	26.46	0.041	0.033
Estonia	9.83	0.015	0.012
Finland	37.23	0.057	0.047
France	12.94	0.020	0.016
Germany	16.96	0.026	0.021
Greece	23.32	0.036	0.029
Hungary	26.95	0.041	0.034
Ireland	20.97	0.032	0.026
Italy	28.63	0.044	0.036
Latvia	13.94	0.021	0.017
Lithuania	14.33	0.022	0.018
Luxembourg	16.01	0.025	0.020
Malta	9.12	0.014	0.011
Netherlands	15.35	0.024	0.019
Poland	10.80	0.017	0.013
Portugal	11.05	0.017	0.014
Romania	7.67	0.012	0.010
Slovakia	8.44	0.013	0.011
Slovenia	10.26	0.016	0.013
Spain	13.11	0.020	0.016
Sweden	23.62	0.036	0.030
UK	19.72	0.030	0.025

Source: FTI Consulting (2011) and Europe Economics' calculations

Based on a comparison of the table above and Figure 23, it is clear that the required price difference for there to be an incentive for cross-border shopping is significantly less than the tax burden in all Member States. This suggests that excise duties may conceivably affect consumers' decisions of whether to purchase tobacco from another

Member State (e.g. if one Member State were to halve its excise duty burden, there would be an incentive for consumers from many other Member States to purchase from that country rather than in the domestic market).

In economic theory, an individual that considers engaging in cross-border excise-duty shopping will probably seek to secure the maximum possible saving on the domestic price of cigarettes. Therefore, our analysis of the incentives for excise duty shopping is based on the maximum price difference between Member States, as reported in the table below.¹⁰⁷ To assess changing incentives over time, we consider first the incentives in 2007, and then in 2012. This will help us understand how the incentives for cross-border trade have changed over time and, in particular, over the period before and after the MED was introduced for cigarettes in many Member States.

Table 19 Incentives for excise-duty shopping in 2007

MS	Maximum price difference per cigarette in 2007 (EUR)	Potential saving if 650 cigarettes per kg, accounting for transport costs (EUR)?	Potential saving if 800 cigarettes per kg (EUR), accounting for transport costs (EUR)?
Austria	0.021	?	?
Belgium	0.033	?	✓
Bulgaria	0.056	✓	✓
Cyprus	0.014	✗	✗
Czech Republic	0.039	✓	✓
Denmark	0.001	✗	✗
Estonia	0.009	✗	?
Finland	0.013	✗	✗
France	0.000	✗	✗
Germany	0.051	✓	✓
Greece	0.048	✓	✓
Hungary	0.113	✓	✓
Ireland	0.181	✓	✓
Italy	0.050	✓	✓
Latvia	0.151	✓	✓
Lithuania	0.148	✓	✓
Luxembourg	0.190	✓	✓
Malta	0.159	✓	✓
Netherlands	0.075	✓	✓
Poland	0.293	✓	✓
Portugal	0.128	✓	✓
Romania	0.167	✓	✓
Slovakia	0.054	✓	✓
Slovenia	0.132	✓	✓
Spain	0.094	✓	✓
Sweden	0.066	✓	✓

¹⁰⁷ The maximum price difference per cigarette is calculated by comparing 2007 retail prices in the country of interest with the retail prices in the same year in all other countries, as reported in Euromonitor data.

MS	Maximum price difference per cigarette in 2007 (EUR)	Potential saving if 650 cigarettes per kg, accounting for transport costs (EUR)?	Potential saving if 800 cigarettes per kg (EUR), accounting for transport costs (EUR)?
UK	0.201	✓	✓

Key: **x** if above required saving; **?** if within 0.005 of required saving; **✓** otherwise.

The results from the table above show that there was a clear incentive for excise-duty shopping in 20 Member States in 2007 (i.e. because the maximum price difference between EU countries exceeded the weighted average transport cost). The incentive was particularly strong in countries such as Poland, the UK, Luxembourg and Ireland. Of these, the level of tobacco excise duty was relatively high in the UK and Ireland but broadly average in Poland and Luxembourg. This suggests that while excise duties provide one explanation for excise duty shopping, other drivers of retail price differences are equally important. Indeed, excise duties only affect the incentive for cross-border shopping because of the impact on retail prices: if changes in excise duties were not passed through to consumers, there would be no impact on the incentive for cross-border shopping.

The table below shows the incentives for excise duty shopping in 2012. Relative to the situation in 2007, there exists an incentive to purchase tobacco from another Member State in slightly fewer countries. In particular, a clear incentive exists in 17 Member States, compared to 20 in 2007. The incentive for cross-border shopping remains particularly strong in Poland and is also strong in Luxembourg and Slovenia. However, the incentive that existed in 2007 in the Czech Republic and Italy was eliminated by 2012 due to a rise in the relative price of cigarettes in those countries. In both cases, this may potentially be explained by the relatively high MED that was established following the implementation of Directive 2011/64/EU.

Table 20 Incentives for excise-duty shopping in 2012

MS	Maximum price difference in 2012 (EUR)	Potential saving if 650 cigarettes per kg, accounting for transport costs (EUR)?	Potential saving if 800 cigarettes per kg, accounting for transport costs (EUR)?
Austria	0.000	X	x
Belgium	0.016	X	?
Bulgaria	0.032	✓	✓
Cyprus	0.022	X	?
Czech Republic	0.017	X	x
Denmark	0.017	X	x
Estonia	0.010	X	x
Finland	0.007	X	x
France	0.019	X	?
Germany	0.025	X	?
Greece	0.043	✓	✓
Hungary	0.105	✓	✓
Ireland	0.141	✓	✓
Italy	0.013	X	x
Latvia	0.119	✓	✓
Lithuania	0.117	✓	✓
Luxembourg	0.190	✓	✓

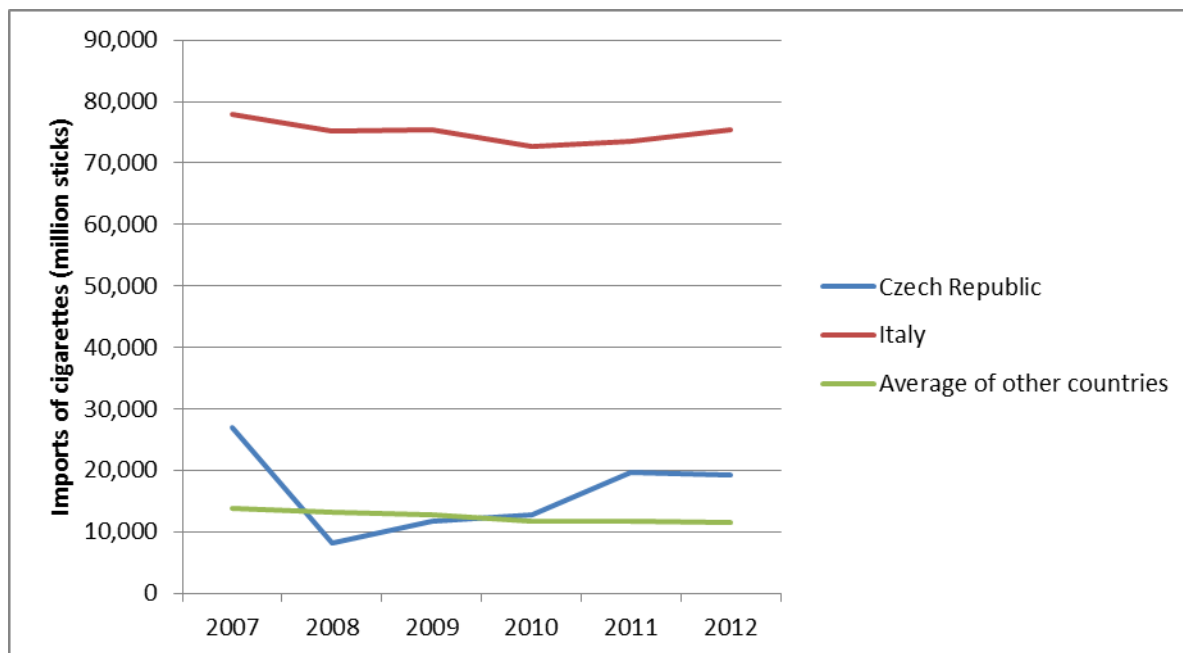
MS	Maximum price difference in 2012 (EUR)	Potential saving if 650 cigarettes per kg, accounting for transport costs (EUR)?	Potential saving if 800 cigarettes per kg, accounting for transport costs (EUR)?
Malta	0.130	✓	✓
Netherlands	0.065	✓	✓
Poland	0.351	✓	✓
Portugal	0.117	✓	✓
Romania	0.120	✓	✓
Slovakia	0.068	✓	✓
Slovenia	0.164	✓	✓
Spain	0.105	✓	✓
Sweden	0.087	✓	✓
UK	0.161	✓	✓

Key: ✗ if above required saving; ? if within 0.005 of required saving; ✓ otherwise.

The erosion of an incentive for cross-border shopping by citizens of the Czech Republic and Italy suggests that an examination of changes in imports to these countries over time may provide an indication of the impact of excise duties on trade.

The figure below shows the total volume of cigarette imports to the Czech Republic and Italy between 2007 and 2012 together with the average volume of imports to other EU countries. The figure shows that the volume of imports to Italy is significantly greater than the average of other EU countries and declined slightly between 2007 and 2012. Imports to the Czech Republic are broadly similar to those of other EU countries and increased each year between 2008 and 2011, following a sharp decline between 2007 and 2008.

Figure 26 Volume of cigarette imports



The data presented in the figure above provide little evidence for the hypothesis that excise duties have a significant impact on trade in cigarettes. In particular, there is not a consistent downward trend in imports between 2007 and 2012, which would be expected if the narrowing of retail prices, at least in part due to the MED, had actually

affected the volume of trade. Furthermore, the volume of imports to Italy actually rose following the implementation of the MED in 2011, which is contrary to the effect expected due to the lower incentive to import products legally from other Member States.

Overall, therefore, it appears that changes in excise duties, via impacts on relative retail prices, are not one of the key determinants on cross-border trade. Indeed, there are many other influences on cigarette imports, including the production deficit (i.e. the difference between the volume of retail sales and the volume of production in a given Member State). The production deficit for the Czech Republic and Italy is presented in the chart below.

Figure 27 Production deficit



Comparing Figure 26 and Figure 27, there appears to be some relationship between the production deficit and imports in both the Czech Republic and Italy, but the correlation is far from perfect. For example, the trends in imports to the Czech Republic and the country's production deficit between 2007 and 2012 are reasonably similar, although the rate of change in the production deficit is somewhat more muted than that of imports. That means that there are likely to be other (unobserved) drivers of changes in the volume of imports over time.

Illicit trade

Rather than engaging in legal cross-border trade to limit exposure to taxation, some parties may instead engage in illicit trade. Quantitative estimates of the total volume of illicit trade – and the associated excise duty loss – were presented in the discussion of Question 2.1. In this section, we provide more detail on the characteristics of illicit trade and the key factors that drive it, including excise duties. The discussion is based on numerous previous studies on these topics and responses to our survey of economic operators and interviews with Member States.

Volume/value of the illicit trade in the EU

Aside from the analysis presented earlier in this report, a number of studies have sought to estimate the volume and/or value of illicit trade in the EU. These include:

- Joossens et al's 2010 analysis reported that the illicit cigarette trade accounted for 11.6 per cent (or 657 billion cigarettes) of all cigarettes sold worldwide in 2007;
- KPMG's project star reported that the volume of contraband and counterfeit (C&C) cigarettes was 56.8 billion in 2006, 60.6 billion in 2007, 60.5 billion in 2008, 61.1 billion in 2009, 64.2 billion in 2010, 65.3 billion in 2011 and 65.5 billion in 2012. This represents 8.3 per cent, 8.4 per cent, 8.6 per cent, 8.9 per cent, 9.9 per cent, 10.4 per cent and 11.1 per cent of total EU consumption respectively;
- The consumption of 'illicit whites' (i.e. cigarettes manufactured for the sole purpose of being smuggled into and sold illegally in another market) had increased to 16 billion sticks in 2012 according to KPMG's report. This means that they accounted for 24% of the total EU C&C cigarettes;
- KPMG's report also tracks the volume of C&C by Member State from 2006 to 2012. However, there are no data on the breakdown by counterfeiting, bootlegging and smuggling;
- Merriman, Yurekli and Chaloupka used expert resources to estimate the share of smuggling as a percentage of 1995 domestic sales by Member States.

Due to the illegal nature of such trade, data obtained and published are limited and often subject to bias. Even if one is completely neutral, limited data availability means that estimates are subject to a significant margin of error.

Factors contributing to illicit trade

Price

Several studies have confirmed that the price and availability in a market of cheap cigarettes affect the level of illicit trade. In general, the demand for cheaper tobacco products greatly outweighs the availability of it in the legal market. This creates a significant incentive for illicit tobacco products, which are usually 30 per cent to 50 per cent cheaper than their legal counterparts. The low cost of manufacturing also makes supplying the illicit market profitable.

In addition to the absolute price, the relative price between countries can also affect the level of smuggling. Norton's study found that the share of bootlegged cigarettes increases with the relative price of cigarettes and decreases with local enforcement activities. Baltagi and Levin's study on the US market shows that a 10 per cent rise in the retail price in a neighbouring state led to an increase in home state sales of 0.8 per cent (implying a cross price elasticity of demand of 0.08). The "small but significant" cross price elasticity implies that where bootlegging is significant, a price change in one state could affect the amount of illicit sales in neighbouring states. Another study using Canadian data shows that taxed consumption is more price elastic than total consumption of tobacco (-1.01 vs -0.4). This implies that price has more impact on where people buy cigarette (legally or illegally) than how much or if they buy it.

The impact of a change in price on illicit trade may depend on the existing price level in a country. Merriman's econometric model on European countries found that lowly-priced countries (such as BG, HU, IT, PL, SK, ES and, outside the EU, Turkey) are "relatively immune to bootlegging", while high-priced countries are more prone to bootlegging.

However, it is recognised that price is not the only factor that affects the level of illicit trade. For instance, the Nordic countries have some of the highest cigarette prices in the world but a low level of smuggling. On the contrary, in Spain and Italy, prices are relatively low but the level of smuggling is high. Merriman's econometric model confirms that a combination of low cigarette prices and other factors (e.g. cultural factors such as street selling being more acceptable in Spain and Italy than in the Nordic countries) contribute towards high levels of illicit trade.

Excise duties

Almost all economic operators that responded on this topic agreed about the effect of the excise duties on illegal tobacco. Essentially, due to high and increasing taxes, the number of smuggled or counterfeit cigarettes has increased significantly. Cigarettes are generally considered to be the most affected tobacco product due to the high demand, the potential for high profits for the sellers and the high savings for the buyers. However fine-cut tobacco has been affected most significantly in France and the UK, and many criminals have begun to manufacture fine-cut illegally because it requires less work to make than cigarettes. Finally, most people agree that cigars and cigarillos have the least potential for illegal activities, due to the fact that the demand is lower and manufacturing costs higher.

One economic operator noted that Her Majesty's Revenue and Customs of the UK has stated that two-thirds of consumers of illicit products buy the illicit products because they cannot afford expensive duty-paid products. The most affected product category is cigarettes as they are generally the most expensive, dominate tobacco product demand and most convenient for the consumers. However, it was stated that as some Member States have increased fine-cut tobacco taxation to the level of cigarette taxation (or above), they have experienced legal market reduction by up to 70 per cent within a few months.

Another respondent noted that, in general, tobacco excise tax increases are regressive and therefore have a greater impact on lower income consumers than higher income smokers. However, despite decades of tax increases, smoking prevalence (i.e. the estimated proportion of individuals that smoke some form of tobacco) is highest among lower and middle income groups. It stated that studies and its own observations show that low income groups are among the first to leave the legal tax-paid market seeking more affordable illegal un-taxed products. For example, the respondent stated that in Bulgaria the economy price segment has been fully substituted by illegal cigarettes while the economy price segment has been highly impacted by illegal cigarettes in Romania.

Nonetheless, while high levels of smuggling have been associated with countries with high tobacco excise duties (e.g. the UK, Ireland and France) and despite the evidence put forward by respondents to our survey, the literature provides limited evidence that lowering tax would have a direct negative impact on smuggling.

Several studies (Bhagwati 1974; Simkin 1974; Norton 1988) find that smuggling increases with tax and tariff levels. In particular, Norton's econometric model shows that for current smugglers, the optimal amount of cigarettes to smuggle increases with the tax rate. The number of firms that smuggle also increases with the tax rate. Hence, the overall level of smuggling increases with the tax rate.

Cooper and Witt cited the examples of Singapore, Malaysia and Ireland, all of which experienced surges in illicit trade following tax hikes. These lend support to the results of Norton's econometric analysis. However, although illicit trade declined after

Singapore imposed a tax freeze, the level of illicit trade remained much higher than before the tax hikes. It is also not clear if the decline was the direct result of tax freeze or due to other measures such as stricter law enforcement.

Besides the level of tax, the speed of a tax increase also affects the amount of illicit trade. The G7 experience has shown that rapid hikes in tobacco duties fuel the increase in illicit trade. On the contrary, countries that gradually increase tax duties experience little change in the amount of smuggling. A recent illustration of this phenomenon concerns the January 2014 increase in tobacco excise duty in France. The total tax burden per 1,000 cigarettes rose from approximately €247 to approximately €264, according to the DG TAXUD Excise duty tables. Indeed, at the time of this 7 per cent increase in excise duties, Euromonitor reports that "Illicit trade [has become an] ... alternative solution to expensive cigarettes in France".¹⁰⁸

Evidence also suggests that a collective tax raise, such as across the EU, leads to an increase in the consumption of illicit cigarettes. The literature suggests that as income levels differ greatly among EU Member States, equalising the levels of excise duty destabilises the market and consumers in some countries switch to the illegal market as a result.

Although there is a strong link between tax level and illicit trade, the fact that the aggregate level of smuggling is generally higher in countries with low taxes than those with high taxes, shows that excise duties cannot be the sole determinant of the level of smuggling. Other factors such as "the ease and cost of operating in a country, industry participation, how well organised crime networks are, the likelihood of being caught, the punishment if caught, corruption levels" can also affect the level of smuggling.

Relationship between price and tax duties

It is worth noting that although tax duties often account for a high percentage of retail cigarette prices, Cooper and Witt state that "there is no correlation between excise tax incidence [i.e. the level of taxes] and the retail price of cigarettes", which could potentially be explained by the application of VAT on top of the excise duty. Similarly, the authors state there is no correlation between the level of excise duty and the affordability of cigarettes. For instance, despite lower excise duties, cigarettes are less affordable in India and South Africa than in Canada and Italy, which have much higher excise duties. Hence, Cooper and Witt concluded that one should not use exercise tax incidence as gauge in forming tobacco policies.

Summary

Our analysis of the extent to which changes in trade patterns have been induced by changes in the tobacco excise duty levels provides the following key findings:

- changes in excise duties only affect trade patterns via the impact on retail prices – if excise duties were absorbed by manufacturers there would be no impact on trade;
- duty changes are generally fully passed through to consumers and both economic operators and tax administrations believe that this has led to excise duty shopping by consumers and increased levels of illicit trade;
- the incentive for excise duty shopping has changed somewhat over time but the impact on trade cannot be identified by economic data;

¹⁰⁸ Euromonitor (2014), "Tobacco in France"

- changes in excise duties have almost no impact on the choice of manufacturing location;
- illicit trade is often more affected by abrupt changes in excise duty rates than by the actual level at which it is set. Illicit trade, once established, declines very slowly and is difficult to reduce.

Q3.3 To what extent does the current structure and rates of the excise duties for manufactured tobacco guarantee the proper functioning of the Internal Market?

The core aim of this task is to understand the extent to which the rules introduced by the 2011 Directive have affected the tobacco market across the EU. For cigarettes, there are strong links between this issue and the analysis of the impacts of MED rules, while the above analysis of trade between EU Member States is relevant for an assessment of the functioning of the internal market with respect to all types of tobacco.

Our analysis of this issue draws on both stakeholders' perceptions and data gathered through desk-based research. We first consider the general functioning of the tobacco markets and then assess the issue separately for cigarettes, cigars, cigarillos, RYO tobacco and pipe tobacco.

All tobacco

The chart below presents the total value of tobacco sales in each EU Member State between 2007 and 2012. The Member States with the largest tobacco markets are Germany, the UK, Italy, France and Spain.

It is interesting to note that there was a clear decline in tobacco sales in Spain between 2010 and 2012. There was relatively little change in the level of tobacco excise duties in Spain between 2010 and 2012 and hence the decline in tobacco retailing retail appears to be driven by other factors. For example, the Spanish economy has experienced a particularly strong downturn in recent years and a reduction in disposable income is likely to have a direct impact on tobacco consumption. Some consumers may switch to cheaper alternatives (e.g. substituting cigarettes with RYO) or illicit products, while others may stop consuming tobacco altogether. Similar trends were observed in Portugal and Greece, both of which have experienced similarly poor economic conditions in recent years.

Figure 28 Total retail value of tobacco



Source: Europe Economics' analysis of Euromonitor data

While the influence of excise duties on tobacco retailing is not immediately evident from the figure above, it is important to understand the extent to which the current structure of excise duties allow for the proper functioning of the Internal Market, neutral conditions of competition and the free formation of prices. The excise duty system should not have an unintentional adverse impact on these issues and any finding of such an effect would be a cause for concern.

Ensuring the proper functioning of the Internal Market

According to the tax administrations of Denmark and Cyprus, the differences in excise duties rates across Member States can encourage cross-border shopping and the illegal trade of tobacco from low excise countries to high excise countries. Lithuania's authority stressed that attention should be paid not only to the impact of the current excise duty structure and rates on the proper functioning of Internal Market but also to illegal imports from non-EU countries: ever growing excise duty rates within the EU would increase the risks of illegal imports from outside of the EU.

It is generally considered that while idiosyncratic conditions in certain countries justify the flexibility left to national administrations, large differences in the structure of excise duties and the applicable rates do not help to improve the proper functioning of the Internal Market. Indeed, the German authority thinks that the source of problems with the proper functioning of the Internal Market is the price differences between Member States (with the differences in excise and tax treatment being one cause of such differences). Reducing such price differences would decrease the share of consumers purchasing tobacco products in other Member States due to lower prices.

However, despite the above assertions, it is not clear that price differences actually place a constraint on trade between Member States and hence hinder the functioning

of the Internal Market. Indeed, economic theory shows that at least for the marginal consumer, price differences between countries should prompt trade.

According to the Czech Republic, the structure and level of excise duties should allow neutral conditions of competition and free formation of prices. However, it considers that this does not absolutely ensure the proper functioning of the Internal Market as most Member States apply different restrictive measures which can have a distortive impact on the whole EU market.

Neutral conditions of competition

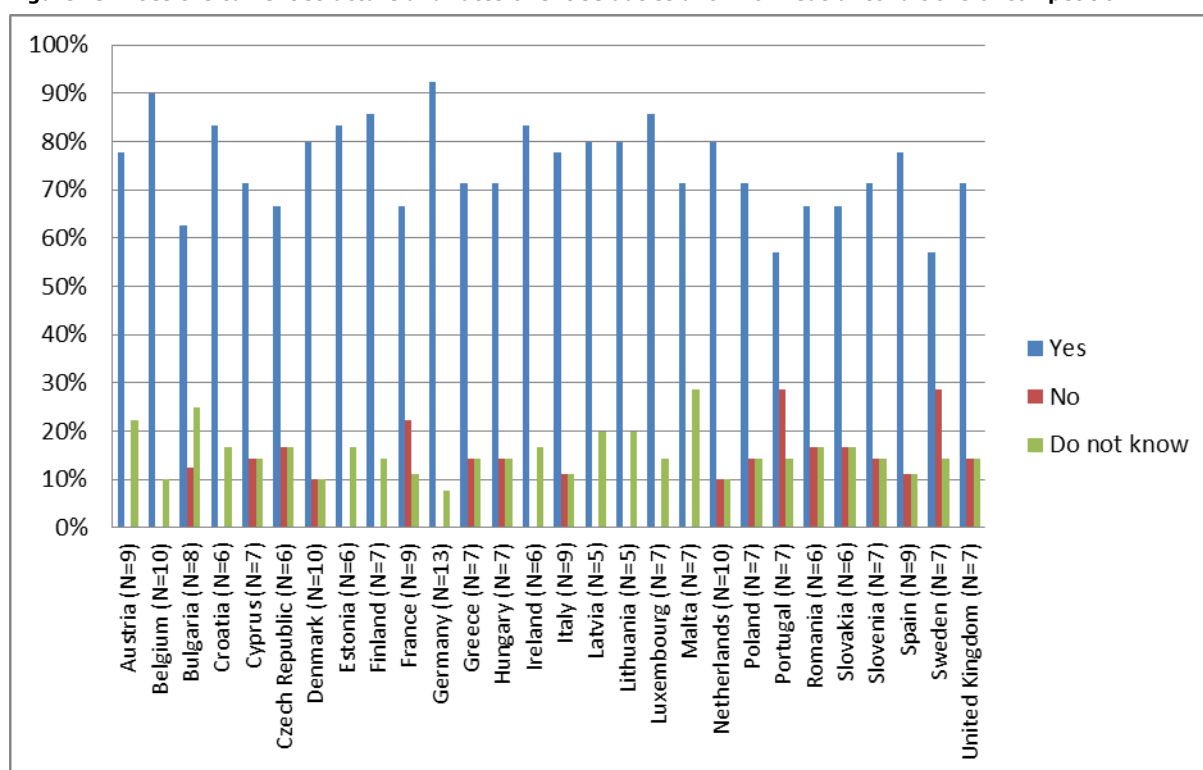
In the interviews with the tax administrations of Member States it was stated by one Member State that the current structure of excise duties had led to a strong concentration of prices, a high collusion of large players and a disappearance of cheap products on the (legal) market. Interestingly, this is seen to be not only acceptable but actually as having a positive impact of the system. From an economic perspective, this is a curious statement because collusion (either legal tacit collusion or illegal active collusion) between market players is typically considered to be undesirable because it raises prices above the level that would obtain in a competitive market. Indeed, competition policy is typically designed to tackle allegations of collusion through remedies. Therefore, we can only assume that the feature is considered 'positive' only because higher prices result in higher tax revenues. .

In contrast, another Member State informed us that it considers the current structure of the excise duty system to be appropriate as it guarantees an increase of retail prices at an even rate for all price levels with respect to cigarettes and smoking tobacco. Thus, tobacco products characterised by different price levels can effectively compete with each other in a given national market.

The chart below is based on economic operators' responses to our survey and presents perceptions in respect of the extent to which the current structure and rates of excise duties allow for neutral conditions of competition.

This graph shows the responses of economic operators, for each Member State they operate in, the analysis, by Member State, ensures that over-representation of any particular economic operator in the survey answers is corrected. The data contains one answer for each country in which respondents have reported to operate.

Figure 29 Does the current structure and rates of excise duties allow for neutral conditions of competition?



Source: Analysis of survey responses

The majority of respondents in all Member States consider that the current structure does not distort the conditions of competition, although a substantial minority of respondents in Portugal, Sweden and France disagreed.

In the economic operators' qualitative responses to this question, one recurring comment was that all Member States are subject to the same general rules and hence in that sense conditions for competition are neutral. In addition, the adoption of prescriptive EU-wide structural rules would most likely result in distortions within individual Member States' markets for various tobacco products since individual Member States would no longer have the opportunity to apply the excise structure that would best fit their specific circumstances.

More specifically, one economic operator noted that 19 Member States have reduced their ad valorem excise rates since January 2011 and increased the share of specific excise. By allowing the greater flexibility to determine cigarette excise structure, the current Directive is considered to have effectively brought it in line with the structure for fine-cut tobacco intended for the rolling of cigarettes. It was noted that this was the intention of the previous Directive review along with the objective to achieve simplification and transparency of the excise structure on tobacco products. It was further noted that the current Directive provides freedom of structure for excise duty on fine-cut tobacco and other smoking tobacco products allowing the Member States to apply the excise structure that would best fit country's specific circumstances.

Overall, the economic operator stated that the current Directive allows an optimal level of flexibility to determine excise structure on cigarettes, fine cut smoking tobacco, cigars and cigarillos, smoking tobacco other than fine cut. Therefore, the operator considers that it does not have an adverse impact on neutral conditions of competition.

However, a small number of respondents argue that the Directive does not allow neutral conditions of competition. For example, one respondent stated that while the structure of excise duty, as described in Directive 2011/63/EU allows for neutral conditions of competition, the application of the Directive by some Member States has a harmful impact on conditions of competition. A particular problem reported by several respondents concerns the application of “excessive” minimum excise tax on cigarettes or an “excessive” level of taxation on tobacco products other than cigarettes.

More specifically, it was noted that the Directive determines only minimum rates and so Member States are free to establish any excise ratio between the individual categories as long as the rates are above the minimum. This flexibility is considered to have led some Member States to apply fine-cut tobacco excise which is above cigarette taxation. Given that cigarettes and fine-cut tobacco are in competition with each other to a greater extent than other types of tobacco products, it is argued that the flexibility has removed neutral conditions of competition for fine-cut tobacco and for manufacturers offering these products. However, another respondent stated that the current Directive provides freedom of choice of the structure for excise duty on fine-cut tobacco and other smoking tobacco products, which allows neutral conditions of competition and should be maintained.

It was also suggested by one economic operator that the rules for minimum excise tax allow for subjective interpretation and that some Member States apply minima that are not neutral in terms of competition and favour certain price segments and certain manufacturers. For example, the respondent suggested that the MED covers 91 per cent of the total market in Portugal and stated that the only brands above the MED are luxury niche brands and tourist brands; brands for local consumption are entirely covered by the MED.

Free formation of prices

Based on the survey of economic operators, the majority of respondents in all Member States consider that the current structure and rates of excise duties allow for the free formation of prices. However, when asked to elaborate, a few respondents stated that the free formation is limited by the excise duty structure.

In particular, one respondent stated that the MED on cigarettes limits to an extent the free formation of prices. Another respondent stated that some Member States apply an MED and/or ad valorem rate which has a significant impact on price levels. The effect on the free formation of prices is qualified by the fact that taxes on tobacco products account for 75 per cent to 85 per cent of retail price for the weighted average price (and even more for less expensive brands). As a result, retail prices do not fully reflect the pre-tax differences.

While the majority of economic operators consider that the rules allow for the free formation of prices, there was less consistency in the opinions of tax administrations. For example, Denmark’s considers that the MED on cigarettes limits the competition and the free formation of prices at least in the parts of the market that are covered by the MED. However, the Netherlands’ authority states that companies that release cigarettes or other smoking products for consumption are free to decide which retail selling prices are applicable for their products, as long as they take the VAT and excise duty into account.

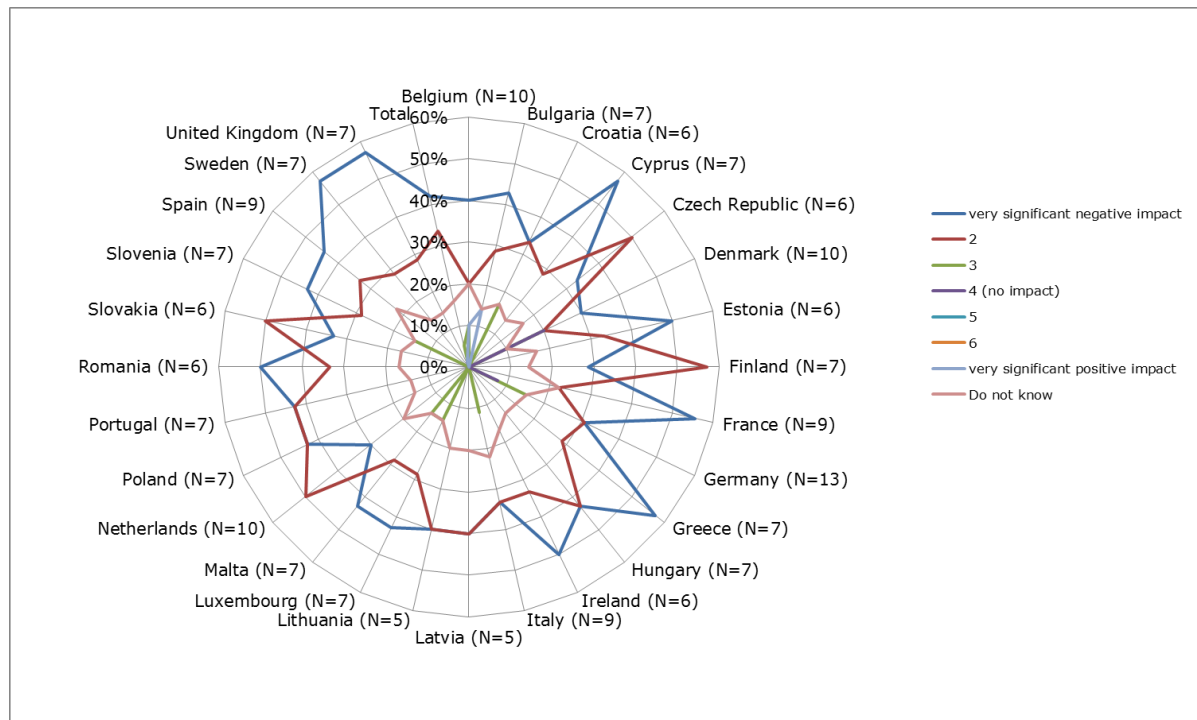
Market impacts

While the excise duty system is not thought to have significant unintentional adverse impacts on the nature or structure of competition in the tobacco market, it may none-

theless affect the total value of sales (since excise duties raise retail higher prices and this leads to lower demand) and the distribution of sales between different types of product (since consumers may respond to increases in the price of one product by substituting towards other products).

The chart below shows how increases in tobacco excise duties are perceived by economic operators to affect tobacco sales. The answers were measured on a scale of one to seven, where one represented a very significant negative impact (drop in sales) and a seven represented a very significant positive impact (increase in sales). The general consensus among respondents was that increases in excise duties negatively affect tobacco sales. Indeed, 75 per cent of respondents selected option one or two.

Figure 30 To what extent have increases in tobacco excise duty affected the sales of your tobacco products?



Source: Analysis of survey responses

The general consensus of economic operators was that, as a result of increases in excise duties, sales of cigarettes have decreased, while other tobacco products may have increased. This is likely to be the result of down-trading by consumers from cigarettes to products such as cigarillos or fine-cut tobacco as they seek to maintain or reduce their tobacco expenditure. However, some respondents also stated that there has been substitution from the legal tobacco market to the illegal one. An issue that many economic operators reported is that cigars and cigarillos are in the same tax category, even though they are different products.

In general, the respondents mention that sales typically decrease due to taxes, but the magnitude varies. Many respondents mentioned that as the price elasticity of demand increases, so does the impact of a tax increase on sales. More specifically, one respondent noted that increases in price (induced by excise or any other factor) always lead to a decrease in demand for any product and the magnitude of the impact is measured by the price elasticity of demand. However, the price elasticity varies over time and in the tobacco sector it can be different for individual levels of price, or even for individual price and tobacco product categories. Therefore, it was acknowledged

that measuring the magnitude is not easy and that it is very difficult to isolate the excise impact from other measures such as anti-tobacco education.

Nonetheless, the respondent observed that increases in excise duties in line with inflation normally have limited or no impact on the legal market, in particular, if the retail price of tobacco remains relatively unchanged compared with net incomes. Given that the demand for cigarettes is relatively price inelastic, such a statement is not surprising. Several other respondents stated that the impact of structure on the total cigarette sales is rather limited and/or that they are not aware of any case that excise increases had positive impact on sales.

Other respondents, however, considered the impact of excise duties to be greater. Indeed, one economic operator suggested that due to the economic crisis and the need for governments to generate additional tax revenues from tobacco products, there have been significant increases in excise tax sometimes combined with increase of standard VAT rate. Such tax increases are perceived to be the main driver of increases in retail prices and as such they are a key cause of the decline in sales. Another respondent noted that excise increases for all product categories normally result in losses for the most expensive category (cigarettes) and a relatively stable size for the lower priced categories, as the entering consumers are balanced by exiting consumers, while the illicit market generally grows following duty increases. An exception to this rule is changes in the MED, which affect the demand for economy cigarettes and thereby are unlikely to confer any adverse impacts on relatively expensive cigarettes.

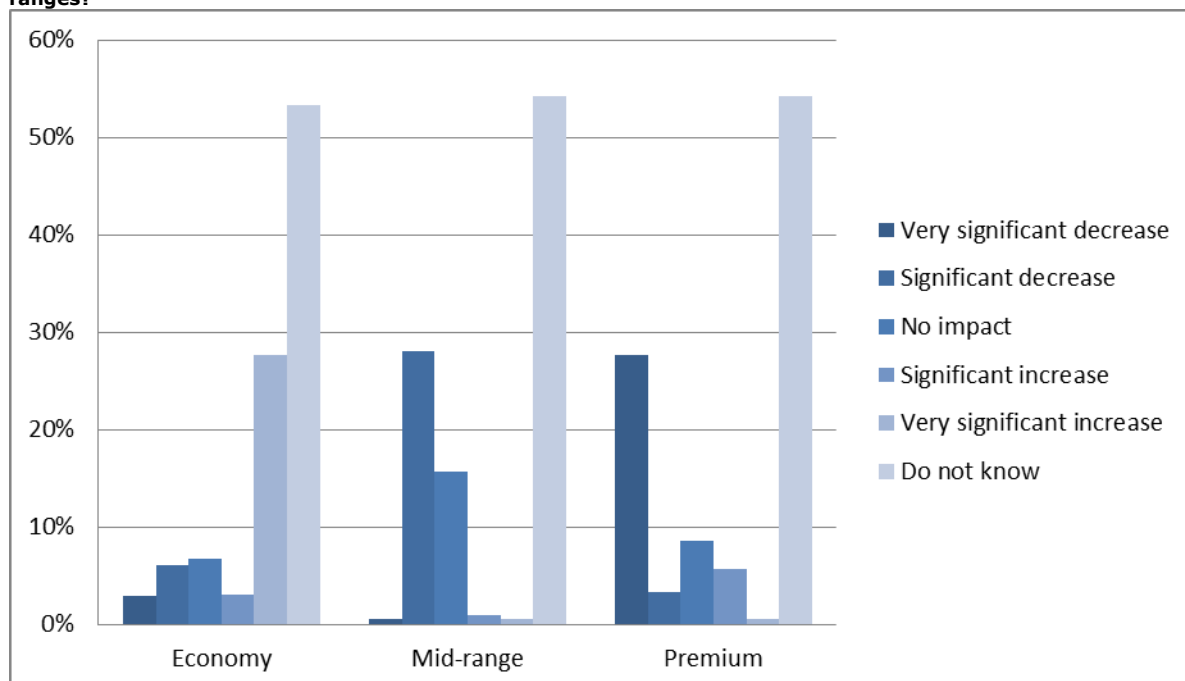
Given that increases in excise duties can affect tobacco sales as a whole and lead to a pattern of substitution between products, the changes may also affect the competitiveness of firms. In response to the survey of economic operators, several stated that their competitiveness does not depend significantly on the excise tax structure because product portfolios can be readjusted and because all manufacturers face the same rules. In any case, several respondents stated that that the level of the tax, not the structure, is what affects competitiveness.

However, one respondent stated that competition is affected in situations where prices across categories are converging due to excise. However, the direction of impact is not certain: the firm's competitiveness can be affected positively as well as negatively, depending on the product portfolio.

Indeed, the impact of excise duties may differ depending on the price point of the product (economy, mid-range or premium). The figure below shows how the current excise duty affects products at different price ranges. Responses were measured on a scale of one to seven, with one representing a very significant relative decrease in sales and seven representing a very significant increase in sales.

This figure shows that more than 50 per cent of respondents did not know how the tax structure affected the sales of economy, mid-range and premium products. Of those that were able to provide a response, there is a perception that the current structure of excise duty has led to an increase in sales of cheaper products and to a decline in the sales of more expensive products. Indeed, 28 per cent of respondents stated that there had been a very significant relative increase in sales of economy products while the same proportion reported that there had been a very significant relative decrease in sales of premium products.

Figure 31 How does the current structure of excise duty affect products at different price ranges?¹⁰⁹



Source: Analysis of survey responses

Our analysis of the qualitative responses to this question shows that when looking at the sales of different brands of cigarettes, economic operators tend to focus on the difference between ad valorem and specific taxes. More specifically, the respondents claim that specific tax systems favour premium brands, while ad valorem systems favour economy brands. Another point is that any changes will be dependent upon the retail price gap between economy and premium brands.

One economic operator stated that the high level of taxation on all tobacco products, and cigarettes in particular, reduces affordability which in turn causes consumers to trade down from high taxed cigarettes (premium) to low taxed cigarettes (economy) and from cigarettes to other tobacco products. As such, premium products are most affected by the high level of taxation prevailing in EU Member States. Moreover, the negative impact of tax increases is considered to be exacerbated in countries with high total ad valorem component (excise and VAT) as the multiplier effect of the ad valorem component further exacerbates price differentials, and thus down-trading.

Another respondent noted that changes in the relative excise difference between products can affect products at different price ranges but the impact on sales depends on the excise system applied in the specific country. In general, excise systems that consist primarily of an ad valorem duty seem to favour economy brands, whereas excise systems, consisting primarily of specific duty seem to favour premium brands.

It was also noted that price bands are generally smaller where the structure of excise duties is largely specific and larger where the structure is largely ad valorem, although this is limited through the use of a MED in the case of cigarettes.

The perception that the excise structure can have a significant impact on sales was not held universally amongst economic operators, however. One economic operator

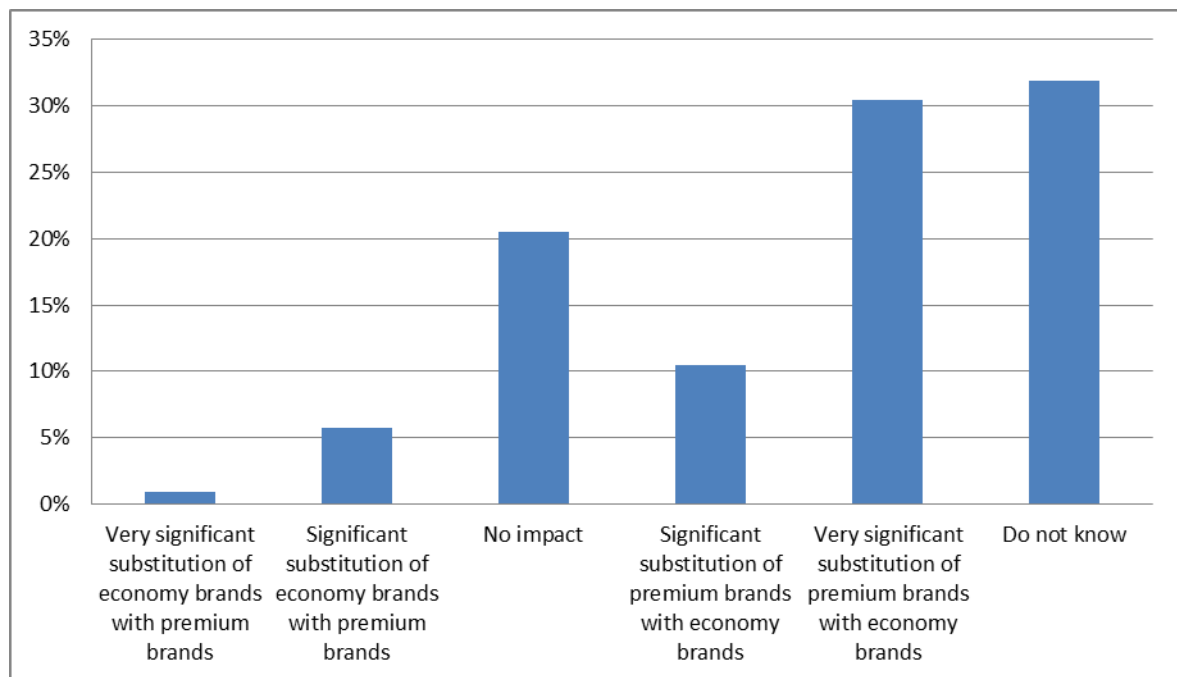
¹⁰⁹ This graph is based on responses done for each market in which economic operators who responded the questionnaire operate.

suggested that the duty structure has a very limited impact on the sales of brands at different price categories. With regards to cigarettes, it was suggested that tax and price gaps between economy and premium brands are generally small due to wide spread use of MED. Therefore, the respondent considers that most EU markets are compressed from tax and price perspectives and so the influence of price segmentation on sales has declined as economy cigarettes are no longer cheap.

Given that the MED in the case of cigarettes is perceived to have adversely affected sales of economy cigarettes, the finding that economic operators perceive the current structure of excise duties to benefit sales of economy cigarettes is particularly interesting. Indeed, the consistent perception that the negative impact of excise duties is increasing price suggests that consumers may choose cheaper products rather than more expensive ones as a result of excise duties.

To assess the relevance of this hypothesis, the graph below presents the perceptions of economic operators with respect to excise duty induced substitution within the same product category (e.g. the extent to which consumers switch from premium to economy cigarettes because of taxes).

Figure 32 What is the extent of excise duty tax induced substitution within the same product category?¹¹⁰



Source: Analysis of survey responses

Overall, the responses provide evidence for the hypothesis that consumers substitute premium brands with economy brands as a result of the excise duty system while there is very little evidence for the reverse effect. Indeed, respondents for Portugal and Romania were the only two countries to report very significant substitution of economy brands with premium brands. The Czech Republic reported the highest substitution of premium brands with economy brands at an estimated 50 per cent.

Many economic operators argued that the structure of excise duties causes people to switch from premium brands to economy brand tobacco products, via the impact on the retail price. Others argued that it is not the structure of the directive that causes

¹¹⁰ This graph is based on responses received at the level of for each national market in which economic operators operate.

the substitution, but rather the level of the tax. Further, some respondents mentioned that it depends on the behaviour of the consumer. For example, one respondent wrote, "Someone who prefers to smoke a hand rolled premium cigar, will never smoke an economy brand and vice-versa." Others mentioned how the purchasing power of the consumer can play a role in the substitution effect. Finally, many respondents agreed that high tax rates on tobacco products lead to illicit production and use, as illicit prices are lower and more affordable to consumers.

One respondent noted that changes in excise duty can lead to substitution within the same product category, other things being equal, but the substitution can go in both directions (i.e. to more as well as less expensive products) depending on the product category and the excise change. The extent of substitution is largely determined by retail price differences but excise duty taxes may allow for changes in price gaps resulting in minor movements from premium brands to economy brands and vice versa.

Another respondent provided information on the patterns of substitution by consumers. In particular, it was noted that consumers typically trade down, i.e.:

- premium to cheap cigarettes;
- from cigarettes to less expensive other legal products;
- from legal products to illicit products; and finally
- from illicit products to the cheapest possible options such as unmanufactured tobacco, home grown tobacco or green tobacco plants and leaves stolen from farmers.

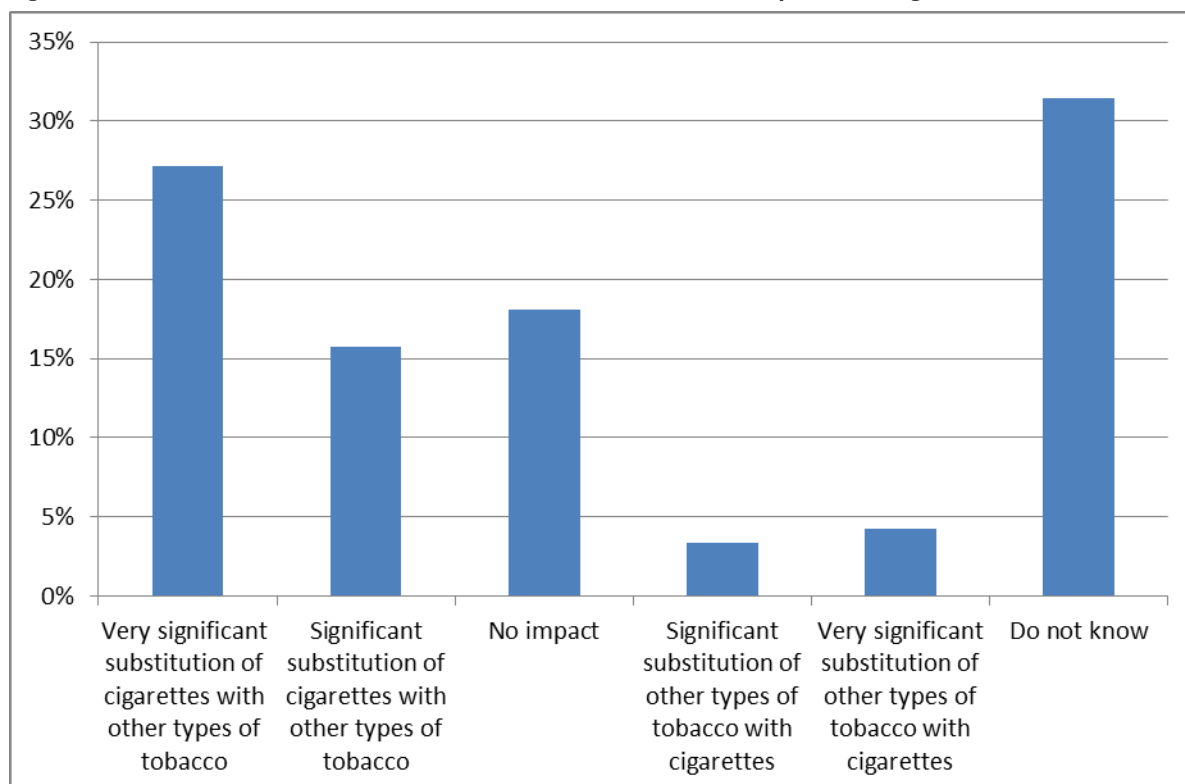
These developments are considered to have taken place in most Member States and are most distinct in the new Member States where affordability is lowest.

However, while the findings do suggest that excise duties can influence product substitution, it is not possible to rule out alternative explanations. For example, economic theory suggests that consumers substitute towards cheaper alternatives during an economic downturn resulting in an erosion of real incomes. Indeed, one economic operator noted that a time of intensified need for financial restraint by households, may result in more or less temporary fluctuations towards less expensive products. Unfortunately, it is not possible to separate the influence of general economic conditions from that of excise duties and hence excise duties may provide only part of the explanation for patterns of substitution within a given type of tobacco product.

In addition to substituting with cheaper alternatives within the same type of tobacco product, it is possible that the excise duty system could lead consumers to choose a different tobacco product, thereby creating excise tax induced substitution between product categories.

The chart below presents stakeholders' perceptions of the extent to which substitution between tobacco products is influenced by excise duties. There is some evidence of significant substitution of cigarettes with other types of tobacco although 18 per cent of respondents claim excise duties have no impact on substitution between product categories. There is limited evidence of significant substitution of other types of tobacco with cigarettes.

Figure 33 What is the extent of excise tax induced substitution between product categories?¹¹¹



Source: Analysis of survey responses

In qualitative responses to this question, many economic operators agreed that tax and duty changes led to a decrease in cigarette consumption and an increase in sales of fine-cut tobacco used for RYO. However, it was equally noted that this is not due to the structure of the excise rates, but rather the Member States' tax policies.

It was stated that a substitution of cigarettes with other tobacco products generally occurs when significant excise tax discrepancy exists, and thus prices are significantly different (e.g. in comparison to fine-cut, cigarillos, other smoking tobacco). A gradual closure of tax gaps between cigarettes and other tobacco products was stated to be necessary to limit this phenomenon.

However, some economic operators considered there to be limited excise tax induced substitution between product categories as it is mainly determined by consumer choice and purchasing power. Indeed, it was noted by many respondents that duties are not the only driver of substitution between products. Consumer preferences and purchasing power are considered to play important roles, as are factors such as unemployment and economic growth. A recurring theme in the respondents' answers is that e-cigarettes are playing an increasingly important role in the substitution between categories: it was stated that there has been a rise in e-cigarette consumption, in part because these items are not taxed.

Overall, the above analysis has found that the current structure of tobacco excise duties does not significantly distort the nature of competition within the tobacco market and does not constrain the free formation of prices. These are positive features of the excise duty system.

¹¹¹ This graph is based on responses received at the level of for each national market in which economic operators operate.

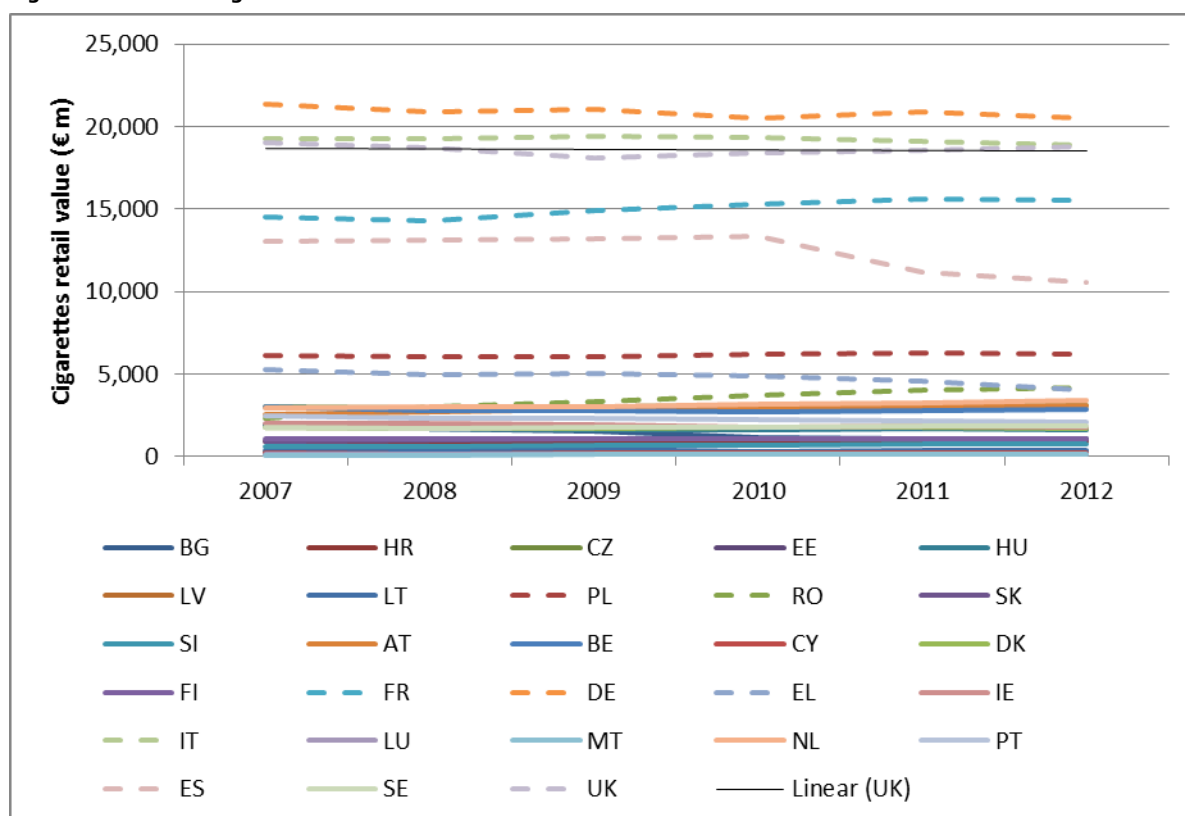
However, the current structure of the excise duty system is perceived to have different impacts on different types of products. In particular, it is perceived to have led to an increase in sales of cheaper products and to a decline in the sales of more expensive products. This pattern appears to be explained by substitution towards economy products. There is also a perception that consumers have substituted other types of tobacco for cigarettes as a result of the excise duty system.

While these findings provide a high-level indication of the economic impacts of the excise duty system on the tobacco market, a full understanding of the impacts can only be obtained by looking into each product in more detail. This analysis is undertaken in the following sub-sections.

Cigarettes

The chart below shows that the total value of cigarette sales declined in many EU Member States between 2007 and 2012. Across the EU as a whole, the total value of sales declined by two per cent between 2007 and 2012 but this average masks significant differences between Member States. For example, the total value of sales in Bulgaria fell by 45 per cent over the period whereas sales increased by 77 per cent in Romania. A sharp drop in sales in Spain is observed after 2010, which almost certainly reflects the sharp economic downturn and high unemployment experienced at that time.

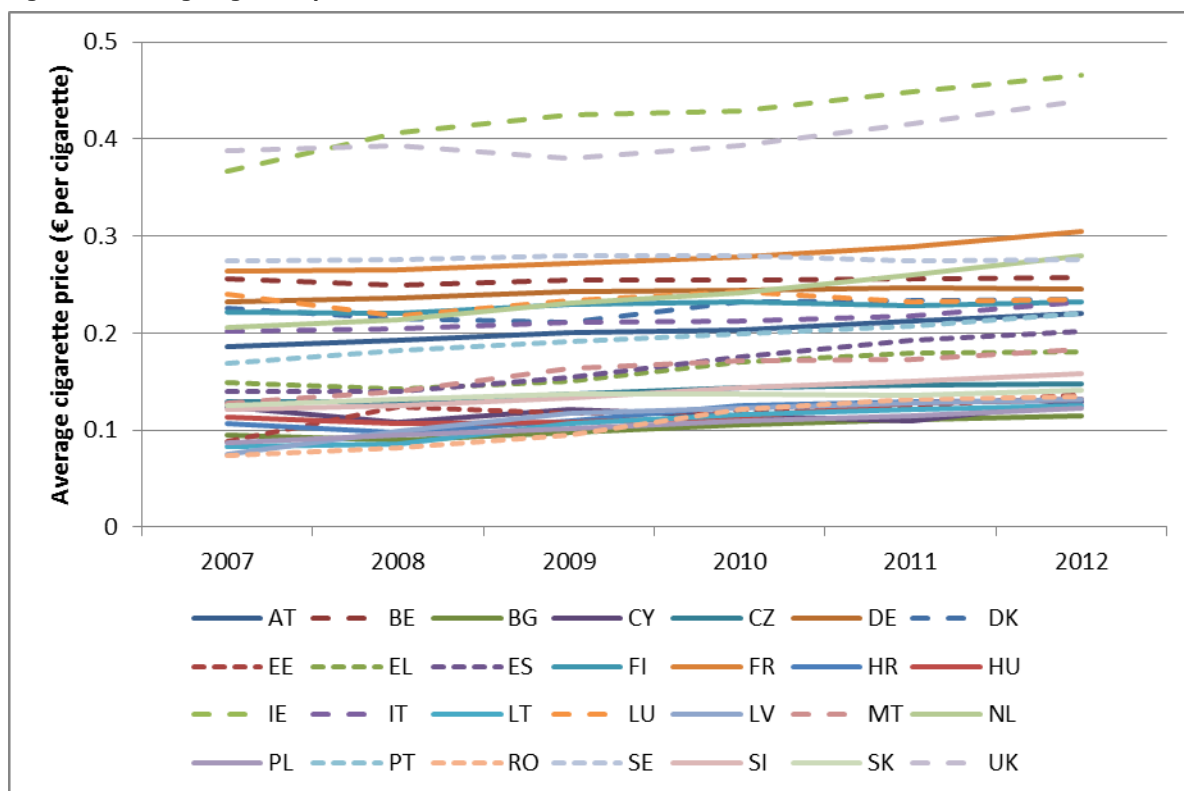
Figure 34 Value of cigarette sales



Source: Europe Economics' analysis of Euromonitor data

Average cigarette prices rose by an average of 25 per cent across the EU between 2007 and 2012. Indeed, as shown in the figure below, prices rose during the period in all countries other than Luxembourg and many countries experienced a monotonic increase in average prices. In general, prices rose more sharply over the period in Eastern Europe than in Western, Northern and Southern Europe.

Figure 35 Average cigarette price



Source: Europe Economics' analysis of Euromonitor data

In the table below, we compare the change in price with the percentage change in sales for each Member State between 2007 and 2012.

Table 21 Comparison of the change in price and in sales

Country	Percentage change in price	Percentage change in sales
Austria	18%	21%
Belgium	1%	-3%
Bulgaria	21%	-45%
Cyprus	4%	3%
Czech Republic	13%	17%
Germany	5%	1%
Denmark	4%	-4%
Estonia	56%	29%
Greece	21%	-1%
Spain	44%	7%
Finland	5%	-4%
France	16%	-22%
Croatia	23%	-14%
Hungary	17%	-11%
Ireland	27%	-2%
Italy	15%	-3%
Lithuania	52%	-13%

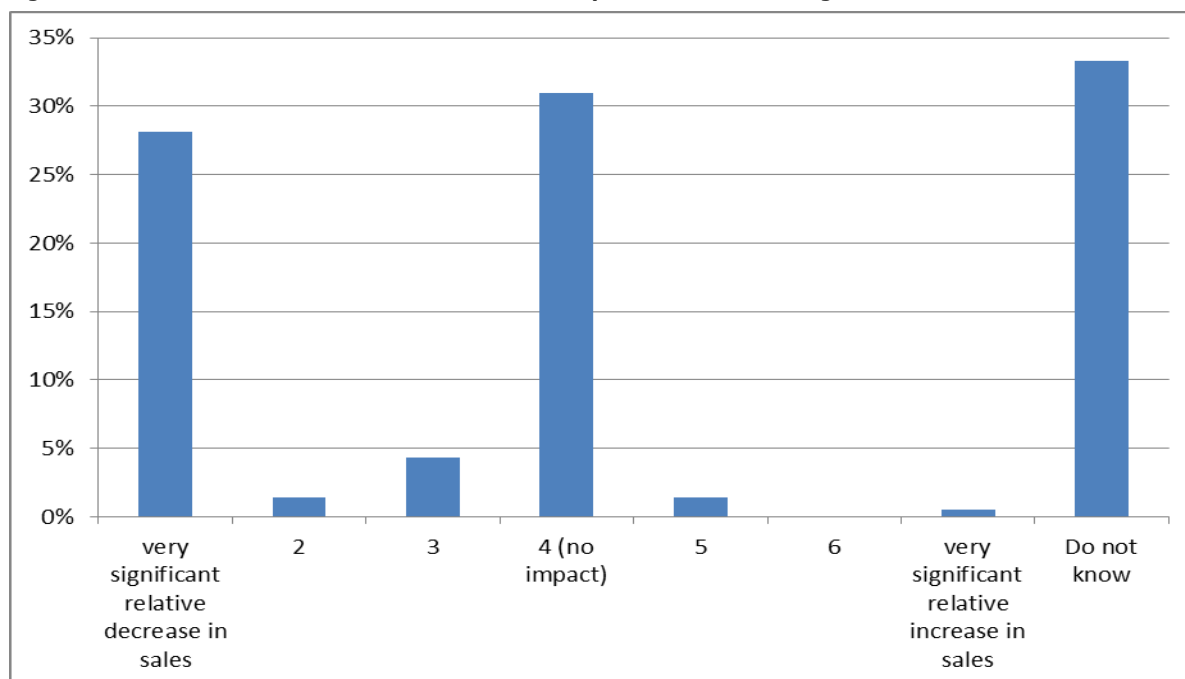
Country	Percentage change in price	Percentage change in sales
Luxembourg	-2%	-7%
Latvia	75%	22%
Malta	44%	14%
Netherlands	36%	2%
Poland	40%	-14%
Portugal	31%	77%
Romania	82%	12%
Sweden	1%	28%
Slovenia	30%	-19%
Slovakia	13%	2%
United Kingdom	13%	-1%

The table shows that there is relatively little apparent correlation between changes in prices and changes in sales (the correlation coefficient is 23 per cent). For example, retail prices in Latvia rose by 75 per cent while sales grew by 22 per cent. In contrast, prices in Luxembourg fell by two per cent but sales fell by seven per cent. This implies that changes in the value of cigarette sales are explained by other factors in addition to price. Given that changes in excise duties will only affect consumption decisions via the impact on retail prices, while acknowledging that excise duties are not the only factor determining the prices, this analysis suggests that the influence of excise duties on cigarettes and (licit) sales volumes is weak.

Indeed, the chart below shows how economic operators perceive the current structure of excise duty to affect the sales of cigarettes. Overall, 31 per cent believed that the tax had no impact on cigarette sales. Cyprus was the only country in which a respondent reported a very significant relative increase in sales of cigarettes due to the structure of excise duties.

Overall, 28 per cent of respondents stated that there had been a significant decrease in cigarette sales due to the structure of tobacco excise duties (e.g. because they are taxed at a greater level than reasonably similar products such as cigarillos) but this average again masks differences between countries. Indeed, only 15 per cent of German respondents stated that there was a significant decrease in sales whereas 40 per cent of respondents from Latvia and Lithuania reported a significant decrease.

Figure 36 How does the current structure of excise duty affect the sales of cigarettes?¹¹²



Source: Analysis of survey responses

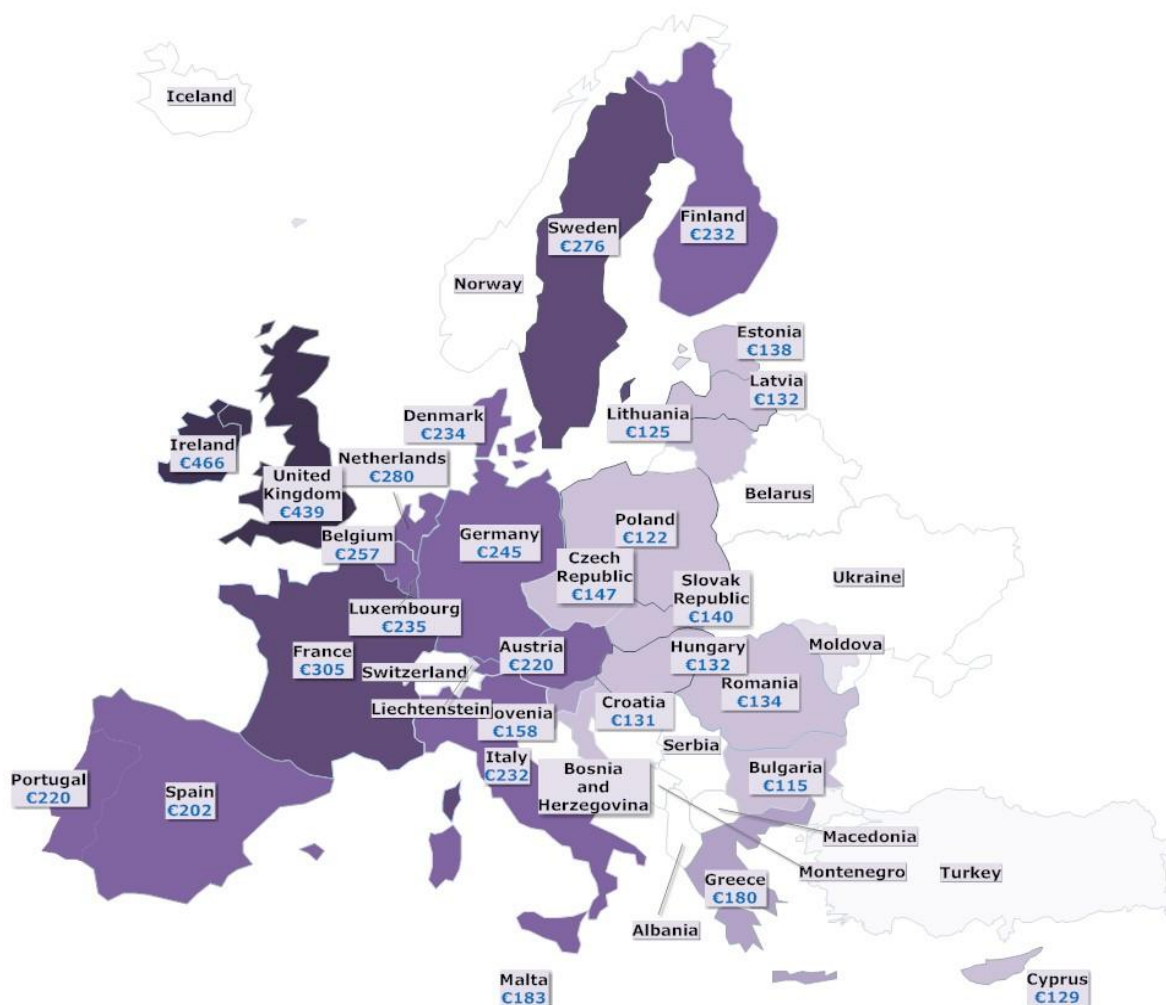
Where tobacco excise duties are perceived to have had an impact on cigarette sales, the question arises of what actions were taken by those consumers whose behaviour led to the reduced number of purchased cigarettes. In principle, consumers may have stopped purchasing tobacco altogether, down-traded to a cheaper product such as fine-cut tobacco, engaged in licit cross-border trade or purchased products from the illicit market.

To understand the extent to which cigarette excise duties may affect the functioning of the internal market we present the average price per thousand cigarettes in the figure below. The figure shows that there were some substantial retail price differences between neighbouring countries in 2012, particularly on borders between Western and Eastern Member States. For example, the price of 1,000 cigarettes is approximately €100 lower in the Czech Republic than in Germany and hence there is an incentive for German consumers that live close to the border to travel to the Czech Republic in order to purchase tobacco products. Of this €100 price difference, approximately 80 per cent can be attributed to excise duties and hence the excise duty system does appear to have an influence on cross-border purchasing in this case.

More generally, the figure below suggests that there was an incentive for cross-border trade between neighbouring countries in that year, particularly for consumers that live in border regions. Any change in relative duty levels between neighbouring countries would, given that excise duty changes are generally passed through entirely to consumers, affect the retail price difference and so may potentially affect the incentive on consumers to engage in cross-border trade. However, it must be emphasised that the incentive is likely to apply primarily to consumers who live in border regions and hence the overall scale of the impact is likely to be limited (and hence not observable in economic data).

¹¹² This graph is based on responses received at the level of for each national market in which economic operators operate.

Figure 37 Price per thousand cigarettes, 2012



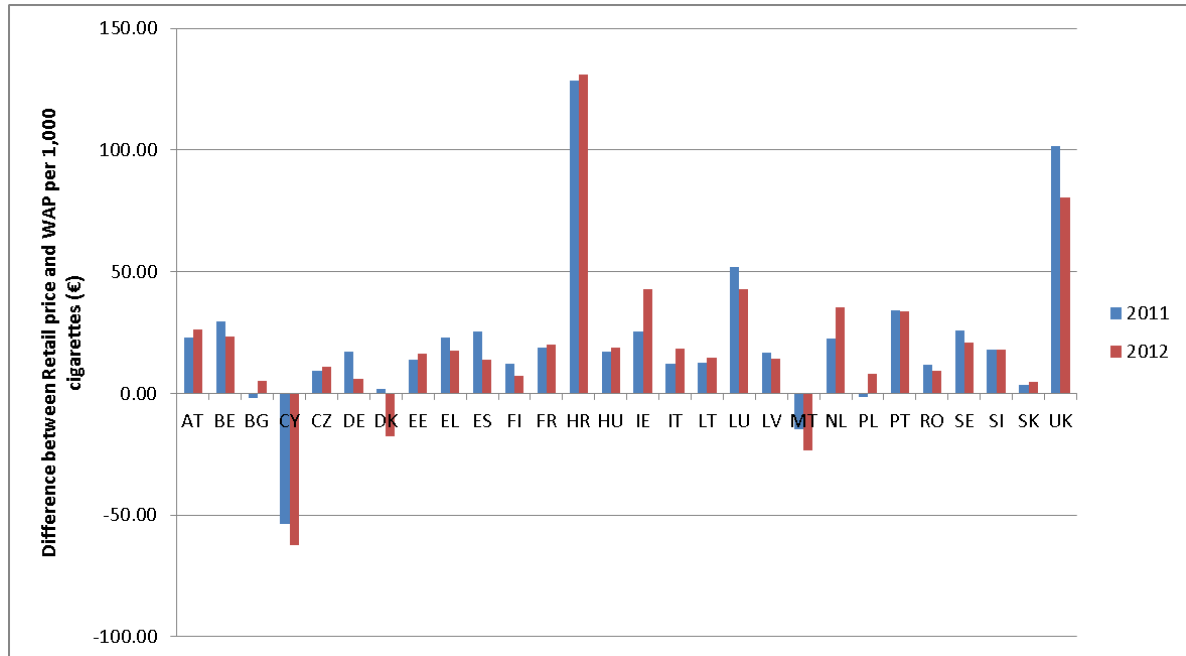
In this context, it is also interesting to assess the relationship between the WAP (which serves as the basis for excise duty rules) and retail prices. The figure below shows the difference between the retail price and WAP per 1,000 cigarettes in 2011 and 2012 (the only years for which data on the WAP are available). It is clear that in the majority of countries, the average retail price exceeds the WAP but the reverse is true in Cyprus and Malta, as well as for Denmark (albeit only for 2012). The difference was particularly large in Croatia and the UK.

Nonetheless, the year-on year change within each country is relatively low and hence there is limited support for a hypothesis that the WAP is correlated with the prevailing retail price in each country, notwithstanding the fact that the absolute gap between the two variables differs significantly between countries. In fact, the correlation appears to be far from perfect given that we observe a significant year-on-year change in the gap in Ireland, the Netherlands and the UK. In addition, the persistence of the differences between 2011 and 2012 may reflect systemic differences in the calculation methodologies employed by DG TAXUD and Euromonitor, such that a closer correlation between the figures cannot be expected.

Finally, it must be noted that we can only draw tentative conclusions at this stage. A more robust analysis of the correlation between the WAP and retail prices requires more than two years of data and, given that we only observe the WAP from 2011 on-

wards, and that retail price data for 2013 are not yet available, such an analysis is not possible at this stage.

Figure 38 Difference between retail price and WAP



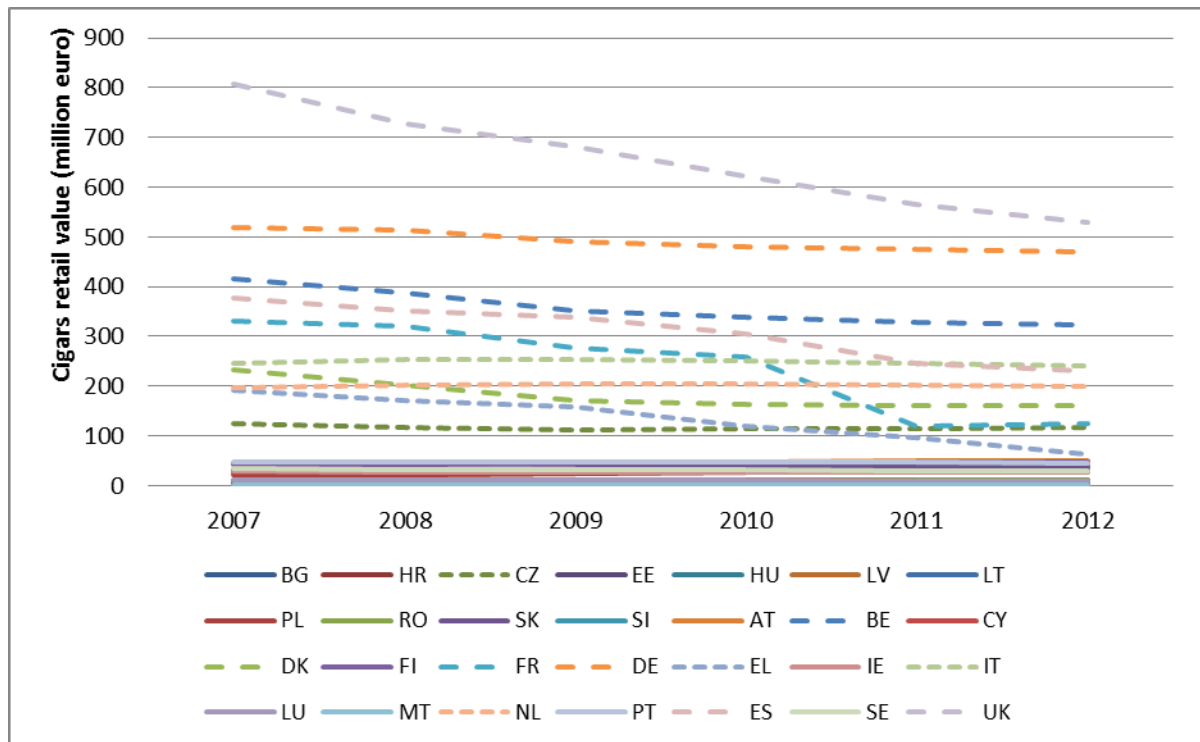
Source: Europe Economics' analysis of Euromonitor and DG TAXUD data

Cigars

The graph below shows the total value of cigar sales in each Member State between 2007 and 2012. The countries with the largest cigar markets are the UK and Germany, followed by Spain and Belgium.

It is interesting to note that the UK had a very large cigar market in 2007, with total sales of approximately €800 million. However, the market has shrunk somewhat since 2007, which may partly be explained by higher taxation on cigars. France experienced a similarly significant decline in cigar sales, particularly between 2010 and 2011. The reason for this is not clear, however: there was no change in excise duties between 2010 and 2011 and no change in VAT applicable to cigars.

Figure 39 Value of cigar sales

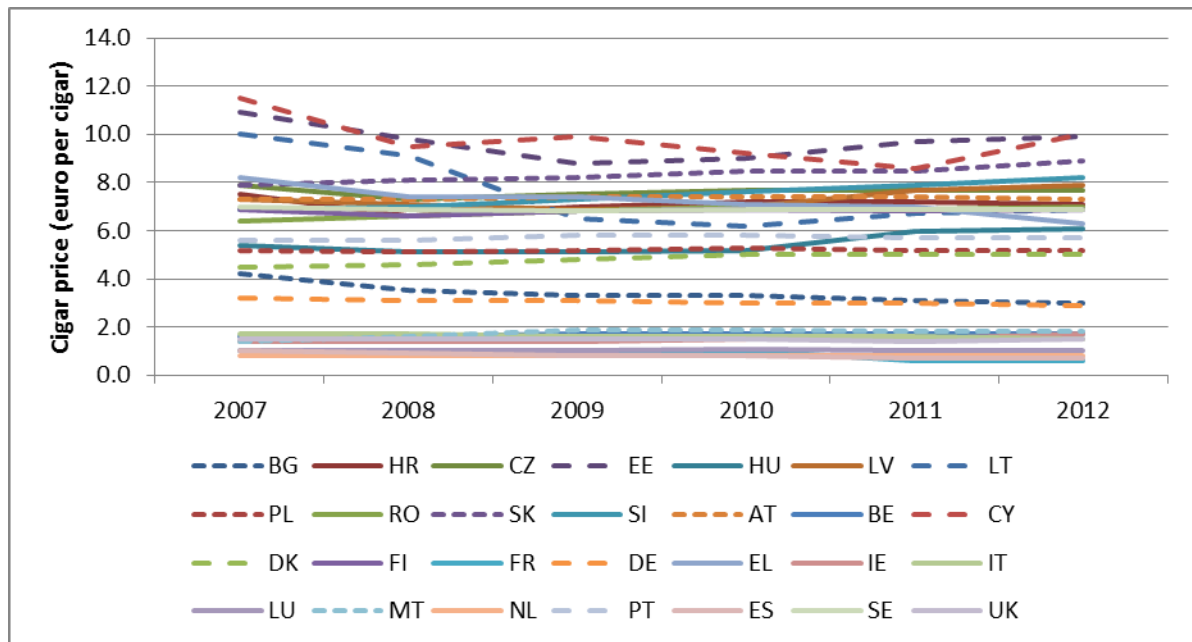


Source: Europe Economics' analysis of Euromonitor data

As illustrated in the chart below, average cigar prices differ significantly between EU countries, as does the volatility of prices between 2007 and 2012. During the period considered, average cigar prices were highest in Cyprus and Estonia, while Slovakia moved from having the third-highest price in 2007 to a broadly average price in 2012. Prices have been relatively volatile in each of these three countries.

Overall, there has been relatively little change over time in average cigar prices although it is notable that many countries experienced a fall in average prices in 2008 and / or 2009 followed by a subsequent rise.

Figure 40 Average cigar price



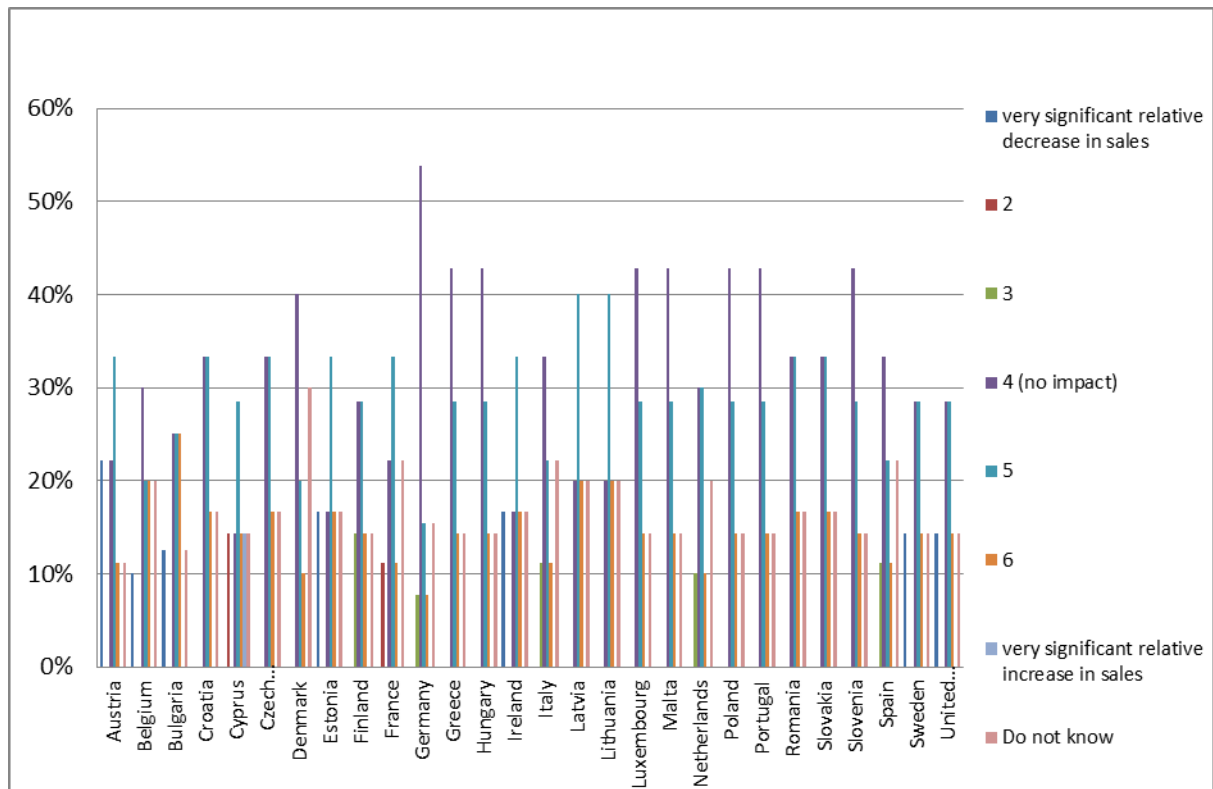
Source: Europe Economics' analysis of Euromonitor data

Based on these two graphs, there is not a clear correlation between changes in price and the total value of cigar sales. In the majority of EU countries, the value of sales either remained flat or underwent a monotonic decline between 2007 and 2012. Prices, by contrast, were generally more volatile over the period.

This suggests that the changes in demand for cigars may be explained by other factors, such as the poor performance of the economy during the period. Poor economic performance is likely to have led to a decline in demand for cigars, which are a premium product: as the real value of consumers' income declines during a recession, demand for luxury goods is likely to fall. Such a decline may be partially reflected in an increased demand for other tobacco products, such as cigarillos, due to the substitution effect.

The chart below shows how the current structure of tobacco excise duties is perceived by respondents to our survey of economic operators to affect sales of cigars/cigarillos in different Member States. More than 50 per cent of respondents stated that there had been relatively little impact on sales, although the minor impact that has been observed is considered to be positive.

Figure 41 How does the current structure of excise duty affect the sales of cigars/cigarillos?



Source: Analysis of survey responses

As for the case of cigarettes, where consumers may respond to changes in excise duties by amending their purchasing habit, they may have stopped purchasing tobacco altogether, down-traded to a cheaper product such as cigarettes or cigarillos, engaged in licit cross-border trade or engaged in the illicit market.

To understand the extent to which cigar excise duties may affect the functioning of the internal market we present the average price per thousand cigars in the figure below.

Figure 42 Price per thousand cigars, 2012



The pattern of cigar prices across Europe differs substantially from that of cigarettes. In particular, prices were generally lowest in western and southern Europe and there were significantly more pronounced price differences between neighbouring countries than was the case for cigarettes. For example, each cigar purchased in Portugal was €5 more expensive than in Spain and hence there was a strong incentive for cross-border trade. However, the rates of excise duty were reasonably similar between these countries and hence the tobacco excise duty system does not appear to be a particularly significant influence on cross-border purchasing of cigars within the Internal Market.

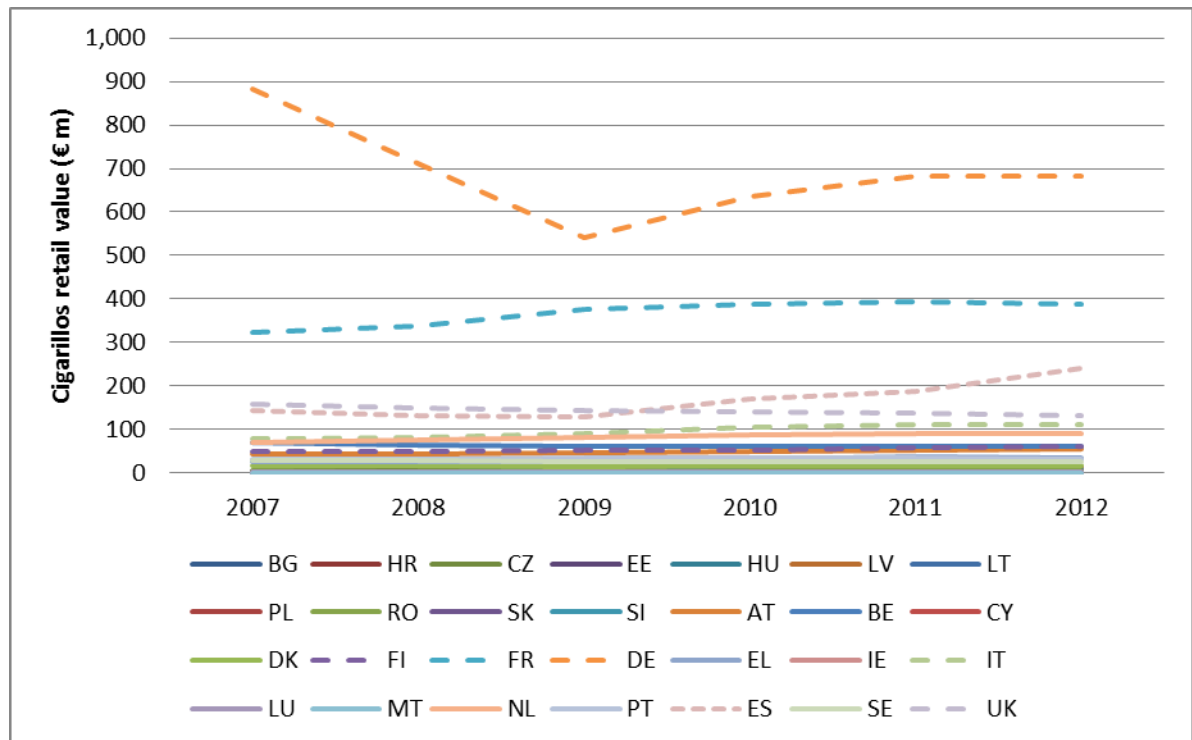
Cigarillos

In common with cigarettes, total sales of cigarillos are highest in Germany, France, the UK and Spain. Total sales in Germany were €900 million in 2007 and fell to approximately €550 million in 2009. After 2009, the consumption of cigarillos in Germany starts to increase again and at the end of 2012, it is about €700 million. The increase in consumption of cigarillos in Spain offsets, to a minor extent, the decline in cigarette sales.

More generally, the figure provides some evidence for our above hypothesis that consumers have engaged in down-trading during the economic downturn. While some of the trend towards substituting cigarettes with cigarillos might be explained by excise

duties (in particular because the level of duty on cigarillos is typically lower), the impact of declining real incomes cannot be ignored. Indeed, it is natural to expect that consumers would substitute towards cheaper products following a reduction in their disposable income and so it is not possible to identify the extent to which the pattern observed in the figure below is influenced by excise duties and the extent to which it is influenced by other factors.

Figure 43 Value of cigarillo sales

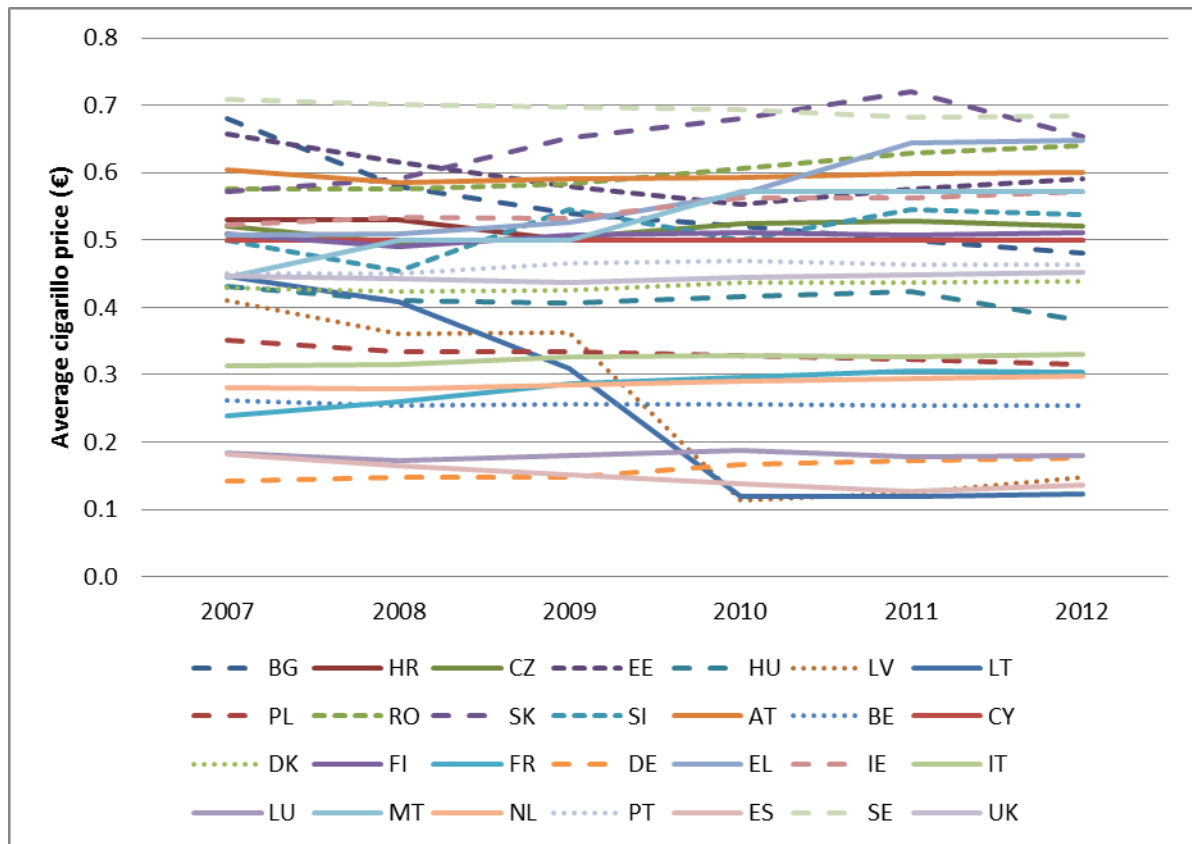


Source: Europe Economics' analysis of Euromonitor data

As shown in the chart below, there was relatively little change in the average price of cigarillos between 2007 and 2012 in most Member States. However, very significant price changes are observed in Lithuania and Latvia:

- The average price in Lithuania started to decrease in 2007, reaching its lowest point in 2010.
- The pattern in Latvia is similar to Lithuania—its price started to decrease at a low rate in 2007 and remained stable from 2008 to 2009. A sharp decrease occurs in 2009, when the average price dropped from €0.36 to €0.11.

Figure 44 Average price of cigarillos



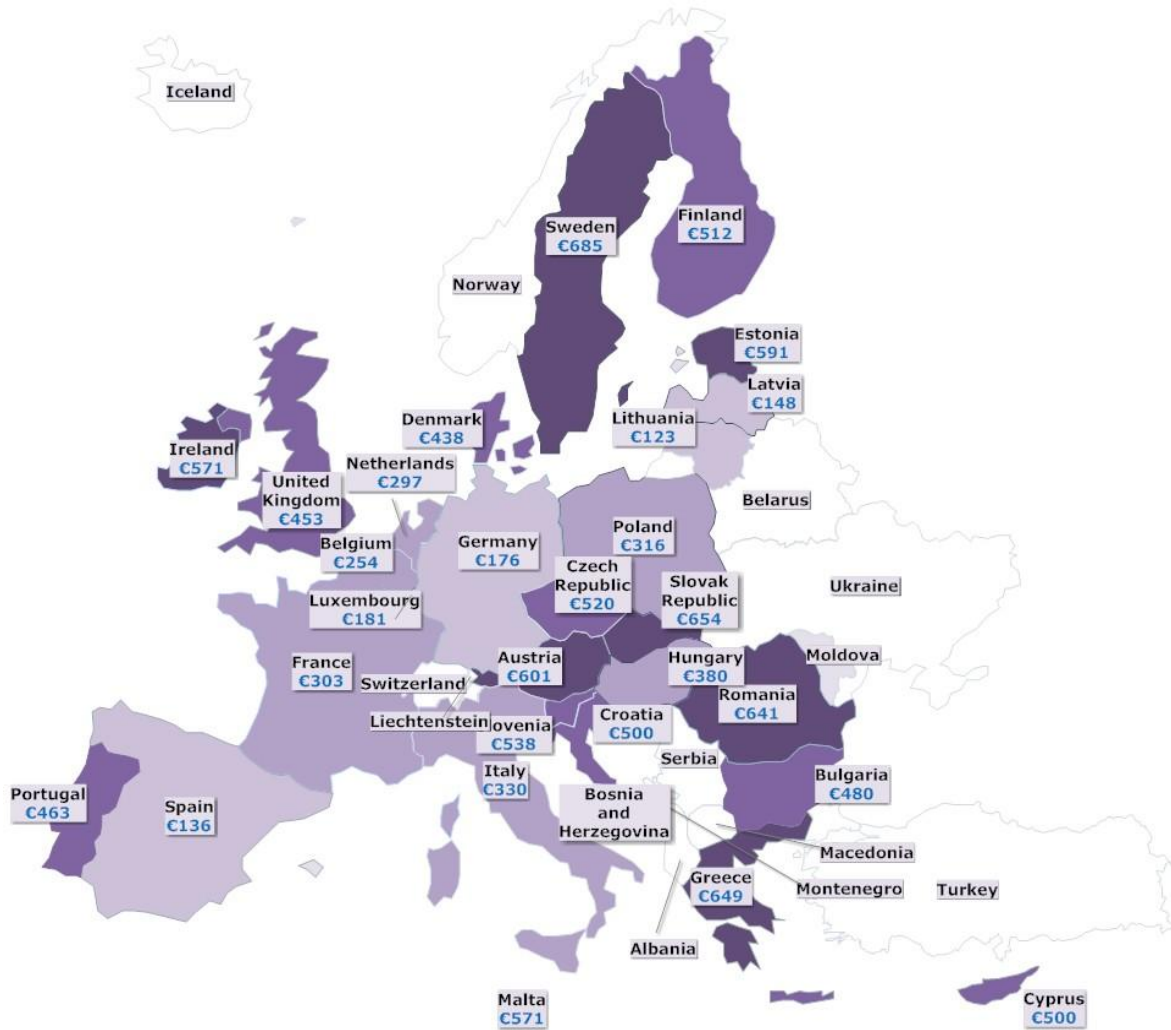
Source: Europe Economics' analysis of Euromonitor data

Following these price changes over time, there were some significant differences in retail cigarillo prices between countries, as illustrated in the figure below. An interesting case study from the figure below concerns the Baltic countries as the retail price of cigarillos was significantly greater in Estonia than it was in Latvia and Lithuania. Some of the price differences can be explained by excise duties: in 2012, Estonia levied a specific excise duty of €192 per 1,000 cigarillos, whereas the duties levied by Latvia and Lithuania are less than €40. No ad valorem duties were applied and VAT rates were reasonably similar in all countries.

This suggests that excise duties are an important influence on differences in retail prices in the Baltic Member States, though by no means the only driver of such differences. Nonetheless, the analysis suggests that excise duties on cigarillos are likely to have played a role in cross-border trade in the Baltic countries, particularly with respect to Estonian consumers crossing the border to purchase products from Latvia.

However, this conclusion does not hold for all cases in which there are substantial price differences between neighbouring countries. For example, excise duty rates are reasonably similar in Portugal and Spain and hence other factors must explain price differences between these countries. In such cases, therefore, the excise duty system does not appear to have a significant impact on cross-border trade in cigarillos.

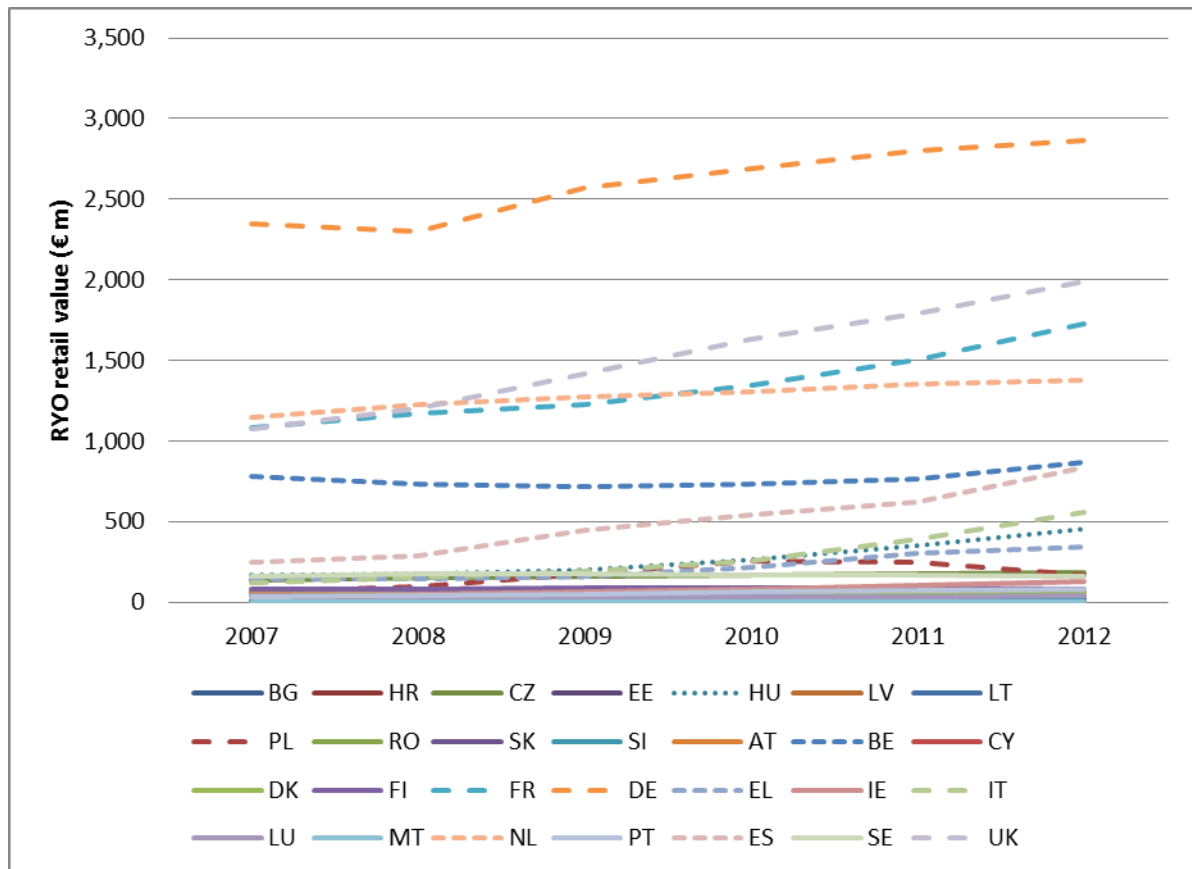
Figure 45 Price per thousand cigarillos, 2012



RYO Tobacco

The graph below shows that there was an increase in the total value of RYO tobacco sales in many Member States between 2007 and 2012. It is quite possible that this reflects the economic downturn that occurred over that period, and a pattern of substitution away from relatively more expensive products, such as cigarettes, to the cheaper alternative of RYO tobacco. In common with other tobacco products, Germany has the largest value of RYO tobacco sales. The Netherlands, France, the UK and Belgium also have large markets.

Figure 46 Value of RYO sales

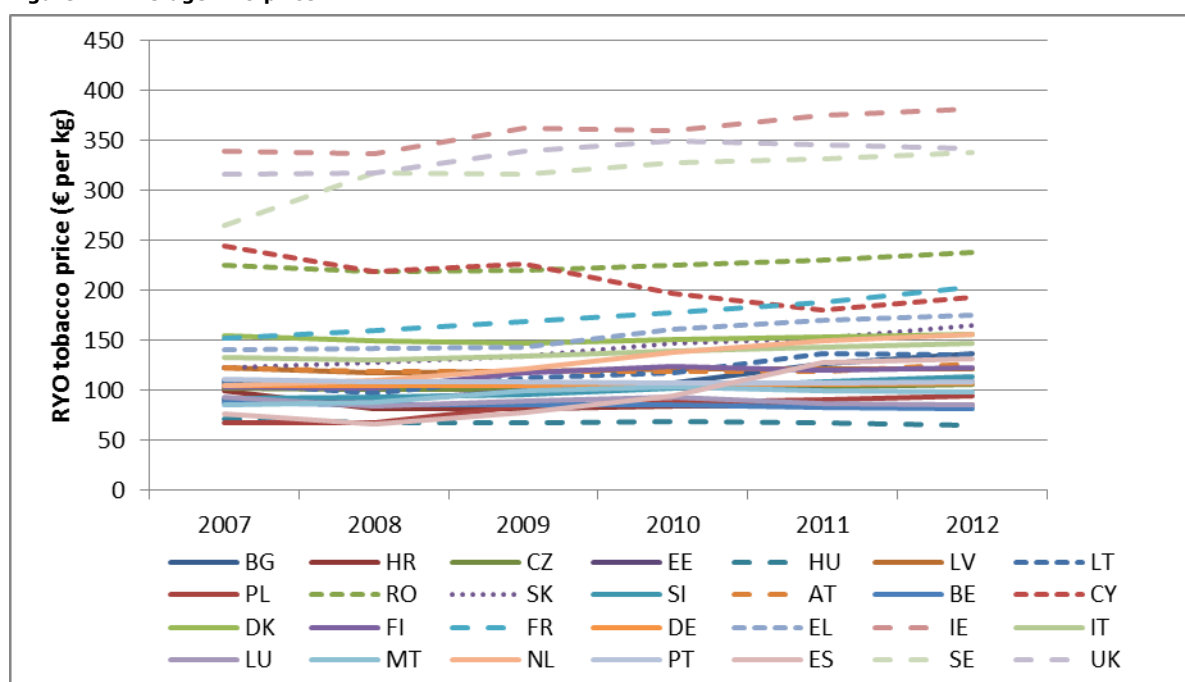


Source: Europe Economics' analysis of Euromonitor data

The figure below shows that the average price of RYO tobacco differs significantly between countries. Nonetheless, prices in the majority of European countries lie within the range of €50 to €150 kilogram. The exceptions to this rule are Sweden, the UK and Ireland, and to a smaller extent Romania and Cyprus:

- The average price in Ireland fluctuates somewhat between 2007 and 2012. The price is decreasing in 2007-08 and 2009-10 while it is increasing in 2008-09, 2010-11 and 2011-12.
- The average price of RYO tobacco in both Sweden and the UK increased from 2007 to 2012.

Figure 47 Average RYO price



Source: Europe Economics' analysis of Euromonitor data

A comparison of the two figures above indicates that the increase in demand for RYO tobacco arose primarily as a result of changes in the price of other products rather than changes in the price of RYO.

Demand increases as prices fall, and vice versa, except for in certain special cases such as Veblen goods (i.e. the demand for a luxury goods may rise as the price increases). In the case of RYO tobacco, however, which we don't consider to be a Veblen good, we observe an increase in demand at the same time as a rise in its price in many countries. There are two probable explanations for this phenomenon:

- the prices of other tobacco products increased to a greater extent than did the price of RYO tobacco, thereby reducing the relative price of RYO and increasing demand;
- the real income of European consumers fell during the period of study and this would, according to economic theory, encourage consumers to substitute towards cheaper alternatives.

It is likely that both of these possible explanations are relevant. We can test this using data and evidence from previous research.

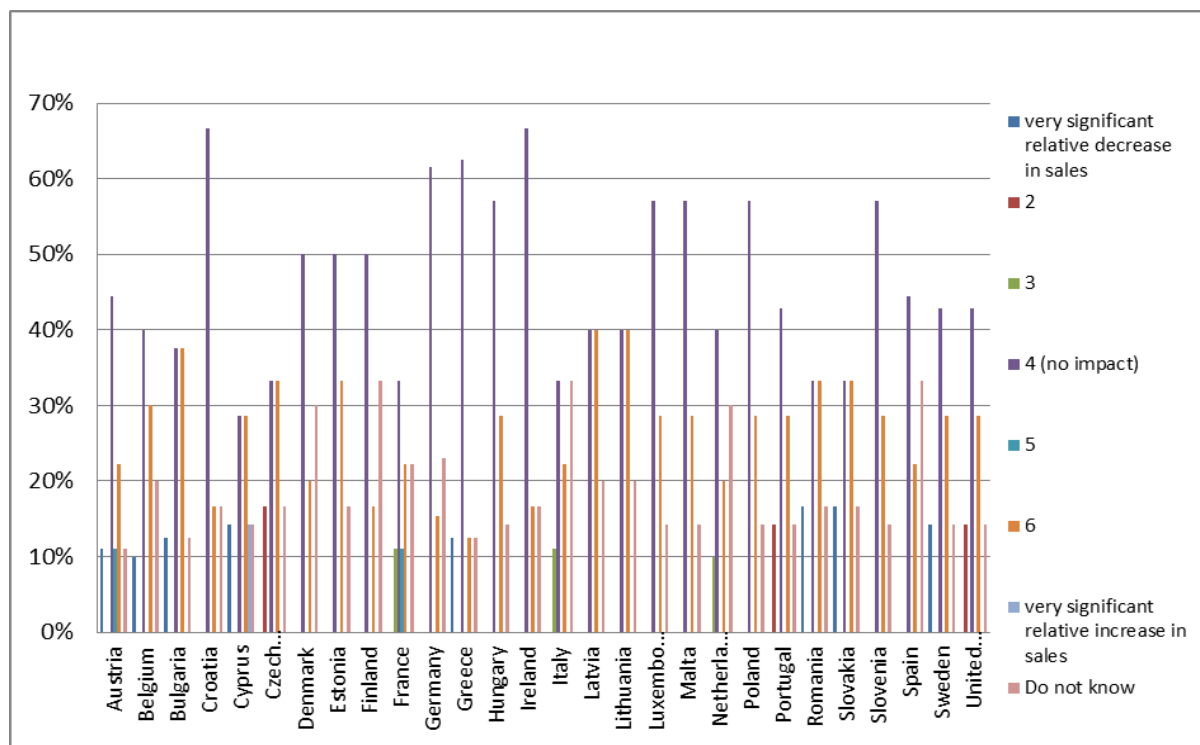
Cullum and Pissarides (2004) suggest that the cross-price elasticity between cigarettes and fine-cut tobacco is 0.38, indicating that a rise in the price of cigarettes by 10 per cent leads to an increase in demand for RYO tobacco of 3.8 per cent.

Our data indicate that cigarette prices changed by between -2 per cent (Luxembourg) and 82 per cent (Romania) between 2007 and 2012, with an EU-wide change of 25 per cent. Given the estimated cross-price elasticity of 0.38 we would expect demand for RYO tobacco to rise by 9.5 per cent, all else being equal, as a result of this substitution effect. In fact, the expected impact would be slightly less than this given the increase in the price of RYO tobacco across the period.

In reality, the EU demand for RYO tobacco measured in terms of volume, rose by 33 per cent between 2007 and 2012. This clearly indicates that substitution from cigarettes to RYO does not provide the full story. Substitution from other tobacco products to RYO is likely to be relevant, as is the impact of falling real incomes. Unfortunately, we cannot test these hypotheses due to a lack of appropriate cross-elasticity estimates in the literature.

The chart below shows how the current structure of tobacco excise duties is perceived by economic operators to affect the sales of fine-cut tobacco. There is generally considered to have been little impact: almost half of the respondents said that there is no impact at all. Furthermore, it is important to note that although 26 per cent of respondents reported a significant increase in sales (response code six), only one respondent stated that the increase had been very significant.

Figure 48 How does the current structure of excise duty affect the sales of fine-cut?



Source: Analysis of survey responses

Another factor that may, for some countries at least, explain why we observe a rise in sales of RYO tobacco at the same time as a rise in price might be retail price differences between countries. As shown in the figure below, there are some substantial differences in price between neighbouring Member States. Therefore, it is possible that a country may experience a rise in demand from a neighbouring country even where its retail price increased, for example if the price in the neighbouring country rose by a greater amount.

Some of the price differences between countries – and the changes in price over time – may be explained by differences in excise duties but other factors also play an important role. For example, there was only a small difference in excise duties between Romania and Bulgaria in 2012 and hence the retail price difference in those countries must be explained by other factors. In this case, and in similar cases, it appears that excise duties do not have a significant influence on cross-border trade.

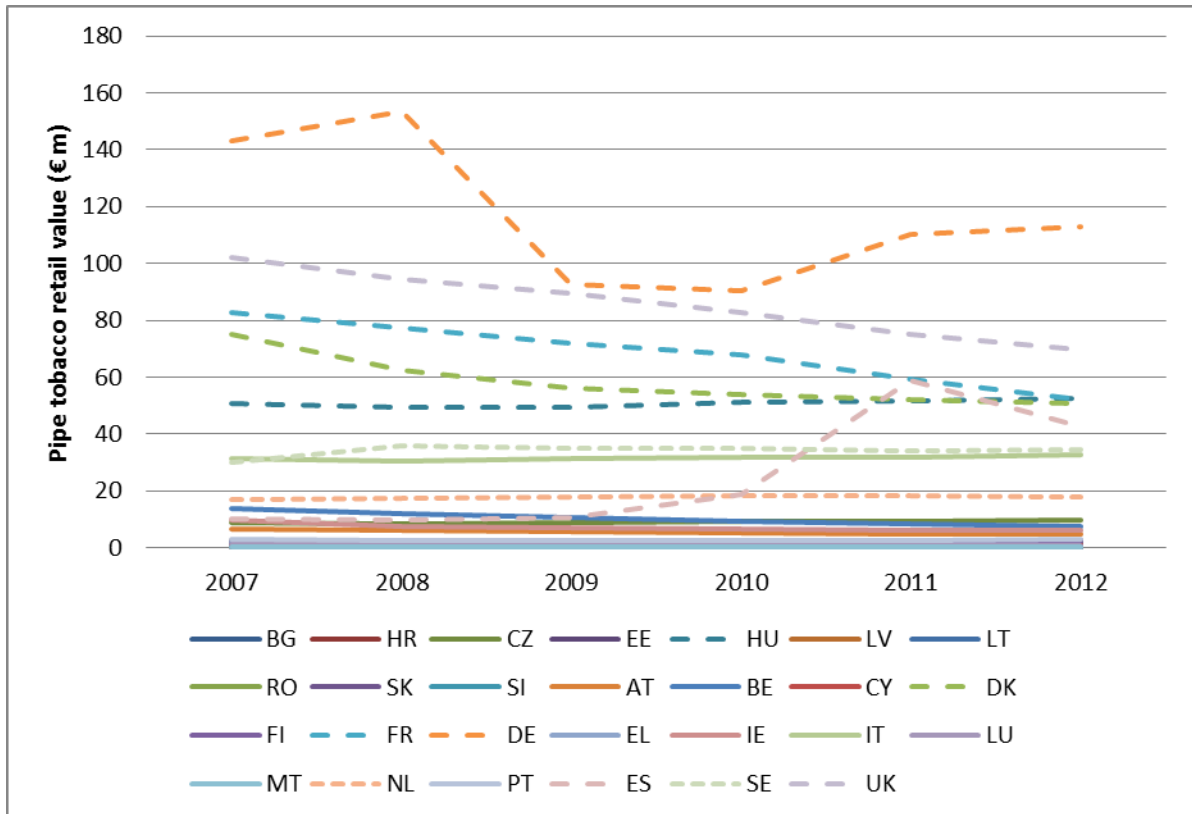
Figure 49 Price per kilogram of RYO tobacco, 2012



Pipe tobacco

The graph below shows that there has been relatively little change over time in the total sales of pipe tobacco in many EU countries and that the value of total sales is relatively similar, equal to or less than €150 million. However, sales in Germany showed some fluctuation over the period while those in Spain increased significantly from 2009 onwards. To some extent, the increase in sales of pipe tobacco in Spain offsets the decline in cigarette sales and, as per the discussion above, is likely to reflect down-trading by consumers during times of economic hardship.

Figure 50 Value of pipe tobacco sales

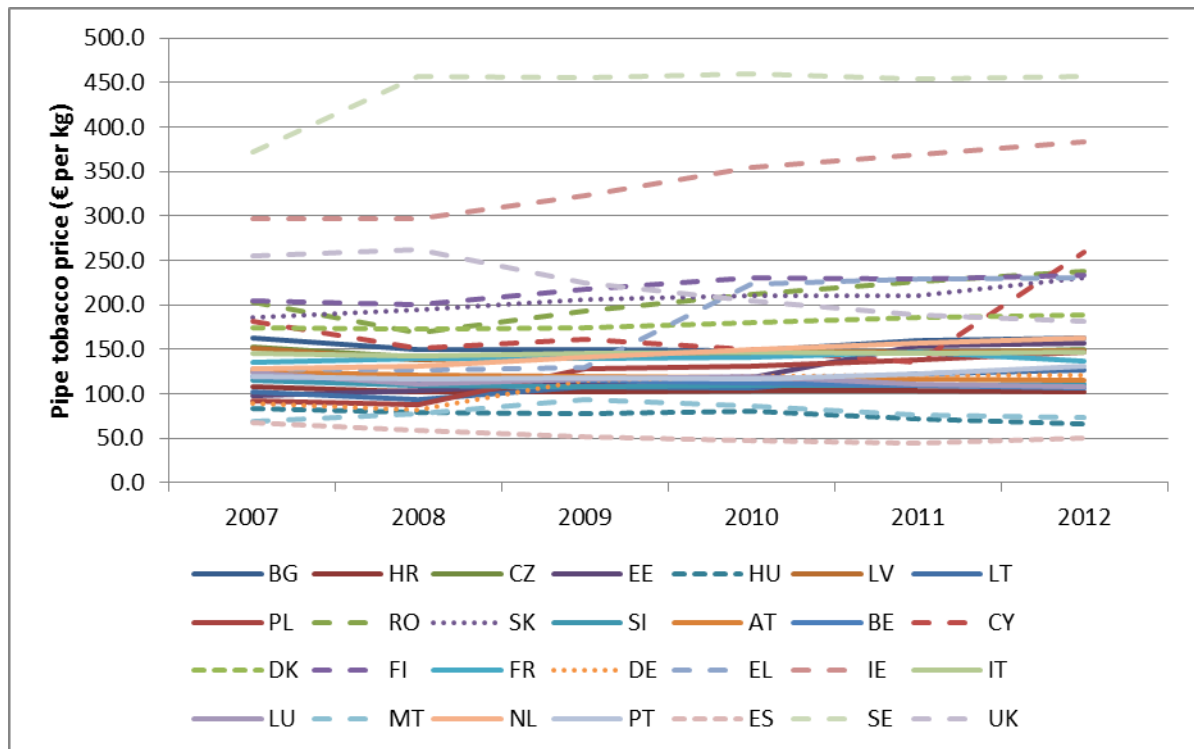


Source: Europe Economics' analysis of Euromonitor data.

Note: Poland has been excluded from chart due to obscure data.

The graph below shows that pipe tobacco was relatively expensive in Sweden and Ireland between 2007 and 2012. Indeed, the price in Sweden was generally double that in most Member States.

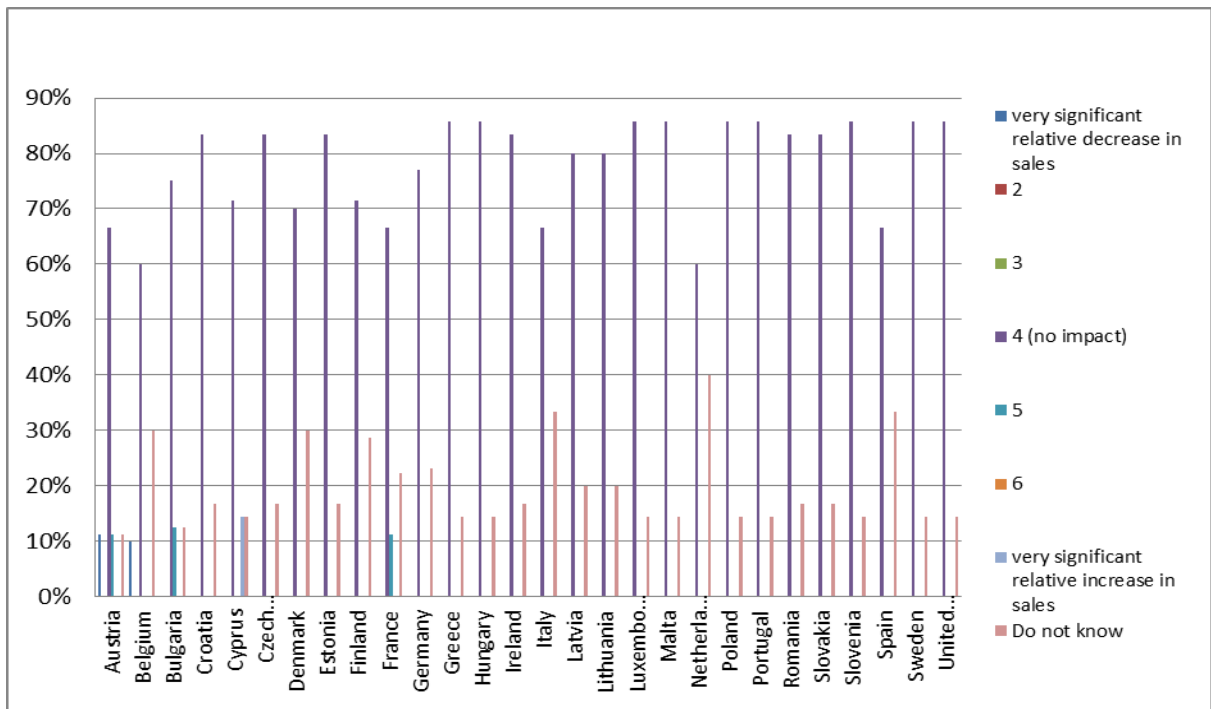
Figure 51 Average pipe tobacco price



Source: Europe Economics' analysis of Euromonitor data

The chart below shows how the current structure of tobacco excise duties is perceived by economic operators to affect sales of other tobacco (including pipe tobacco). Overall, there is considered to have been little impact: 77 per cent of respondents stated that there has been no impact on the sales of other smoking tobacco. Just one per cent of respondents claimed that there had been a very significant decrease in sales, one per cent selected a number 5, and the other 20 per cent claimed not to know.

Figure 52: How does the current structure of excise duty affect the sales of other smoking tobacco?



Source: Analysis of survey responses

The structure and level of excise duties may also affect cross-border trade in pipe tobacco, particularly for consumers located in border regions. As shown in the figure below, some significant price differences were observed between neighbouring countries in 2012. For example, the price of pipe tobacco in Ireland was more than double that of the United Kingdom and hence there was an incentive for Irish consumers to cross the border to Northern Ireland to purchase pipe tobacco. Some of this price difference can be explained by excise duties: the specific duty on pipe tobacco in Ireland was almost €190 in 2012, while it was less than €100 in the UK. Therefore, excise duties are likely to have had an influence on cross-border trade in this case. This conclusion does not hold in general, however. For example, there is little difference in duties between Romania and Bulgaria, but a significant difference in retail prices. This finding again confirms that excise duties are not, in general, the most important influence on cross-border trade.

Figure 53 Price per kilogram pipe tobacco, 2012



Summary

Our analysis of the extent to which the current structure and rates of the excise duties for manufactured tobacco guarantee the proper functioning of the Internal Market suggests the following conclusions:

- the current structure and rates are generally considered to allow for neutral conditions of competition and the free formation of prices, although the MED is considered by some stakeholders to place a constraint on these;
- changes in the level of excise duties can lead to substitution both within a given type of tobacco product (e.g. from premium to economy brands, or vice versa) and between different types of tobacco products (e.g. from cigarettes to RYO or vice versa);
- however, many other factors affect demand for tobacco products (e.g. household incomes) and these influences can dominate excise duty changes; and
- impacts do not seem to differ significantly between manufacturers as all manufacturers will adjust their product portfolios in line with demand (e.g. many manufacturers are currently entering the market for e-cigarettes in response to increased demand for this product).

Q3.4 What is the impact of the derogations and exceptions granted to/by certain Member States/EU regions in application of the tobacco excise duties on the Internal Market;

The preamble to the 2011 Directive states that “in order to prevent damage to Corsica’s economic and social equilibrium, it is both essential and justifiable to provide for a derogation, until 31 December 2015, by which France may apply a rate of excise duty that is lower than the national rate to cigarettes and other manufactured tobaccos released for consumption in Corsica”. Specific derogations were included within the Directive for: Germany and Hungary until 2014 (with respect to the definition of cigarettes); Bulgaria, Estonia, Greece, Latvia, Lithuania, Hungary, Poland and Romania until 2017 (with respect to the rules on duties for cigarettes); Portugal and France (with respect to the excise duty rules on cigarettes in their remote communities of the Azores, Madeira and Corsica); and France (with respect to the excise duty rules on products other than cigarettes in Corsica).

We have explored the extent to which these derogations have been used by the eligible Member States and the impacts of these derogations through the stakeholder survey and interview programme.

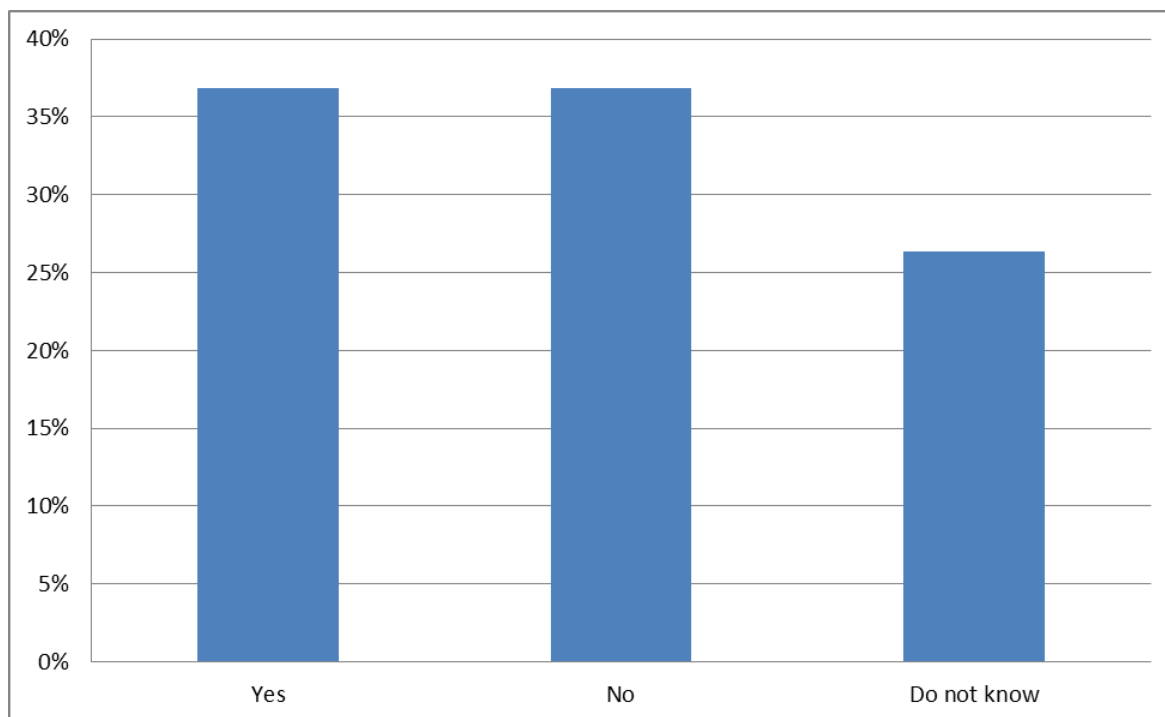
Derogations and exceptions granted to/by certain Member States have multiple impacts, but according to the tax administrations of different Member States, some of these impacts are more significant in certain areas, as these rules are dependent upon geography.

Out of 25 countries that responded to our questions on derogations, 11 reported that they are affected by derogations, or they know of the impacts that derogations carry. On the other hand, 13 countries state that derogations do not cause a problem. The remaining one did not know the impact of derogations.

This fairly even split in the responses of the tax administrations is replicated in the responses of economic operators, as shown in the figure below.¹¹³

¹¹³ *This graph corrects for any possible over-representation of answers by considering one answer for each economic grouping*

Figure 54 Do derogations and exceptions granted to/by certain Member States/EU regions affect the activities of your organisation?



Source: Analysis of survey responses

Some of the impacts highlighted by tax administrations and economic operators include:

- **Cross-border shopping**

Derogations can, in principle, create a price differential between countries and can therefore increase the amount of cross-border shopping. For the countries to which the derogation applies, this would have a positive impact on sales. However, for the neighbouring countries, there would be a negative impact on sales because they are not able to compete with the derogations. For example, the Slovenian administration's view is that derogations and lower prices in Croatia and Hungary led to increased cross-border shopping. However, the physical remoteness of certain territories where derogations apply (i.e. the Azores and Corsica where, in fact, this is part of the rationale for the derogation) makes this less of an issue.

- **Illicit trade and smuggling**

Derogations can also increase illicit trade and smuggling because of the price differentials that they create. For example, the Republic of Ireland believes that the transitional period granted to Bulgaria, Estonia, Greece, Latvia, Lithuania, Hungary, Poland, Romania and Croatia in the Directives has had an effect on ensuring a large difference in excise duty rates between Ireland and some of these Member States, and this has an influence on cross-border shopping and illicit trade, particularly smuggling from these countries. Nonetheless, a significant proportion of all illicit tobacco originates from outside the EU.

When analysing illicit trade and illicit activity, one has to keep in mind the different national laws, which authorise, or not, certain tobacco products. A famous

example is the snus – a type of smokeless tobacco product derived from snuff; – in 2012, 8,210 boxes of snus were confiscated in Finland: while snus is legal in Sweden it is illegal elsewhere in the EU.

▪ **Classification**

An additional problem created by derogations is that they can cause confusion over the classification of different tobacco products.

▪ **Adaptation**

Derogations and exceptions are considered to have been very important for new Member States in order to allow them sufficient time to adapt to the EU rules. It is also noted that when new rules enter into force, one Member State may need more time to adapt than others and so derogations can be beneficial in this context. However, it is important that derogations/exceptions are not granted for too long so as to ensure that the derogation does not simply help the competitiveness of one Member State.

Summary

Our analysis of the impact of derogations and exceptions has identified the following key results:

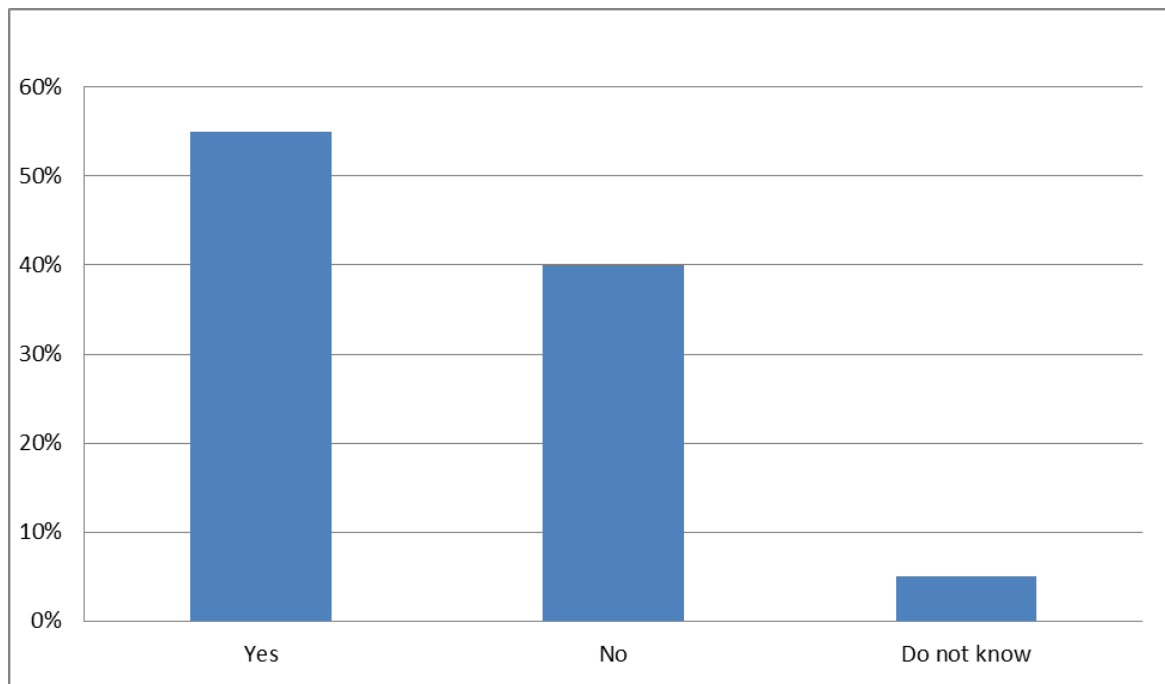
- there are mixed feelings amongst tax administrations and economic operators concerning the impact of derogations and exceptions;
- those respondents that considered that there is a nontrivial impact of derogations and exceptions highlighted cross-border shopping, illicit trade / smuggling, classification uncertainty and ease of adaptation to be the key impacts.

Q3.5 To what extent non-harmonisation of anti-forestalling measure is detrimental to the proper functioning of the Internal Market?

Anti-forestalling measures place limits on the number of cigarettes that can be removed from duty suspension arrangements (e.g. excises warehouses and registered stores) in periods before a duty change is known or expected to occur.

The measures are not harmonised within the EU at present and this may, in theory, have a detrimental impact on the functioning of the Internal Market, lead to economic operators in some countries being disadvantaged (e.g. because of stricter anti-forestalling measures) and/or affect decisions of where to locate a business within the EU. Indeed, it is interesting to note that, as shown in the figure below, approximately 40 per cent of respondents to our survey of economic operators are active only in countries with no anti-forestalling measures. According to our interviews with tax administrations, anti-forestalling measures are currently applied in approximately 70 per cent of Member States (i.e. all member States other than Finland, Germany, Austria, Greece, the Czech Republic, Ireland, Italy, Sweden and Spain).

Figure 55 Are there anti-forestalling measures applied in one or more of the Member States that you operate in?¹¹⁴



Source: Analysis of survey responses

We have explored the extent to which the theoretical problems linked to the non-harmonisation of anti-forestalling measures are borne out in practice through the stakeholder survey and interview programme. We have also garnered views on whether stakeholders consider that there is a need for EU intervention.

Current Measures

There are many anti-forestalling measures in place across the EU, including the following:

- **Cap on tax stamps**

Denmark has adopted this policy, which says that if tobacco companies buy 20 per cent more than they usually purchase between 31 October and 31 December, the purchase above the 20 per cent will then be considered a January purchase of the following year.

- **Cap on release for consumption**

This policy exists in a number of countries. For example, in the UK companies face a limit on the total quantity of cigarettes that they release for consumption between 1 January and Budget Day (i.e. the date on which changes to excise duties are announced). Cyprus and Luxembourg also limit the amount of tobacco that can be released for consumption. Portugal limits the quantity released between 1 September and 31 December to be equal to or less than the average of the past 12 months with a 10 per cent differential. Malta has a similar policy, in that a limit applies for one month prior to its Budget Day (when rate changes come into effect), set at the average of the past 12 months.

¹¹⁴ This graph corrects for any possible over-representation of answers by considering one answer for each economic grouping

- **Sell-by date**

A sell-by date creates a restriction on when products can be sold with certain tax rates. In Estonia, when a new tax rate is implemented, goods can be sold for three calendar months after the date of the new rate. Hungary has a similar policy in which wholesalers must sell within 15 days of the date. In the Netherlands, manufacturers, wholesalers, and importers can sell cigarettes and smoking tobacco products with an old tax stamp for up to two months after the new tax stamp, but the policy does not apply to retailers. Finally, in Poland, stamps are only valid for the current calendar year, and up to the last day of February in the next year.

- **Mixed**

A mixed policy, such as that used in Belgium, includes both a sell by date and a cap on releases for consumption. Before a change in an excise duty, tobacco companies are assigned a quota that is based on previous sales. They also have a certain amount of time to then sell their products with the old tax stamp.

- **Paying the tax difference**

In some countries, when there is an increase in the tax rate, wholesalers are responsible for paying the difference. In Lithuania, the policy applies only to cigarettes still held by the wholesales whereas in Latvia and Slovenia, an inventory is taken and then the companies must pay the government the total tax difference.

- **Others**

Romania's policy includes applying for approval for release for consumption, which must be approved by the local customs office. Also, Croatia must apply for extra tax stamps. Whether or not they are approved is based on regular business activities, planned expansion of the tobacco market, and the seasonality of the tobacco market.

Impacts of anti-forestalling measures on the Internal Market

According to feedback from economic operators there are both positive and negative impacts of implementing anti-forestalling measures in a country. The benefits include reducing volatility in the market, thus protecting jobs, better planning and allocation of resources and fostering effective competition. However, anti-forestalling measures impose administrative and compliance costs. For example, many countries require economic operators to perform a stock count or change their tax stamps as part of their anti-forestalling policies.

Despite the benefits cited above, several economic operators argue that a lack of anti-forestalling measures does not have negative impacts because it is not possible to engage in excessive forestalling. The rationale for such a statement is that tax changes are generally not known in advance, gradual and/or are linked to inflation. This provides little incentive to engage in excessive forestalling.

However, a counterargument is that it is possible for the entire supply chain to be affected if the proper anti-forestalling measures are not in place, because tobacco manufacturers and wholesalers can then release large volumes of tobacco, prior to the increase and by doing so undermine the competitive position of other market players. Indeed, one economic operator argued that a combination of lack of anti-forestalling regulation and large excise tax increases mean that market functioning is severely disrupted in the periods immediately before and after a tax increase. The operator stated

that some operators use excise tax increases as a tool to gain market share by releasing for consumption large amounts of tobacco products prior to an excise increase. It was argued that this allows them to delay increases in their retail selling prices and so artificially improves their competitive position.

As a consequence of such practices, the respondent argued that all other operators are forced to follow and engage in forestalling themselves or see their market shares eroded. In the recent past the practice has become more evident (also due to the large increase in excise), with some operators forestalling the equivalent of several months' worth of sales in correspondence of excise increases. From an operational point of view, the economic operator perceives the main negative effects to be a loss of efficiency associated with having to deal with artificially high peaks in production, distribution, etc., and with the increase in working capital.

Harmonisation of anti-forestalling measures

Some economic operators consider that the lack of a single overarching anti-forestalling measure throughout the European Union means that the functioning of the Single Market is impeded. However, it is recognised that with the different features of the tobacco market and different approaches to duty collection that already exist in different countries, it is nearly impossible to implement one anti-forestalling policy. For example, a solution based on a cap on the number of tax stamps supplied to manufacturers/importers, could certainly not form the basis for a common anti-forestalling system, as several Member States do not use tax stamps (or other fiscal markers) for excise collection. Therefore, while a single policy would increase predictability and would most likely simplify the process, thereby potentially reducing administrative and compliance costs, at least for international operators, such a solution is not feasible until there is greater harmonisation of other features of the Member States' tobacco markets.

In general, tax administrations agree that it is not feasible to have the same anti-forestalling policies across all Member States: no respondent proposed full harmonisation and the majority of Member States are in fact opposed to a harmonised approach at EU level.¹¹⁵ However, most agreed that an overall framework for anti-forestalling measures within the European Union should be provided. This framework would clarify what policies are acceptable, and what policies are not. The Member States would then have the freedom to set their policies within the guidelines outlined by the EU.

Summary

Our assessment of the extent to which non-harmonisation of anti-forestalling measures is detrimental to the proper functioning of the Internal Market has found that:

- a wide range of measures are currently in place across the EU;
- the measures in place are considered to be beneficial by tax administrations and some economic operators, but other economic operators feel that the measures are not effective; and
- the lack of harmonization is perceived to somewhat hinder the functioning of the single market but there is little call for harmonization by either tax administrations or economic operators. Full harmonization is not considered feasible in the absence of harmonisation of tax collection systems (e.g. tax stamps, fiscal markings, etc.).

¹¹⁵ *This position has been made clear both in the context of this study as well as in the context of the Fiscalis workshop on tobacco excise duty in Vilnius, September 2013*

Overall Conclusions

Overall, we find that the current arrangements for excise duty on tobacco products do not fully ensure the proper functioning of the Internal Market and are not fully adequate to ensure the avoidance of distortions in competition. The key findings in support of this conclusion are:

- MED is applied only in certain Member States and the level differs significantly. It affects the relative price of economy cigarettes and affects relative prices between Member States.
- Other than the MED, however, there is no clear evidence of changes in trade patterns being induced by recent changes in the tobacco excise duty levels.
- Furthermore, the current structure and rates generally allow for neutral conditions of competition and the free formation of prices, with the exception of the MED.
- Derogations and exceptions seem to have had a limited impact on cross-border shopping and illicit trade. They can create confusion on classification but can help adaptation for new Member States.
- The inconsistent treatment of a number of tobacco products and of e-cigarettes, as analysed as part of Question 2 may also have a negative impact on the functioning of the internal market.

The lack of harmonisation of anti-forestalling measures somewhat hinders the functioning of Internal Market but there is no call for full harmonisation.

Question 4: To what extent are the current arrangements for excise duty on tobacco products implemented in a cost-effective way?

While the previous questions investigated the extent to which the current provisions on the excise duty allow for safeguarding the budgetary interests of the Member States (Q.2) and ensuring the proper functioning of the Internal Market (Q.3), Q.4 engages with the issue of efficiency, i.e. with the **administrative costs** falling on tax administrations and economic operators.

By systematically **mapping key activities** carried out by tax administrations and economic operators, it has been possible to identify those that are perceived as being more resource intensive, i.e. present the greatest room for improvements. A first round of consultation with economic operators and tax administrations supported a high-level identification of activities and functions which have been then explored in detail through case studies. Inputs from the survey to economic operators have also been included to provide further insight into certain phenomena. By merging these sources it has been possible to identify costly activities, and gain a better understanding of the driving factors and the consequences.

Given the breadth of the set of activities and procedures carried out by tax administrations and economic operators on a daily basis to comply with the provisions of the current system, it has been decided to structure the answers to Q.4.1 and Q.4.2 according to **key thematic areas**. These are:

- pre-authorisation of economic operators;
- production, holding and storing of tobacco products;
- trade and logistics of tobacco products;
- definitions and classification; and
- dual coding.

For each thematic area, a brief explanation on the key **activities** carried out will be provided. This will represent the basis for estimating the **amount of resources** spent by the relevant actors and for identifying those which are more problematic from an **efficiency** standpoint.

This chapter presents the results of the analysis of data collected in the context of the case studies, for a complete, descriptive, overview of the features of tobacco collection systems can be found in Appendix 5 – *Question 1: Background Information*; specifically with respect to answering Q1.2; Q1.3 and Q1.4.

Q4.1 Are there any administrative tasks, monitoring or control procedures that could be improved in order to achieve a high level of efficiency for the tax authorities (i.e. in terms of administrative costs)?

This section builds on the information collected through the questionnaire to tax administration, the case studies in 5 countries and desk research.

Pre-authorisation of economic operators

Activities

This theme encompasses the activities carried out by the tax administration following a request for authorisation by an economic operator. An overview has already been provided in Q.1.3.

The activities carried out at this stage by tax authorities are quite standardized as they usually encompass:

- The analysis of the documentation provided by the economic operator (e.g. legal, financial information, business plan),
- Intelligence work and background checks on the people involved in the business and on the company,
- Analysis of the supply chain and the economic viability of the undertaking.

These activities are most of the time followed by the physical inspection of the premises, especially in the case of warehouse keepers, to verify the security arrangements for the control of goods, persons (company personnel, visitors, maintenance contractors, etc.) and vehicles as well as the truthfulness of the information provided. The results of these processes are used to build a profile risk of the operator and to calculate the size of the guarantee to be provided.

Resources

Certain countries set time limits for responding to a request. This is the case of among others the UK (45 days) and EL (15 days). Others do not have specified time limits. In FI, the whole application process (including the amendment of an existing licence) can take up to 2 months (excluding the calculation of the guarantee).

In terms of human resources, the situation varies a great deal across countries: in FI, 10-15 people have been reported to be involved throughout the whole process (even though the bulk of the work is conducted by 1-2 people), while in other countries (e.g. UK), dedicated departments exist for the authorisation process. In the latter case, they would usually deal with all excise goods not only tobacco products.

Efficiency

Member States did not report significant costs related to performing these activities. Processes are generally regarded as efficient, also considering the small amount of requests received. Indeed, given that the specificities and the history of the tobacco market, relatively few requests are submitted on a yearly basis. The number ranges between 1 and 20-30 a year including amendments of existing authorisations. The reason is that this market is quite concentrated with very large long established tobacco manufacturers (often holding multiple authorisations) controlling a significant share of the market. As a consequence, new applications mainly concern smaller operators which pose less of a burden on the national administrations.

Reported resource intensive activities include the risk assessment of the premises and of the business (i.e. economy of the company), and the calculation of the guarantee. For instance, in FI the calculation of the guarantee can take between 2 weeks and 3-4 months (2 weeks up to 1 month of actual work), thus the tax authority excluded this activity from the pre-authorisation process upon payment of a smaller guarantee.

Production/Holding/Storing of tobacco products

Activities

The activities falling within this area include analysis of the information and data collected from economic operators through

- Periodical reports for accounting purposes;

- Intelligence work;
- Audit-based and physical inspections.

Data from different sources are used to perform cross-checks. Audits are aimed at verifying the correspondence between the stocks of tobacco products and the supporting documentation and assuring that commercial records for the receipt, production, storage and removal of excise goods live up to the agreed standards. On-site inspections entail the controls of the premises, the verification of the procedures, the continued compliance with the terms of the authorisation and, where applicable, the check of the balance of fiscal marks.

Resources

In terms of resources spent on monitoring the production and the holding of tobacco products, it has proven challenging for tax administration to come up with a figure due to the fact that often the units deputed to carry out these controls are responsible for different (if not all) excise goods. In Denmark, 5 full-time employees are estimated to deal with tobacco products while in Greece the number is estimated at 25-30 units. In the UK, a dedicated unit called Large Business Service, serves as the single contact point for large enterprises on all the issues related to taxation, including excise duties: 3-5 people work in the tobacco field.

Efficiency

None of the interviewed tax administrations reported the existence of resource intensive activities. Physical inspections by nature entail a larger absorption of resources (up to 2 weeks). However, they are conducted on the basis of risk assessment. In this respect, one country reported to apply a differentiated approach in terms of frequency and thoroughness of the checks based on the risk category of the economic operator.

As a consequence it seems that the possibility to conduct risk analysis is the key aspect for guaranteeing an efficient functioning of the tax administration. As pointed out in Q.1.5, this depends on the availability of data as well as of IT tools for the analysis of the data.

Trade and logistics of tobacco products

Activities

For the monitoring of the movements of tobacco products, Member States rely on EMCS. A dedicated application within EMCS, known as MVS, is used for the monitoring of the movements of duty-paid goods even though the level of detail and automation of the process is rather limited.

Activities falling within the scope of these files encompass:

- Verifying the correspondence of the tobacco products with the supporting documentation and the compatibility of the quantities with the accounting data
- Carrying out risk assessment based on the data from EMCS and other sources (e.g. customs' databases);
- Conducting inspections of premises and vehicles;
- Checking use and movement of excise stamps (e.g. in Greece, operators have 5 months after buying excise stamps to release the products for consumptions or return the them);
- Exchanging information with other tax administrations across the EU.

Resources

In the case study countries, interviewees reported that few people and resources are used for the monitoring of the movement of tobacco products. In Romania, less than 100 FTEs are involved on the monitoring of excise goods including people in the field conducting inspection, while in Denmark the overall management of EMCS absorbs 0.5 FTE. The possibility to use an electronic tool such as EMCS has been pointed at as a major contributor to the increased efficiency in this field.

Efficiency

As in the case of activities conducted for the monitoring of production and storing of tobacco product, tax administrations did not encounter particular difficulties and do not regard the activities connected to the monitoring of logistics as being resource intensive.

At the same time, in some countries simplified procedures are in place to further reduce the burden of conducting certain operations. In the UK and in Denmark, the movement of duty-suspended goods in the national territory needs not be accompanied by the coverage of an electronic guarantee. In fact, commercial accompanying documents are sufficient.

Direct delivery, whereby a trader (usually consignee) can have the excise goods delivered at a third party address, helps reduce the overall number of movements. The fact that such an arrangement may be only granted to selected economic operators, in the opinion of one respondent, allows for striking a balance between economic savings and higher risk entailed by such movements.

Given that the a substantial part of the work conducted in this field is based on risk analysis, as in the case of production and storing, the availability of data and IT tools is key to safeguarding efficiency. In this respect, a number of Member States pointed out that the exchange of information between tax administrations within already existing means of administrative cooperation could improve the monitoring abilities. While respondents agree that this is one of the main tools for fighting against a problem that has a cross-border nature, no examples of systematic sharing of information exist. Moreover, individual requests for assistance are rarely answered in a timely manner, thus jeopardizing the benefits from such a tool.

Definitions and classification

Activities

The classification of tobacco products, i.e. the decision that a certain product is consistent with a definition as per Directive 2011/64/EU, is the result of an articulated set of activities. In the case of products being manufactured/imported/discovered **for the first time**, the procedure might include one or more of the following activities:

- Analysis of the information (e.g. description, technical specifications, samples, chemical analysis) provided by the economic operator when manufacturing/importing of the tobacco products;
- Laboratory tests conducted by the tax administration (through own laboratories, customs' laboratories, or private service providers);
- Request of any additional information deemed necessary for the correct classification (to the discretion of the tax authority);
- Possibility for the economic operator to appeal the decision of the administration or to ask for a Binding Tariff Information, a decision issued by the customs administration of a Member State valid throughout the Community.

These procedures might vary depending on the origin of the goods. Locally registered manufacturers are usually requested to provide a standardized set of information on the new product before launching it in the market together with a proposed categorisation in terms of both CN code and excise tax code (e.g. RO, EL). If there is any doubt regarding the tax treatment of this product, laboratory testing may be requested. On the other hand, economic operators importing a (new) tobacco product are usually subject to more thorough controls for verifying the correct classification of the goods. These controls usually consist of visual inspections conducted by customs officials when the customs declaration (and the tariff classification) is done and, unless special warrants are raised, do not entail lab tests.

It should be noted that not all countries have predefined and structured process for the classification of products. To a high extent, procedures are adapted to the specific case. For instance, in the UK it is up to the Large Business Service to decide whether further investigation is needed when a large operator introduces a new product. In complex cases, the opinion of a specialized Binding Classification Team can be sought. In other instances (e.g. DK) the economic operator is not obliged to give the tax administration prior notice of the introduction of a new product in the market.

When dealing in products that have **already been classified**, it is the responsibility of the economic operator to report the correct codes. Controls are less systematic in this case and may only consist of visual inspection, unless a specific risk is identified.

Resources

While procedures vary between countries and specific cases, the information collected in the case study countries allows for a rough estimate of the administrative activities this process entails.

In general, costs have been assessed to be moderate or low. In the case study countries visited, where a systematic process takes place, it takes between 15 and 90 days for the tax administration to come out with a final decision on the classification of a new product, depending on the workload of the relevant services and the degree of complexity of the case at stake. Between 2 and 3 days would be spent on conducting the analysis and reporting the results. Once the results are ready, the relevant customs department would give a decision within 2-3 days and, if conducted by a separate department, another 2-3 days will pass until the excise code is assigned.

Efficiency

The vast majority of the Member States reported that the current rules on classification/definition **do not create additional or unnecessary administrative costs**. Tax administration claimed that activities such as lab tests are more resource intensive. Meanwhile, they are only conducted in the context of investigations or when particularly complex cases appear on the market. This is reported to be rare event (on average once a year). Moreover, the market for tobacco products is mostly dominated by a small number of large companies which would usually liaise with tax administrations before launching a new product thus reducing the costs entailed by classification.

Quite interestingly, though, 4 countries reported that current definitions **impinge on the efficient functioning** of the tax administration in a more indirect way. Indeed, the lack of definitions for certain products and/or the open wording of the Directive (as discussed in Q.2) have led in some cases to a different tax treatment of the same product between Member States. The **legal uncertainty** stemming from such a phenomenon may require the conduction of an investigation and possibly the opening of a case in court. In both cases resources would need to be diverted from other tasks and this might disrupt the functioning of the tax administration. Furthermore, the out-

comes of the investigations or the law rulings might entail a revision of the relevant legislation which would translate into increased (transitional) costs. Table 22 below summarizes some of the cases reported by tax administrations and highlights what kind costs their solution entailed.

Table 22 Examples of issues stemming from classification with impact on efficiency

Tobacco product	Issue	Country affected	Administrative burden
Raw tobacco leaves (whole or cut)	Interpretation of "capable of being smoked without further industrial processing"	UK, IT, SE	Court-case Administrative ruling/guidance
Reconstituted tobacco	Interpretation of "capable of being smoked without further industrial processing"	RO	(Pending)
Tobacco refuse	Interpretation of "capable of being smoked as they are"	DE, CZ	Court-case Administrative ruling
Cigars/Cigarillos (e.g. Silverado)	Definitions of cigarettes and cigars/cigarillos	BE	Court-case Binding Tariff Information
Cigars (e.g. Gullivers, Party Cigars)	Cigar-like tobacco "sticks" that can be used for rolling cigarettes	PL	Court-case (open)
Tobacco-free water-pipe tobacco	The main problem was/is the loose legal term "capable of being smoked as they are"	DE	Objection raised to the economic operator; no need for court ruling
Fine-cut tobacco delivered in bulk	Interpretation of "being capable of being smoked without further industrial processing"	HU	Laboratory tests Court-case
Aromatic products intended for refreshing air which could be used as water-pipe tobaccos	Lack of specific definition	PL, IT	Administrative ruling (other smoking tobacco if containing tobacco)

When asked what the **source** of the added complexity is, tax administrations listed the following:

- Loose formulation of certain requirements (e.g. "capable of being smoked as they are", "industrial processing") which create confusion in among economic operators and departments within the tax administration;
- Lack of definition of certain tobacco products which led to cases where the same product is considered excisable in some countries and not excisable in others (e.g. tobacco refuse, raw tobacco, expanded shredded stems);
- Inconsistencies with the definitions provided in the Explanatory notes to the Common Nomenclature¹¹⁶.

¹¹⁶ This aspect will be discussed in greater detail in the next section

Dual coding

Activities

As extensively discussed in Q.2, there exist two non-fully consistent systems for the classification of tobacco products: the categorisation according to the definitions laid down in Articles 2-5 of Directive 2011/64/EU for excise purposes and the specifications contained in the Explanatory Notes to the CN system for customs purposes. In the context of the monitoring of the movements of tobacco products under duty suspension arrangement, i.e. under EMCS, the presence of a dual coding system might create several problems, including inconsistent treatment of the products across time and countries, unfair competition between product groups, impossibility to create certain combinations between CN and excise duty codes.

The activities performed by tax administrations for coping with the presence of a dual classification system vary across Member States depending on the degree of integration between the tax administration and the customs authority. Where the two are separated, the use of dual coding is reported as not creating major disturbances to the efficient functioning of the system, as each administration would use its own datasets and procedures. In instances where the degree of integration between the two authorities is higher (e.g. FI, EL, RO), the customs administration leads the way, in the sense that it would be either responsible for conducting the lab analysis for both excise and customs purposes or its decision on the treatment according to the CN coding system would determine the tax treatment.

Resources

It has proven challenging for the interviewed tax administrations to estimate the resources needed for dealing with the presence of a dual coding system.

One country reported that the analysis of a sample of tobacco product costs EUR 100-150 and that the need to conduct slightly different procedures for the two coding systems would not entail a doubling of the costs. Another Member States estimated the costs to be around EUR 200 per analysis and the extra cost for the dual classification amounting to not more than 10%.

In all other cases, direct costs stemming from the dual coding system have been reported as being negligible considering the small number of analyses conducted for classification purposes.

Efficiency

From the point of view of efficiency, the subject matter of the present section, there are two main reasons why the presence of dual coding might affect negatively the functioning of the tax administration. Firstly, tax administrations might encounter the need to perform duplicate analyses whenever a product needs to be classified (especially in those cases where the responsibility for the monitoring is differentiated between the tax administration and the customs authority). Secondly, additional resources might need to be spent on reconciling the information collected for excise and customs purposes to spot possible inconsistencies.

When asked whether the current system creates complexity or increases the administrative costs, 13 Member States reported that they do **not experience any problem**. In most countries, a single analysis is performed such that the information can be used for both classifications. In several instances the classification for customs purposes precedes the classification for excise purposes. In some countries (e.g. RO, UK), there exists a "conversion table"¹¹⁷ that links CN codes and (national) tax type codes,

¹¹⁷ The conversion is not automatic or binding but it serves as a guide.

i.e. the categories laid down in the Directive, thus the matching is done automatically. In other cases (e.g. SE, FI, PT) the customs and the tax authorities share the same premises and resources, thus the result of the analysis would serve both aims.

As many as 10 countries reported that dual coding **creates some problems**. These are mainly related to uncertainties on how to link CN codes and each tax type codes. The impact on the efficiency might come from:

- The need to consider each case twice: once for customs, and once for excise purposes. Even though costs are not twice as high, there is an increase in costs;
- The need to adapt the technical specification of the EMCS to allow for the right combination of CN codes and tax type codes;
- Allocating time to solve some inconsistency between the two systems. Moreover, as pointed out by one country, the fact that investigative units are more familiar with the CN coding system, they will be particularly vulnerable to efficiency losses caused by inconsistencies, especially in the absence of an unequivocal correspondence.

At the same time, as pointed out by several tax administrations, inconsistencies in the two classifications create loopholes and **legal uncertainty**. These in turn have the potential to lead to disputes which can be resolved in three ways:

- The economic operator accepts the decision of the tax administration (which might take the form of either an administrative ruling or an administrative guidance);
- The economic operator requires a BTI through the national tax administration: this has been reported to take around 3 months;
- The economic operator can challenge the tax administration in court: in this case time and resources are difficult to assess and would depend on the terms of the dispute.

In all cases, additional resources would be spent by all parties to sort out the dispute thus resulting in increased costs. Table 23 below reports on the disputed cases and the way they were sorted out.

Table 23 Examples of issues stemming from dual coding with an impact on efficiency

Tobacco product	Issue	Country affected	Administrative burden
Cigars/Cigarillos (e.g. Break, Partner, West, L&M)	Directive only focuses on the existence of an outer wrap, regardless of whether the filter is covered or not. based on tariff regulations, it depends on the filter being covered or not whether the product is considered a cigar/cigarillo or as a cigarette	DE, LT, NL, PT, EL	Court-case Binding Tariff Information

Summary

Our analysis of the impacts of the current provisions on excise duty on the efficient working of national tax administrations provides the following key findings:

- Pre-authorisation: in light of the limited number of request received, no major issues have been reported;
- Production/Holding/Storing: the possibility to efficiently use resources depends on the extent to which risk analysis is systematic and sound, i.e. on the availability of data as well as of IT tools for the analysis of the data;
- Movement of tobacco products: tax administrations did not encounter particular difficulties and do not regard the activities as being resource intensive. The exchange of information between tax administrations across the EU has been reported as being an important tool to fight against illicit trade but it is not a fully exploited tool;
- Definitions and classification: the majority of the Member States reported that the current rules on classification/definition do not create additional or unnecessary administrative costs. However, some countries were concerned with the costs entailed by legal uncertainty, if disputed cases were to appear more frequently;
- Eliminating the legal uncertainty with respect to the treatment of reported "borderline" products would potentially lead to a higher level of efficiency for tax authorities.
- Dual coding: it is the opinion of the majority of Member States that dual coding creates no or limited additional costs. Some respondents however pointed out that in a small number of instances legal uncertainty translated into some additional costs as economic operators challenged the classification made by the authority.

Q4.2 Are there any administrative tasks, monitoring or control procedures that could be improved in order to achieve a high level of efficiency for economic operators (compliance costs)?

This section replicates the structure devised for Q.4.1 so as to facilitate the comparison of the results. The approach by **"key thematic areas"** benefits from the results gained through the online survey to economic operators and the interviews conducted during the case studies, as well as from the results of the desk research.

Pre-authorisation of economic operators

Activities

Mirroring the activities that the tax administration needs to carry out when deciding on the award of a license, economic operators are responsible for initiating the process by filing a formal request together with the required documentation. As already explained this initial information is aimed at verifying the compliance with legal, economic (e.g. business plan), financial and operational (e.g. accounting system) requirements and to demonstrate the ability to carry out an excise business. In some countries, as part of the information to be provided, an economic operator must demonstrate the economic need for setting up such a business.

Applicants are usually requested to (be in the condition of) lodge a financial security such as a guarantee to cover potential losses related to the conduction of the business. Sometimes, as it happens in Finland, an initial minimum financial guarantee is provided while the tax administration conducts all the checks necessary for the calculation of the exact amount. In other cases, the size of the guarantee will be calculated before the approval agreement is signed.

When seeking authorization for a premise, a description of the security arrangements, and a description of the physical and technical features of the facilities must be provided to the tax authority together with the blueprints of the premise. Physical inspection is usually conducted to verify the truthfulness of the reported information. If, on the basis of the inspection, improvements are required, they will be paid for by the economic operator. In IT, authorized manufacturers must also bear the costs related to providing a physical space and the technical equipment to the unit of officers permanently stationed at the premise.

While in some cases authorizations do not have a pre-defined expiry date, they are valid as long as the operator complies with all the requirements, in other instances (e.g. RO) these need to be renewed periodically.

Resources

In the case studies countries, economic operators faced difficulties in recalling the time spent on these activities either because the authorisation was issued many years ago and did not require renewal or because the time and resources spent were assessed as negligible.

Based on the available information, it takes between 1 and 6 months between the submission of the application and the release of the authorisation/amendment to the authorisation. One economic operator reported that the amendment to an existing licence took 11 months but the tax administration was able to issue a temporary authorisation while conducting the necessary checks.

While it may seem that the time spent on this activity is significant, the actual work performed by the economic operator can be estimated to be 1-20 days for a first-time authorisation or for the renewal (depending on the countries)

The costs of obtaining/renewing an authorisation in Romania

As in Romania authorisations are subject to renewal every 3 years, it has been possible to estimate the costs of each step on the basis of the information provided by three economic operators. The documentation to be provided includes:

- Balance sheets for the last 2 years
- Criminal records of the administrators
- Certificate from the Registry of Commerce
- Manufacturing licenses issued by the Ministry of Agriculture
- Documents to prove usage right over the premises proposed to be authorized (property documents / rent agreements)
- Declaration regarding the maximum storage capacity, the quantities and the types of excisable goods
- Fiscal attestation certificate & Fiscal record certificate
- Confirmation from the fiscal authorities regarding the status of the company as excise tax payer
- Calculation of the guarantee proposed
- Letter of intention from the bank which will submit the guarantee
- Preparing the file to be submitted to the authorities

These activities add up to 90-170 hours depending on whether it is a first time application or a renewal of an existing one.

Efficiency

The most resource intensive activities refer to three aspects:

- Types of documents: certain documents have been reported to be accessible by tax authorities thus they should not be requested to the operator;
- Types of authorisation: warehouse approvals were reported by one operator to be particularly time consuming as they entail several government administrations to coordinate;
- Type of communication with the administration: in one country the economic operator lamented that it is difficult to interact with the tax administration as it is not possible to contact case workers and requests might take between 30 and 90 days before being answered. In another country an economic operator pointed out that electronic applications are more efficient than paper-based ones.

Overall, no major inefficiencies stemming from the current provisions could be identified. According to operators, some room for improvement exist, however, given that gaining an authorisation is either a one-off procedure or it occurs every couple of years, the costs do not significantly impact on the efficiency of the economic operator. This conclusion should be interpreted with care as the sample of economic operators interviewed only comprised large businesses: it might be the case that smaller operators face greater costs.

Production/Holding/Storing of tobacco products

Activities

The survey and the interviews with economic operators allowed for the identification of the activities performed in order to comply with the requirements in terms of production, holding and storing of tobacco products.

The following activities have been most often included in the calculations of time spent (mainly by warehouse keepers):

- Keeping, for each tax warehouse where tobacco products are manufactured, detailed accounts of records showing the quantities and description of: all materials received, all materials used in each manufacturing batch, all materials disposed of, any refuse deriving from materials used, all refuse disposed of;
- Keeping accounts of stock and movements of excise goods including a minimum set of information (e.g. date, type of tobacco product, brand, size of retail pack, description of the goods, duty status, current location within the warehouse), including periodical stocktaking;
- Periodical submission of reports and notifications, including where applicable declaration of duty stamps: this can be made daily as in the UK and EL, or less frequently (e.g. quarterly in DK);
- Establishing and maintaining guarantees to cover the risk inherent in the production, processing and holding of excise goods;
- Setting up and operating an appropriate marking system such that goods can be identified in the stock account in a univocal manner;
- Complying with obligations related to the holding for commercial purposes of goods in another MS other than the one in which they were released for consumption;
- Facilitating the work of the tax administration in case of audits or physical inspections.

Registered consignees and temporary registered consignees are subject to less stringent requirements, indeed they are usually requested to keep delivery receipts, commercial documents and copies of the e-AD when goods move under suspension of excise duty.

Resources

The compliance costs of carrying out all activities related to the production and storing of tobacco products have been estimated to be between 1 and 4 FTEs for record keeping, notification and reporting. Additional resources are spent obtaining a financial security, but these are said to be limited (2-5 man days a year).¹¹⁸

Finally, inspections might be carried out to the discretion of the tax administration or on a regular basis. Larger manufacturers reported that this event is rare (once every couple of years) and entails neither disruption of the activities nor absorption of significant resources.

In a cross-country perspective, transnational companies reported that the time spent on complying with the obligations resulting from the authorisation is higher (22%), the

¹¹⁸ *Estimations are based on the responses of large economic operators interviewed in the context of case studies.*

same (18%) or smaller than the average Member State where they operate (9%). The majority of the sample could not answer this question.

Efficiency

The activities reported as being resource consuming include:

- Tracking and tracing requirements are perceived as particularly cumbersome as they entail internal costs (design, development, implementation and handling of the tracking and tracing system by internal personnel) and external costs (purchase of hardware, development of software, handling costs of warehousing and distribution service providers and modification of manufacturing equipment to comply with the rules);
- Complying with the provisions on fiscal markings management, monitoring and reporting;
- Destroying obsolete goods and solving cases where goods got lost are viewed as costly activities.

With respect to the first aspect, it should be noted that this might represent a major issue impinging on the efficiency for smaller operators. Larger businesses make use of Enterprise Resource Planning (ERP), i.e. suites of integrated management applications, that allow for the monitoring of activities and for the easy extraction of the information needed for compiling reports for the tax administration. At least three manufacturers reported using such a system and claimed they would use it regardless of legislation, as it is a fundamental tool for (internal) management. Once the infrastructure is in place, reporting and notification to tax administration can be easily arranged.

It should be noted that the design of some aspects of ERP systems is linked to the requirements set out in the relevant excise duty law, thus major changes in the legislation would translate into significant (transitional) costs due to the reengineering of the processes.

Trade and logistics of tobacco products

Activities

Complying with the requirements for the movement of tobacco products requires the economic operator to carry out a variety of activities, depending on the excise status of the good and the type of economic operator.

European legislation requires all economic operators moving excise goods under duty suspension arrangement to register on SEED-on-Europa. This is usually done in parallel with the registration of the economic operator provided the business entails dealing in duty suspended goods. SEED has been integrated into EMCS, the main platform for the movement of duty-suspended goods. Each time a new movement is created, EMCS automatically cross-checks the data on the economic operators involved before validating the movement and creating the Administrative Reference Code (ARC).

Specifically, the activities carried out by an economic operator dealing in duty-suspended goods encompass:

- Drafting the electronic administrative document by collecting all the necessary information;
- Collecting the information for the creation of a record under ICS/ECS in case of trade with third countries;
- Establishing the guarantees before movement under suspension can begin;

- Providing the person accompanying the excise goods with a printed version of the electronic administrative document;
- Drafting a report of receipt of goods;
- Keeping records of movements of excisable tobacco products in EMCS when products are moved to and from other Member States

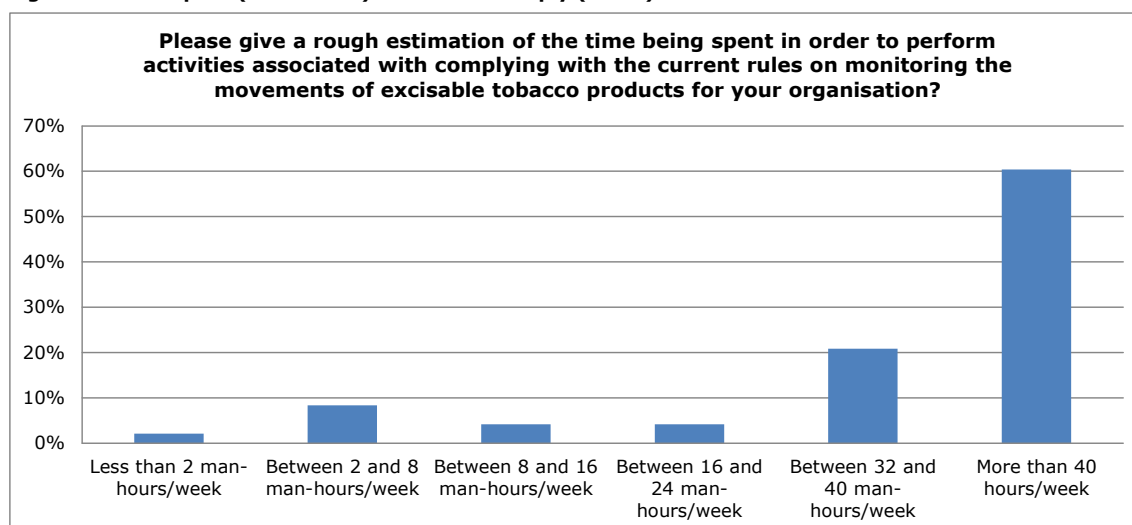
When products are moved within the national territory, they need not be registered in EMCS if the economic operator benefits from a simplified procedure. In Denmark, Finland and the UK, such arrangement allows for the e-AD to be replaced with a consignment note or invoice containing a predefined set of information.

In the case of raw tobacco, as already mentioned, provisions vary considerably across Member States. In Poland, raw tobacco must be packaged and sealed before moving it under the coverage of an accompanying document. In Denmark and Finland, the system is paper-based, even though in Finland the issue is theoretical as no cases exist. Paper-based systems are also found to be applied in the case of tobacco products not explicitly defined in Directive 2011/64/EU, e.g. cigarette paper in Finland.

Resources

Based on the data collected through the survey to economic operators reported in Figure 56, it can be noted that 81% spend 32 hours or more per week (60% more than 40 hours) on tasks associated with complying with the current rules on monitoring the movements of excisable products.

Figure 56 Time spent (man-hours) in order to comply (N=48)



EMCS is not regarded as entailing any particular resource-intensive activity by 60% of the respondents. However, this has been shown to be a biased estimate of the phenomenon, as it is driven by the responses of a cluster of operators belonging to a large transnational tobacco company. When the analysis is broken down to account for this fact, 90% of the respondents think that there are particularly resource consuming activities connected to the EMCS.

Interviews with large businesses in case study countries confirmed that dimension is a major discriminant for the assessment of the resources spent on complying with the rules on the movement of excise goods. Indeed, the costs for purchasing and operating technological equipment were estimated to range between EUR 30 000 and EU 50

000 for the initial investment and EUR 5 000 up to EUR 250 000 for operating and maintaining the systems (on a yearly basis). This would entail a considerable effort for smaller entities.

A costing exercise could only be performed for larger enterprises which agreed on sharing this information with the evaluator. On average, creating, managing and confirming a movement under EMCS takes between 5 and 15 minutes. The figure does not change with the number of movements, indeed the same numbers were reported by operators moving very different volumes of products (ranging from 45 to over 1000 a month). Such level of efficiency is usually achieved through the use of ERP software applications (e.g. SAP) which are able to generate system files directly uploaded in the customs system (EMCS or ECS/ICS for movement to/from third countries).

While precise figures cannot be provided for smaller companies, suffice it to say that when lacking dedicated software tools that allow for a great level of automation, economic operators need to create EMCS records through web-based portals made available by tax administrations. While some, such as the one provided in the UK, allows for some information to be prepopulated, in general they entail manual entry thus result in a high absorption of resources.

Efficiency

Larger economic operators do not highlight any significant burden coming from the provisions on the movement of excise goods under duty suspension arrangement; indeed ERP systems can be integrated with EMCS and other customs systems to achieve high level of automation, efficiency and to reduce errors.

However, 40% of the surveyed economic operators do consider certain aspects to be resource-intensive. These include:

- Drafting of the electronic administrative document and of the reports of receipt of goods;
- Establishing guarantees before movement under suspension;
- Dealing with fall-back procedures and maintenance shutdowns;
- Managing trade with third countries which requires double entries under EMCS and ICS/ECS.

The issue of establishing guarantees is reported to increase costs. This is mainly due to the fact that transportation companies are reluctant to take the risk of transporting the tobacco goods and provisions on liability vary significantly across countries (e.g. in DE the insurance companies can only make reduced recourse claim regarding excises against the transportation companies). Furthermore, it is mentioned as an issue, that in the case of theft, an insurance claim for the lost excise duty must be made in the Member State where the theft took place. However, it is not always known whether the theft happened in one Member State or another. Both examples are reported to create legal uncertainty and potentially lead to reduced efficiency.

The fact that ECS and EMCS are not linked has been pointed out by several respondents as leading to increased compliance costs as the operator needs to perform similar steps twice. According to some operators, this creates an obstacle to the movement of products which are considered excisable in one Member State and not excisable in others. Even when operators have own platforms integrated with EMCS and ECS, IT costs are still higher as different integration modules are needed. Moreover, when a failure occurs, it is not easy to find who is responsible for fixing it: this creates additional costs.

Finally, EMCS is reported to be the third most time-consuming activity in the current excise duty legislation and would need a more user-friendly guidance. In regard to this, it has been pointed out that upgrades to EMCS should be better coordinated across Member State to minimize costs related to adapting to the new technical features. However, based on the results of the survey, economic operators advocated for a continuous and timely update of the technical specifications of EMCS to keep pace with changes in the explanatory notes (e.g. natural wrapped cigarillos) which are immediately effective. Indeed, as the EMCS in some Member States can only be used for predetermined CN codes, a delayed adjustment of the system would create problems in terms of planning the production and the launch of products, i.e. would increase the administrative costs borne by the operators.

Definitions and classification

Activities

Classification of tobacco products may be conducted:

- Once, upon introduction (production/import) of a new product in the market;
- Periodically, to adapt to modifications of the relevant provisions.

In the first case, economic operators are required to provide a **pre-defined set of information** on the product to the tax administration before the product is launched. This is the case, among others, of Romania, where the classification of the products the operator will deal in is made at the time when the request for the authorisation is submitted. In this case, the tax administration is provided with the description (and samples if needed) of the product and a proposed classification which can be accepted or rejected. The classification is not repeated unless the product changes.

In other instances, such as in Greece, the classification is performed **every time some features of the tobacco product change**. In this case the economic operator before introducing the product in the market, would need to liaise with the customs authority and the tax administration to obtain confirmation of the proposed CN code and tax type code (the latter consistent with the categories set out in Directive 2011/64/EU). In case it is only the price that changes, there is no need to submit all the information again.

The obligation to notify tax administration does not exist in all countries. However, liaising with the tax administration at an early stage of the development of a product is common practice at least for larger operators.

In countries where tobacco products are mainly imported (e.g. Finland), the activities to be performed for classifying them are rather limited as both the CN and the excise code are included in the customs declaration. In the case of Finland, larger economic operators trade with affiliated companies in other Member States thus classification is easier and it is considered a standard procedure.

Laboratory testing of products is seldom conducted by tax authorities and mainly concerns products imported from third countries. In cases where the classification is particularly difficult, the economic operator can ask the national authority to request a Binding Tariff Information (BTI).

Resources

Resources spent on classification vary across countries and typology of products. Based on the information collected from economic operators, the time employed for classifying a “typical” product, i.e. a product that does not pose particular problems, ranges between 2 and 8 hours. The total burden is depends on:

- Whether classification must be repeated periodically (e.g. annually, each time the price changes, etc.) such as in EL and FI or if it is a one-off procedure;
- The size of the businesses in terms of number of Stock Keeping Units (SKU).¹¹⁹

In the case of more complicated cases where there arises a dispute between the economic operator and the tax administration, time and resources dedicated to solving this problem would increase as a consequence of initiating a court or administrative case.

Resources spent for classification in FI

A new SKU for excise purposes involves the product to be classified and product basic data to be set up into ERP and EMCS. Annually, all SKUs are reassessed/undergo changes as this task has to be carried out every time prices changes, the tax form changes or the design requirements change (this change, however, does not involve all SKUs, as not concerning all brands).

The classification process, excluding testing, was estimated to take 2 hours for excise/customs category in a typical case, i.e. not posing particular problems, and 4 hours for more complicated ones (e.g. Make Your Own, MYO). Estimating an hourly cost of EUR 27.35 this would amount to:

- **Typical case:** EUR 27.35*2 hrs= EUR 54.7
- **Complicated case:** EUR 27.35*4 hrs= EUR 109.4

Efficiency

As pointed out in Q.2.2, there are two main reasons for a dispute to rise. Firstly, the wording of the existing definition might open the way to **subjective interpretations**. This increases the odds of a disagreement between the tax administration and the operator to occur. At the same time, when taking a cross-country perspective, it might be the case that the same product is treated in different manners in different Member States. Secondly, existing definitions might **not be able to keep up with the developments in the market**, thus it can be questioned whether certain products fall within the scope of Directive 2011/64/EU, e.g. whole tobacco leaves being sold to final consumers. On both cases legal uncertainty on the treatment of the product would follow.

According to the results of the survey, 74% of the respondents experienced some kind of disputes between their company and the tax authorities. When excluding the business affiliated to a large transnational tobacco company, the figure drops to 37%. The legal uncertainty relating to the classification of excisable products is considered to lead to an increase in administrative costs by the majority of economic operators. In general, 86% of them consider the increase to be very high, 6% to be high, and only

¹¹⁹ A SKU is a distinct item as classified for inventory management purposes. Each SKU corresponds to a set of attributes (e.g. product description, material, size, colour, packaging) associated with the item and that distinguish it from all other items. Such classification helps tracking amounts of product in inventory, and/or units of billable entities sold.

9% consider the increases to be low. None of the respondents say that the legal uncertainty did not have an effect at all. These figures shall be interpreted with the due care as replies from the businesses affiliated to the same transnational tobacco company are likely to drive the results.

In general, companies struggled to quantify the resources dedicated to classification as this is seen as an integral part of operating in an excise business. This would suggest that costs are negligible. Anecdotal evidence suggests that liaising with the tax administration at an early stage of the development of a new product is the strategy adopted by larger operators to minimize the **legal uncertainty** related to the excise treatment of the product. This is the case, among other of Expanded Shredded Stems (ESS)¹²⁰ which is treated as not excisable in FR and excisable in UK: the economic operator contacted the administration as it was unsure about the classification of the product. The administration rejected the proposed classification as tobacco refuse and the issue was sorted out within 3-4 days with virtually no costs. A similar case was raised in DK where the economic operator spontaneously contacted the administration to verify the correct classification of water-pipe tobacco: this took a couple of hours of time.

Even though at a system level this may not appear to be a widespread phenomenon, the costs associated with a **single dispute** can be high from the perspective of the single economic operator. Indeed, not only are there direct costs (e.g. costs of obtaining legal and technical assistance) but also indirect costs in the form of administrative proceedings, disruption in the supply of products, delays in new product launch, costs for external advisors, foregone revenues (i.e. reduced capacity/impossibility to recover the costs of the initial investment), as well as unfair competition as a result of companies exploiting the existing loopholes in some markets. The green box below reports one example of a dispute between an economic operator and a tax administration.

Disputes about definitions mainly concern **certain types of products** such as natural wrapped cigarillos with filter (e.g. Silverado in BE), filter rods with a section containing tobacco, tobacco sticks (e.g. Gullivers in LV, PL, SK, CZ), e-cigarettes, tobacco leaves (e.g. in IT, UK, PL, SE). Regarding natural wrapped cigarillos with filter, the dispute was often centred on whether this product should be classified as a cigarillo or as a cigarette (cigarillo had an outer wrapper covering the tobacco rod but not the filter). Based on the information of the survey, many of these cases above are still pending before courts and/or have been partially resolved.

¹²⁰ Expanded shredded tobacco stems (ESS) are rolled, flattened, and shredded tobacco leaf stems that are expanded by being soaked in water and rapidly heated. They are used in the manufacture of cigarettes to increase the tobacco blend filling capacity.

The case of reconstituted tobacco in Romania

Reconstituted tobacco

Reconstituted tobacco, also known as "recon," "foil" or "sheet" tobacco is an ingredient employed in the manufacturing of tobacco products for:

- Blend construction, in combination with other tobacco leaf, to produce the filler for cigarette, cigar, smoking tobacco and pipe;
- Production of wrapper and binder for machine made cigars.

Reconstituted tobacco is produced from the remnants of virgin tobacco generated from previous processes (e.g. Threshing Line, Primary production and Make & Pack). These by products are collected and manufactured into sheets.

The case

An economic operator based in Romania is currently facing problems with respect to its operations involving the treatment of reconstituted tobacco (CN code 2403 91 00).

The economic operator argues that this product should not be excisable, as requires further industrial processing before it can be smoked. This is consistent with the treatment to which is subject in the country of dispatch (FR) where it is considered as raw tobacco.

The Romanian authorities considered the product to be excisable under the "other smoking tobacco" category, as in their opinion, it can be smoked without further industrial processing.

The consequences

At the moment, there are no significant consequences of this dispute, as the product arrives under a customs suspension regime, and therefore, with a simple customs declaration the economic operator is able to receive the product without interfering with its treatment as an excisable tobacco product.

If the product did not come under a customs suspension regime, the economic operator would NOT be able to legally import the product, as the country of origin would not be able to ship it under the EMCS, therefore, the operator would be liable for excise duty. Considering that the operator imported 1.4 tonnes of reconstituted tobacco in 2013, this would amount to an exposure worth EUR 113 400.

In addition to the exposure, legal costs of EUR 3 000 and 10-30 internal man/days were spent on trying to clarify this dispute which is at present still open.

Dual coding

Activities

Activities performed by economic operators for complying with the requirements of the legislation in terms of classification of tobacco products for customs and excise purposes are inherently related to those performed when moving such goods. Thus economic operators would usually:

- Support the tax and customs administrations' work by either providing a proposed classification or by providing the necessary documentation;
- Enter the excise duty as well as the CN codes when creating an entry in EMCS.

Resources

It has not been possible to estimate the costs related to dual classification as the procedures are overlapping with those undertaken for complying with the provisions for the classification for excise purposes, as explained in the previous section. Indeed, the same supporting documentation and activities (e.g. lab tests) are used for both classifications.

Efficiency

The application of differentiated definitions of tobacco products for excise duty and for customs purposes is considered to be **problematic** among the surveyed economic operators. On a general level, 68% of the respondents state that the differentiated definitions result in a high increase of administrative costs, while 4% even think that the increase is very high. 67% of the respondents identified the double entries as the most burdensome activity connected to the differentiated definitions. 21% consider the application of differentiated definitions to have no effect while 6% states that there is effect to a low extent. Additional testing only result in increased administrative costs for 6% of the respondents, while legal uncertainty caused by the inapplicability of the customs classification for excise duty purposes results in increased administrative costs in 10% of the cases.

Similarly to the case of classification for excise purposes, inconsistencies between the specifications of the two coding systems have the potential to negatively impact on the costs structure of economic operators by creating **legal uncertainty**¹²¹ over the correct treatment of the product. This might be an issue for smaller operators.

An example of a cigarillo dispute

The matter of dispute

In the view of the economic operator, the source of the problem is that there exists an inconsistency in the definition of cigars/cigarillos as laid down in the Explanatory Notes to the CN and in Article 4(1) Directive 2011/64/EU. The matter of dispute is whether the filter must be covered by the wrapper.

The consequences

The economic operator's proposed classification was challenged by the tax administration and a BTI request was formulated. The manufacturer employed a large number of people for the preparation of the case (including sending sample to the customs laboratories) for a total of 9 days.

Indirect costs related to this procedure include the delayed launch of the product and the distortion of the production plan.

The entire process took 2 months and the BTI ruled in favour of the operator subject to a change in the of the product's characteristics.

These results are not fully consistent with the evidence collected in the case study countries where none of the economic operators interviewed reported experiencing problems linked to the simultaneous existence of two coding systems. A possible explanation for this puzzle is that interviewed economic operators were mainly large enterprises (often affiliates of transnational tobacco companies) which use advanced IT platforms which make the process of dealing with EMCS and coding automatic. More-

¹²¹ For a detailed discussion of the legal uncertainty on efficiency please refer to the previous section.

over, by virtue of their belonging to the same group, they often trade with affiliate or established partners which are well aware of the correct classification of the traded goods and have aligned the processes to avoid any divergent interpretation.

When taking a cross-national perspective, the majority of respondents think that there are not any significant differences in the compliance costs across Member States where they operate.

Summary

Our analysis of the impacts of the current provisions on excise duty on the efficient working of economic operators provides the following key findings:

- Pre-authorisation: no major inefficiencies stemming from the current provisions could be identified, also given the limited frequency with which this operation must be carried out;
- Production/Holding/Storing: some activities were reported as being resource intensive including tracking and tracing requirements, management of fiscal marks and destruction of tobacco products;
- Movement of tobacco products: it seems that the assessment of the impact of the current provisions related to the movement of tobacco products (mainly EMCS) on efficiency depends on the size of the business. Smaller business reported that fulfilling all the requirements is associated with time consuming activities which imping on their efficiency. On the other hand, larger economic operators succeeded in achieving high level of automation and efficiency by developing platforms that integrate with EMCS and ECS/ICS;
- Definitions and classification: companies struggled to quantify the resources dedicated to classification as this is seen as an integral part of operating in an excise business. This seems to suggest that costs at the systemic level are negligible.
- Costs associated with disputes caused by the classification of "borderline" products can be high, removing legal uncertainty with respect to the treatment of products whose classification requires subjective interpretation of the law would increase the efficiency of economic operators;
- Dual coding: the application of differentiated definitions of tobacco products for excise duty and for customs purposes is considered to be problematic as it translates into double entries and legal uncertainty. Larger manufacturers on the contrary, did not report problems, the reason likely being that they use advanced IT platforms which make the process of dealing with EMCS and coding automatic.
- One area of significant potential reduction of costs regards the compliance with the requirements of economic operators with excise stamp obligations, and in particular, with the rules regarding the proof of destruction in light of recovering excise duty due for products which became unfit for consumption or for tax stamps which were never applied to products.

Overall conclusions

The results from Q.4.1 and Q.4.2 are summarized in Table 24 below. By looking at all parties involved, it seems like the greatest negative impact stems from the current definitions as laid down in Directive/2011/64 and in the existence of inconsistencies between them and the Explanatory Notes to the CN. In both cases efficiency is negatively affected by the increase in the operating costs.

The analysis shows that the primary driver is legal uncertainty over the treatment of a specific product. Even though the costs at a systemic level are (still) relatively small as disputed cases concern niche products, the impact on the single business/tax administration can be significant. In the case of tax administrations, resources need to be spent on dealing with the dispute, thus they are diverted from other tasks. From the perspective of the economic operator, the direct costs of preparing the case (e.g. legal opinions) add up to more indirect costs such as the forgone revenues for a delayed launch of the product, financial distress, unfair competition just to name some.

Table 24 Comparison of the effects of the current provisions on efficiency

	Tax administration		Economic operator	
	Negative effect on efficiency*	Source	Negative effect on efficiency	Source
Pre- authorisation	None	n/a	None/Moderate	n/a
Production/ Holding/ Storing	None	n/a	Moderate	Setting up and operating systems for record keeping Fiscal marking
Trade and logistics	None	n/a	Limited (large enterprises) High (small enterprises)	Guarantees Creating records on EMCS/ECS/ICS manually
Definitions and classification	Moderate	Legal uncertainty leading to diversion of resources for investigations and court-cases	Moderate (at systemic level) High (for disputed cases)	Legal uncertainty leading to court-case, admin ruling, etc.
Dual coding	Moderate	Each product must be considered twice Legal uncertainty due to inconsistencies (small number of cases)	Moderate (at systemic level) High (for disputed cases)	Legal uncertainty leading to court-case, admin ruling, etc.

* 4-point scale: None, Moderate, Medium, High

Recommendations

The recommendations are addressed solely to the Commission or regard measures to be taken at EU level. The recommendations are “positive” which means, they take into account actions that should be taken or should be considered for further analysis.

There are a number of measures which can be taken at national level. Meanwhile, as it was not within the remit of this evaluation to assess national choices or systems, recommendations for Member States are not systematically collected for the purpose of presentation in this chapter.

With the view of facilitating reading and allow a suitable overview, the recommendations presented in this chapter have been structured around the main topics evaluated. The expected impact on the objectives pursued by the Directive is included in the presentation.

The “revenue impact” regards the “direct” expected impact on the budgetary objectives of Member States

“Monitoring and controlling” regards the ability of Member States to monitor and control the logistics (production, movement and release for consumption) of excisable tobacco products.

“Reduction of costs” regards the aggregate impact of the recommendations on the administrative costs for Member States administrations, compliance costs for economic operators, taking into account, where relevant, the potential one-off-costs expected.

Definitions of excisable tobacco products

The revision of Art 2-5 of Directive 2011/64/EU, which define excisable tobacco products has the potential to bring significant improvements to the effectiveness (safeguarding budgetary interest of Member States and improving the ability of Member States to control the logistics and monitoring of excisable tobacco products) as well as the efficiency of the tax collection system.

In light of the increasing use of **e-cigarettes** as an alternative to tobacco cigarettes,¹²² it is assessed that the non-inclusion of this type of product in the common framework of excisable tobacco products will have a significant negative impact on the budgetary revenues of Member States. Moreover, as Member States are taking different approaches in regulating the treatment and taxation of this product, the landscape may become fragmented, negatively impacting the functioning of the internal market. As a result, this evaluation recommends the Commission to investigate further the possibility of including e-cigarettes within the scope of the harmonised system of excise duty on tobacco products. It is expected that such a measure will impose some administrative costs on Member States (as a one off cost of setting up the system) and compliance costs on the operators involved.

As thoroughly presented in Q2, Member States believe that systematic, real-time information on **raw tobacco** will greatly improve their ability to monitor the logistics of excisable tobacco products and fight illicit trade. The current systems, however, are inappropriate to generate the necessary data. As the issue is of growing concern to a

¹²² See Appendix 6 – Research note on e-cigarettes for a detailed analysis

number of Member States, different types of systems for monitoring and control of raw tobacco are being implemented at national level. However, as they differ in scope¹²³ and obligations,¹²⁴ they will be inappropriate for generating comparable real time data which can be integrated in the existing systems. Further fragmentation of approaches may also be detrimental to the internal market. As a result, this evaluation considers that steps at EU level to establish a harmonised system for monitoring the control and logistics of raw tobacco are necessary. In order to achieve this, it is recommended that the Commission further analyses the possibility of introducing raw tobacco within the scope of monitoring of excisable tobacco products which will ensure that adequate data becomes available, in a systematic and comparable format across the territory of the EU. This recommendation, however, may imply significant costs for tax administrations¹²⁵ as well as for the economic operators involved. For this reason, it is considered necessary for the aspect of cost to be adequately investigated and taken into account before deciding on further measures (e.g. in the context of a Commission-led impact assessment process).

In order to reduce the legal uncertainty regarding the treatment of certain tobacco products, reducing costs and inconsistent treatment across Member States, a number of specific improvements are recommended. These include:

- Bringing Art 4 (1) in line with its corresponding CN code;
- Reducing uncertainty in relation to Art 5 (1) (a) by specifying that processing refers to processing in a tax warehouse;¹²⁶
- Revising Art 5 (1) (b) by removing the word “retail” from the text.

Due to the fact that Art 5 (1) (a) represents a catch-all category, it’s main purpose is to enable the taxation of tobacco products that are not specifically defined in the other articles, this evaluation has found that this purpose is adequately fulfilled in the case of **water-pipe tobacco**. The composition of water-pipe-tobacco contains sugars, molasses and other dense substances, its properties in terms of weight differs considerably from the other types of products which usually fall under the category of “other smoking tobacco” (e.g. pipe tobacco). Depending on the nature of the market in a particular Member State, a particular rate structure for this category may not be appropriate to apply to both water-pipe tobacco as well as the other products within “other smoking tobacco”. Being unable to find an appropriate balance between the consumption patterns and the rate structure may have significant implications on the budgetary revenues. Applying the same rate to water-pipe tobacco may lead to (a) water-pipe tobacco being over taxed, pushing consumption towards the illicit market, or (b) other types of products in the category being under-taxed, leading to potential revenue losses and harmful tax-induced price advantages. As a result, it is recommended that water-pipe tobacco be introduced in a separate tax category, allowing the imposition of an adequate rate in relation to the characteristics of the product.

Additional specific recommendations are made in relation to the **Customs classification** and its corresponding CN codes and explanatory notes. These include:

¹²³ Different scope with respect to the object monitored (i.e. different definitions of raw tobacco) as well as the subjects (i.e. the parties subject to obligations)

¹²⁴ E.g. requiring the subjects to submit different information at different moments in relation to the movement, dispatch or receipt in different modes (electronic, paper, etc.)

¹²⁵ E.g. setting up the legislative framework, increasing administrative capacity for control and verification, upgrading IT systems, etc.

¹²⁶ I.e. tobacco which can be smoked following any type of processing done outside of a tax warehouse is to be considered smoking tobacco.

- Creating a distinct CN code for expanded tobacco, thereby removing the legal uncertainty with respect to the tax treatment of this product, reducing costs for administrations and operators and improving the functioning of the EMCS
- Further revising the CN classification to ensure that the same code does not contain both excisable and non-excisable tobacco products.

Due to the fact that inconsistent treatment of a number of **tobacco raw materials or by-products**¹²⁷ across Member States takes place and affects the effectiveness and efficiency of the tax collection system, it is recommended to create a zero-rated tax category within the Directive that would reference specific CN codes containing such products ensuring an adequate and consistent monitoring across the EU.

Finally, the **subjective criteria** of Art 4 (1) have been identified to be an important source of legal uncertainty and disputes which have resulted in high costs for Member States and economic operators. It is therefore recommended that steps be taken towards more objective criteria for classification. This recommendation could be achieved by describing excise categories with reference to the CN codes, as is the current practice with alcohol and mineral oils. As described in Q.2.2 (a), this change would officialise already existing practices and would help streamline processes of importation and customs clearance.

These recommendations are summarised in Table 25, below.

Table 25 Summary of recommendations related to Definitions of excisable tobacco products

Recommendation	Revenue impact	Monitoring and control	Reduction of costs
Further analyse the possibility of including e-cigarettes in the scope of excise duty on tobacco products	High	n/a	Negative
Further analyse (with careful consideration to costs and burden involved) of introducing raw tobacco within the scope of monitoring of excisable tobacco products	Medium	High	Negative
Art 4(1) (a) should be brought in line with the CNEN of 2402 10 00	n/a	n/a	Medium
Art 5(1) (a) "capable of being smoked without further industrial processing" to be revised in order to reduce uncertainty related to the treatment of partially processed tobacco put up for sale with the intention of being smoked (e.g. "without further processing in a tax warehouse)	Medium	Medium	Medium
In light of the different characteristics of water-pipe-tobacco, a distinct tax category should be developed, allowing the imposition of an appropriate rate structure	Medium / low	n/a	n/a
Art 5(1) (b) "put up for retail sale and which can be smoked", should be revised by removing wording "retail" from the definition, the CN code should be subsequently brought in line	Medium / low	Medium	Medium
Further analyse the possibility to afford expanded tobacco a distinct CN code.	n/a	Medium	High
In order to remove inconsistencies and legal uncertainty in treatment, further analyse the possibility to include an additional tax category within the scope of the Directive which is to include intermediary products whose monitor-	n/a	Medium	Medium

¹²⁷ E.g. reconstituted tobacco; tobacco refuse not suitable for smoking, expanded tobacco

Recommendation	Revenue impact	Monitoring and control	Reduction of costs
ing under the EMCS is necessary, this category may make reference direct reference to applicable CN codes (e.g. reconstituted tobacco; tobacco refuse not suitable for smoking, expanded tobacco, etc.)			
Aim to eliminate inconsistencies between CN codes and Excise duty categories, prioritising the need for non-excisable products to share the same CN classification as excisable products and for products within the same tariff classification to be potentially classified in multiple excise categories	n/a	Medium	Medium ¹²⁸
Art 4 (1) "given their properties and normal consumer expectations is exclusively intended to be smoked as it is" should be revised to ensure legal clarity and eliminate legal uncertainty and costly disputes	Medium	n/a	High

Rates and structure of Excise duty

The conclusions and findings presented in Q2.1 (b) show that the difference in the level of taxation between cigars/cigarillos and cigarettes may create an incentive for economic operators to design and market **"borderline" products** which objectively fill the requirements of cigarillos/cigars but which are similar in a number of ways (e.g. with respect to smoking time, production methods, unit price, etc.) to cigarettes. The resulting disputes lead to significant costs for both tax administrations as well as economic operators. Additionally, the quantitative analysis presented in section 2.1 (c) suggests that consumer downgrading from cigarettes to cigars/cigarillos is taking place and that it has a sizable impact on the budgetary revenues of Member States. As a result, it is recommended to align minimum excise duty taxes (i.e. through a mechanism similar to the MED on cigarettes¹²⁹) of cigars/cigarillos to the minimum excise taxes on cigarettes. In order to eliminate the incentive to market "borderline" products, such a mechanism does not need to go beyond the objective of ensuring that the same minimum excise tax is levied per unit of cigar/cigarillo as the minimum excise tax levied per unit of cigarette. This recommendation may also be taken up individually, by Member States, which, under the existing arrangements can apply a minimum tax floor¹³⁰ on cigars/cigarillos when using an ad valorem or mixed tax structure.

Finally, as substantiated by Q3.1, the **nature of the MED**¹³¹ and the applicable rules regarding its use do not seem to be clear, despite the Commission having answered a request for clarification. As such, there is evidence of non-compliance with the rules concerning the level at which the MED on cigarettes may be set. Therefore, this evaluation recommends that the Commission revises the rules surrounding the MED on cigarettes to provide sufficient legal clarity with respect to the upper and lower limits at which it may be set.

¹²⁸ Although on an operational level, this will remove legal uncertainty on the long term, the one off costs to both administrations and operators associated with changes of CN classification may be considerable (hence the effect on costs requires further investigation)

¹²⁹ The MED is allowed by Art 7(4) and 8 (6) of Directive 2011/64/EU

¹³⁰ Art 14. Directive 2011/64/EU

¹³¹ Art 7 (4) and Art 8(6))

The two recommendations related to the rate and tax structure are summarised in Table 26, Summary of recommendations related to rates and structure of the excise duty.

Table 26, Summary of recommendations related to rates and structure of the excise duty

Recommendation	Revenue impact	Monitoring and control	Reduction of costs
Consider the possibility of aligning minimum excise taxes on cigars / cigarillos with those of cigarettes in order to eliminate the incentive to market "borderline" products which might attempt to circumvent payment of the higher excise duty.	Medium / High ¹³²	n/a	n/a
Revise Art 7 (4) and Art 8 (6) to remove the uncertainty with respect to the limits imposed on the MED. (not prioritised)	n/a	n/a	n/a

Excise stamps and Track and Trace systems

Article 39 of Directive 2008/118/EC provides that Member States may require that excisable tobacco products carry **tax markings or national identification marks** used for fiscal purposes at the time when the products are released for consumption in their territory.¹³³ Member States are free to decide whether and to which excise products to apply such a system. The fiscal marks *inter alia* are proof that excise duty is paid and is therefore a mean to prevent illegal trade.

Characteristics of fiscal marks differ widely across Member States and therefore it is not possible to describe a "standard" for fiscal marks at the EU level. However, an overall distinction can be made between fiscal marks according to their features and the level of information that they provide. In addition to the information and tracing features, fiscal marks also contain some security features¹³⁴.

The features of the fiscal marks imply different possibilities to tracing the products and combating illicit trade. The information contained in a fiscal mark and/or those made available by T&T systems is (or has the potential to be) used for combating illicit trade however the degree of complementarity/substitution of the two systems varies across Member States. Also, opinions on the potential development for T&T systems differ across the EU.

In light of the evidence collected and presented in the context of this evaluation,¹³⁵ the complete substitution of excise stamps by track and trace systems is not recommended at this moment.

The measurement of administrative and compliance cost conducted has revealed that the management of excise stamps imposes significant operating costs for economic operators. As a result of this, the continuous development of the track and trace systems should continue to be within the focus of the EU Commission and Member States. A future phasing out of excise stamps, when the capabilities and features of the systems will be, at minimum, on par with the expectations of the Member States in terms of their monitoring, control and authentication functions should be considered.

¹³² Given the measure does not have unintended consequences on illicit trade

¹³³ Art. 39 (1) in Council directive 2008/118/EC of 16 December 2008

¹³⁴ Examples include: watermarks, holograms, background aura, micro-text, temperature sensitive ink used on parts of the fiscal mark, design/ colour of the fiscal marks

¹³⁵ As detailed in Appendix 5 – Question 1: Background Information, and specifically in Q1.2

Other

Finally, Table 27 summarises a number of minor recommendations which are seen to bring marginal improvements to the overall system of tax collection in Member States. While they are expected to be beneficial, due to their relatively lower expected impacts, they should be sought in as far as resources are available to implement them and can be given a lower priority than the recommendations presented in the sections above.

Table 27, Summary of recommendations related to other topics analysed in the context of this evaluation

Recommendation	Revenue impact	Monitoring and control	Reduction of costs
A correction message for the e-AD should be introduced in order to correct minor mistakes; however, it should not be possible to change essential data like the quantity, the EPC, the CN-code, etc. (not prioritised)	n/a	low	Low
Consider integrating national EMCS systems in the context of market surveillance and for the purposes of criminal investigations (not prioritised)	n/a	Medium	Medium /Low ¹³⁶
Transit countries should electronically informed of movements taking place on their territory (not prioritised)	n/a	Medium	Negative
Consider developing and recommending a uniform risk analysis tool to be used at EU level (not prioritised)	n/a	Medium	Negative

¹³⁶ May entail one-off costs which Member States might be reluctant to invest, especially in the context of having recently finished the development and implementation of the EMCS.

Appendix 1 – Evaluation Matrix and Evaluation Design

Appendix 2 – Questionnaire to Member States

Appendix 3 – Survey Questionnaire to Economic Operators

Appendix 4 – Analysis of survey data from economic operators

Appendix 5 – Question 1: Background Information

The first question proposed is fundamentally descriptive. The objective is to provide the Commission and the evaluator with an overview of the excise duty system in the different Member States. At the same time, it helps contextualising the issues discussed in the other sections of the report, thus to draw a baseline for further considerations.

Q.1.1 What is the structure of the excise duty applied in each Member State, inclusive of the minimum excise duty?

Questions	Indicators / Descriptors	Data sources
Q.1.1 What is the structure of the excise duty applied in each Member State, inclusive of the minimum excise duty ¹³⁷	Structure of excise duty in each MS for cigarettes and cigars/cigarillos: <ul style="list-style-type: none"> ▪ Specific ▪ Ad valorem (at WAP) ▪ MED (if applies) 	Desk research EE (DG TAXUD, Excise Duty Tables)

As briefly mentioned in a previous section, Directive 2011/64/EU distinguishes between four different types of tobacco products: cigarettes, cigars/cigarillos, fine-cut tobacco for the rolling of cigarettes and other smoking tobacco. Nevertheless, the provisions on the structure and the limits applicable to excise duty can be classified into two groups: cigarettes and tobacco products other than cigarettes.

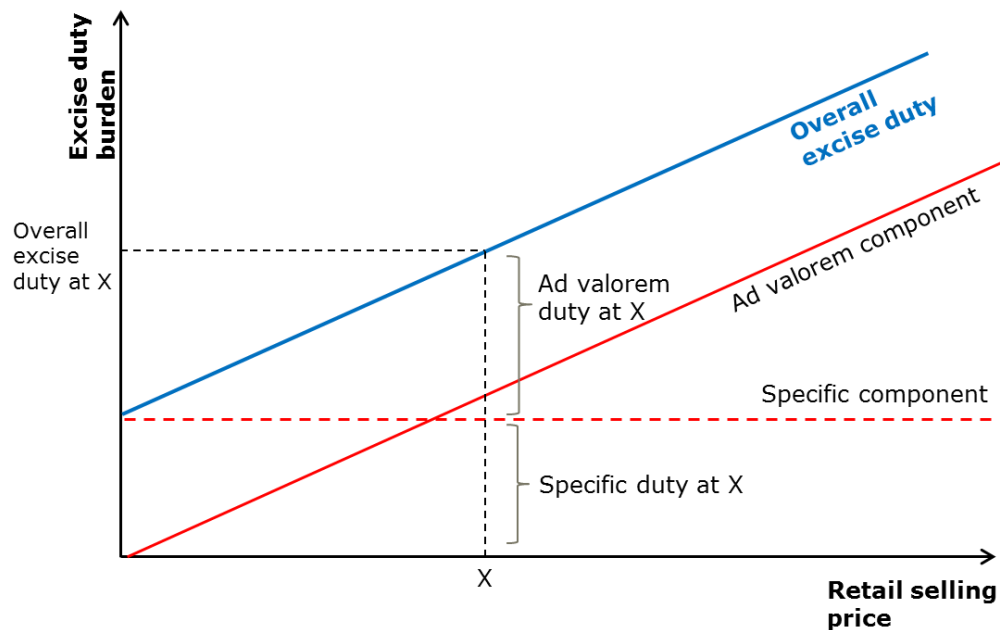
Cigarettes

After providing the definition of cigarettes in Article 3, Directive 2011/64/EU lays down the provisions applicable to this product category in terms of excise duty structure in Articles 7 to 12.

According to the wording of these articles, Member States are requested to apply a mixed tax structure on cigarettes including (i) a specific component calculated and (ii) an *ad valorem* component. While the former is calculated as a fixed monetary amount per unit of product, the latter is a proportional component based on the retail selling price. The illustration below shows how a mixed structure works. The horizontal dotted red line represents the specific component of the overall excise duty and it is defined as a fixed amount per quantity of cigarettes: EU legislation uses 1,000 units as the reference point. The red sloped line represents the ad valorem component which, according to the definition provided in the Directive, is “calculated on the maximum retail selling price, including customs duties”.¹³⁸ An example is provided in the graph for cigarettes priced at X, where the two components are considered separately. As it can be seen, the overall excise duty burden results from the vertical sum of the horizontal and the sloped lines.

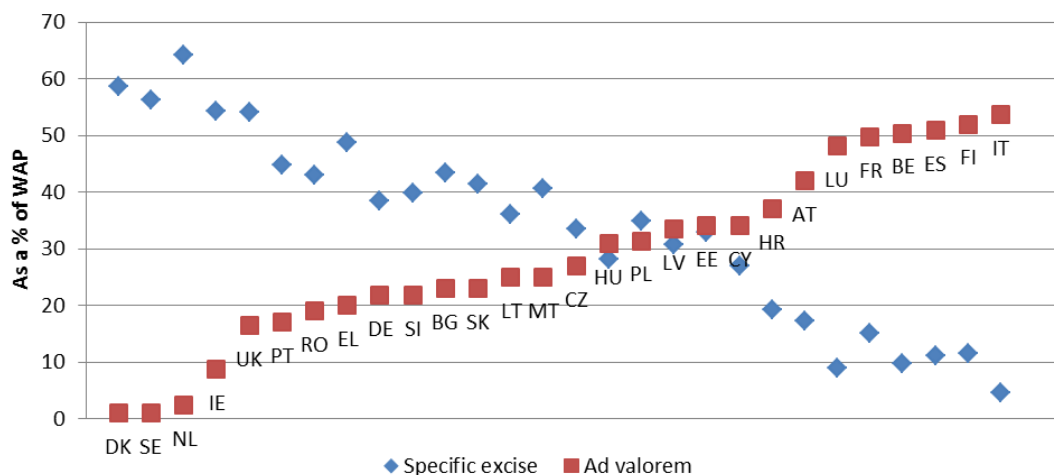
¹³⁷ Art 7 (4) and Art 8 (6) of Directive 2011/64/EU

¹³⁸ Article 7 (1) of Council Directive 2011/64/EU



The figure above, based on the most recent release of the Excise Duty Tables¹³⁹, illustrates the situation in different Member States. Countries can be clustered into three groups. The first group encompasses all countries on the left-hand side of the graph where the structure is skewed towards the specific component. In the second group, including all the countries between the Czech Republic and Cyprus, the relative weight of the two components is more balanced. Finally, the group starting with Hungary shows a preference for an ad valorem component.

Figure 57, Excise duty structure: specific and ad valorem component as % of WAP calculated at WAP



The specific component

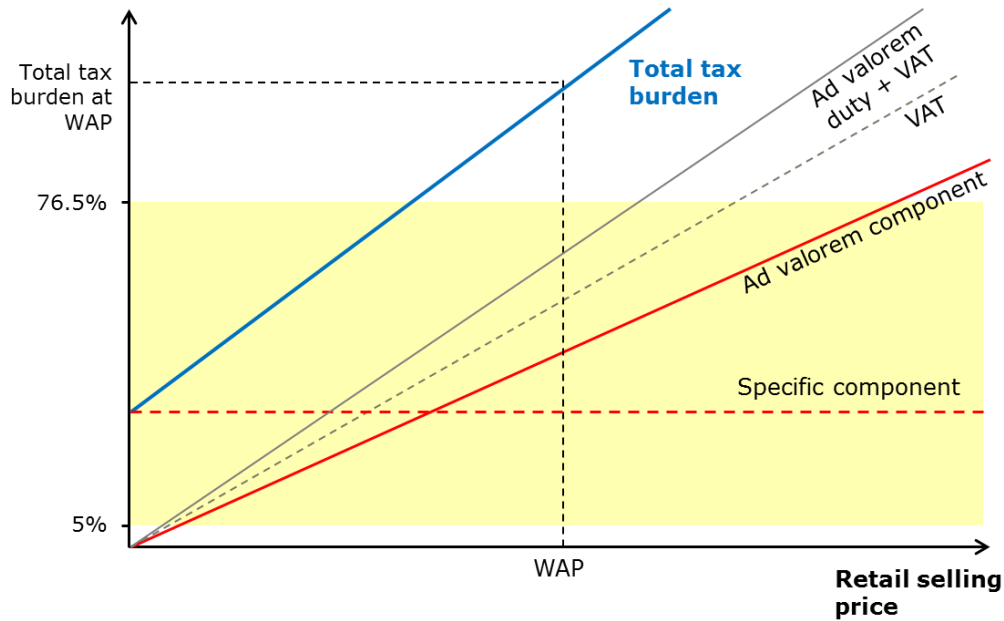
In addition to prescribing a mixed tax structure, the provisions on cigarettes define limits on the **relative weight** of the two components. According to Article 8(3) the specific components shall not be less than 7.5%¹⁴⁰ and not more than 76.5% of the

¹³⁹ European Commission, DG Taxation and Customs Union, 2014, Excise Duty Tables. Part III- Manufactured Tobacco. Situation as of 1 January 2014.

¹⁴⁰ Until 1 January 2014 the lower limit was set at 5% of the WAP.

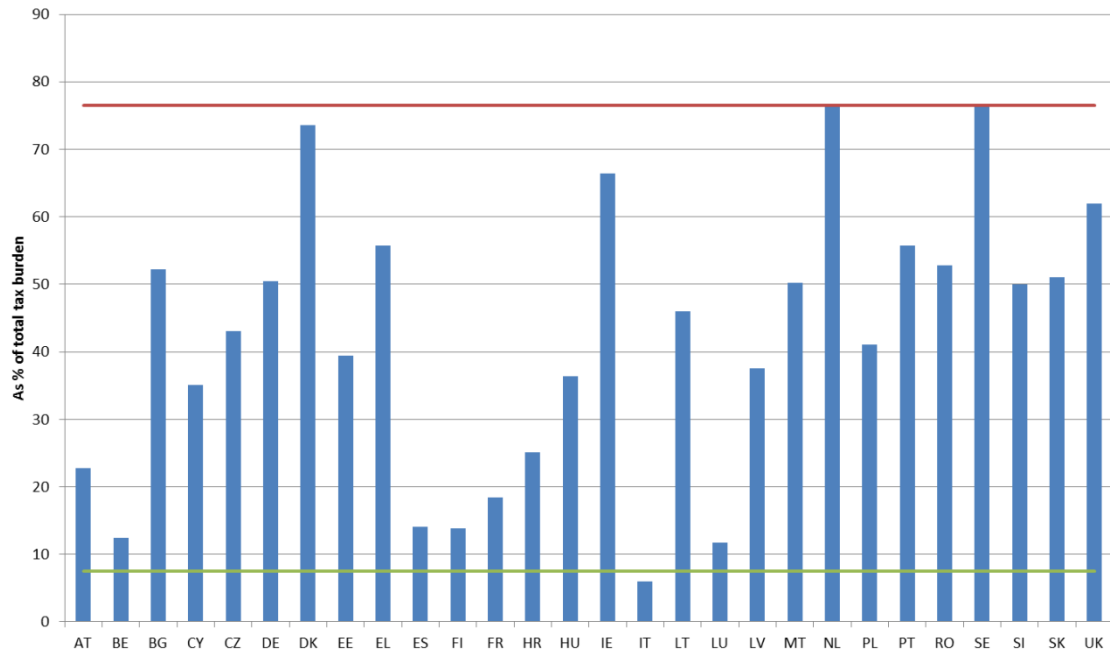
amount of the total tax burden resulting from the aggregation of the specific duty, the ad valorem duty and the VAT, the latter two calculated at the weighted average retail selling price (WAP). The illustration below summarizes the situation and shows that in order for a country to be compliant with the provisions, the specific component shall lay within the shaded area whose lower and upper limits of which are calculated as a share of the total tax burden (including VAT) at the WAP.

Figure 58 The limits on the specific excise duty component



Data reported in the Excise Duty Tables, show that in all countries the specific component falls within the range defined. This can be seen in Figure 59 where the red horizontal lines represent the limits set out in Article 8. The situation varies across countries with some falling short of the recently raised lower limit (e.g. Italy) and others almost hitting the ceiling (e.g. Denmark, Sweden). An interesting case is represented by the Netherlands, where the specific component represents exactly 76.5% of the total tax burden (including VAT).

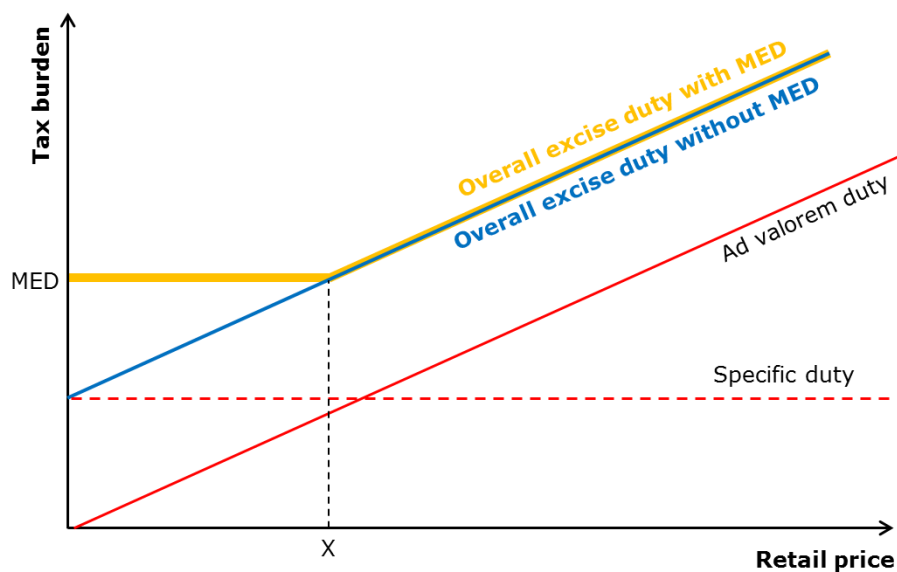
Figure 59 The specific component and the provisions of Article 8(3)



The minimum excise duty (MED)

Article 8(6) provides that Member States may levy a **minimum excise duty** on cigarettes. When applied, this serves, in effect, as a minimum floor for the taxation of cigarettes. The illustration below shows that the effect of the imposition of the MED¹⁴¹ would be to raise the minimum taxation on cheaper brands such that all the products lying on the left of X would be taxed at the level of the MED, while all the others would be subject to the mixed tax structure featuring the specific and ad valorem components.

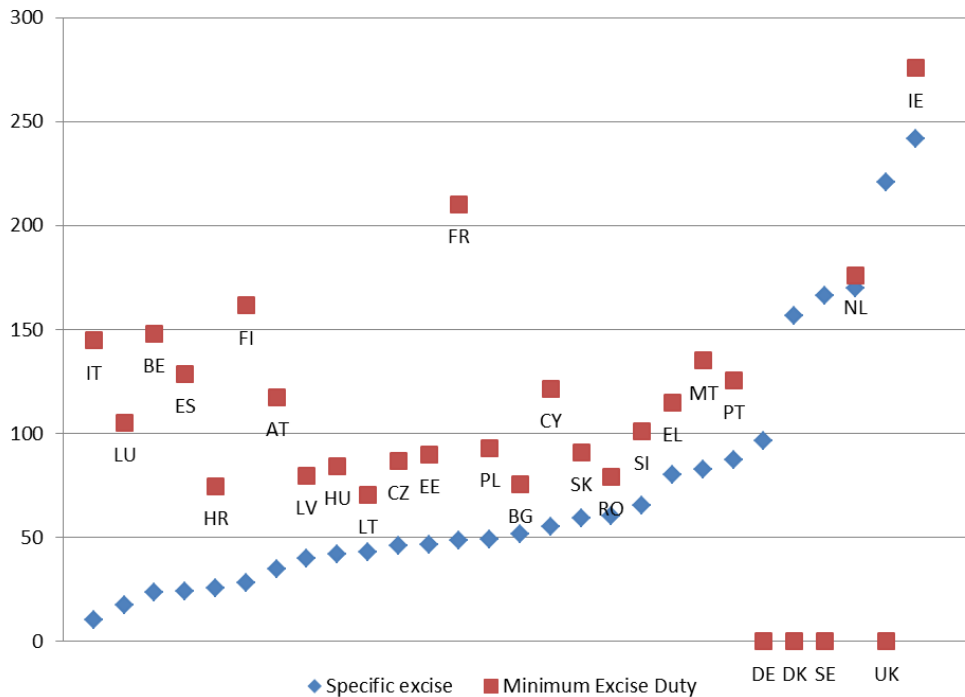
Figure 60 Excise duty structure with the MED



¹⁴¹ Here the MED is assumed as a specific component defined as a fixed amount per unit of the product.

All but four countries (UK, DK,¹⁴² SE and DE) apply a MED as of 1 January 2014 with values ranging from EUR 275.62 (per 1,000 items) in IE to EUR 70.76 in LT. As shown in Figure 61, there is no straightforward relationship between the specific component and the MED such that, for instance, countries with high a specific component also charge a high MED. Finland, Italy and Belgium are such examples of countries with a low specific component and a relatively high MED.

Figure 61 Excise duty structure: Specific component and MED



An interesting case worth exploring is represented by Germany where, according to the information reported in the Excise Duty Tables for Manufactured Tobacco,¹⁴³ a dynamic total tax is in place. This is calculated as a fixed monetary amount per item (currently EUR 0.19259) minus the VAT. This represents an exception in the European landscape.

The effect of the introduction of a MED has been shown above. From the wording of the Directive it is not clear whether this should be treated as a specific component, i.e. if it should comply with the requirements set out in Article 8(3). As explained in greater detail in Question 3.1, our calculations show that the majority of Member States slightly exceeded the upper limit of the allowable range for the specific component as a percentage of the total tax burden. However, it must be noted that the WAP is calculated using data on the releases for consumption made in the preceding calendar year.

The overall excise duty burden

Article 10 of Directive 2011/64/EU mandates that the overall excise duty, inclusive of the specific and the ad valorem component (excluding VAT), shall represent at least 60% of the WAP.¹⁴⁴ An illustration is provided below. The same article provides two ad-

¹⁴² Denmark applied an MED until July 2013.

¹⁴³ European Commission, DG Taxation and Customs Union, 2014, Excise Duty Tables. Part III- Manufactured Tobacco. Released on 1 July 2013.

¹⁴⁴ Until 1 January 2014 the limit was set at respectively 57% of the WAP.

ditional rules (which have been omitted in the graph for the sake of clarity), namely that the overall excise burden shall never be less than EUR 90 per 1 000 cigarettes regardless of the WAP, and that the 60% rule does not apply whenever a country levies an excise duty of at least EUR 115 per 1 000 cigarettes at the WAP.¹⁴⁵

Figure 62 The provision on the overall excise duty

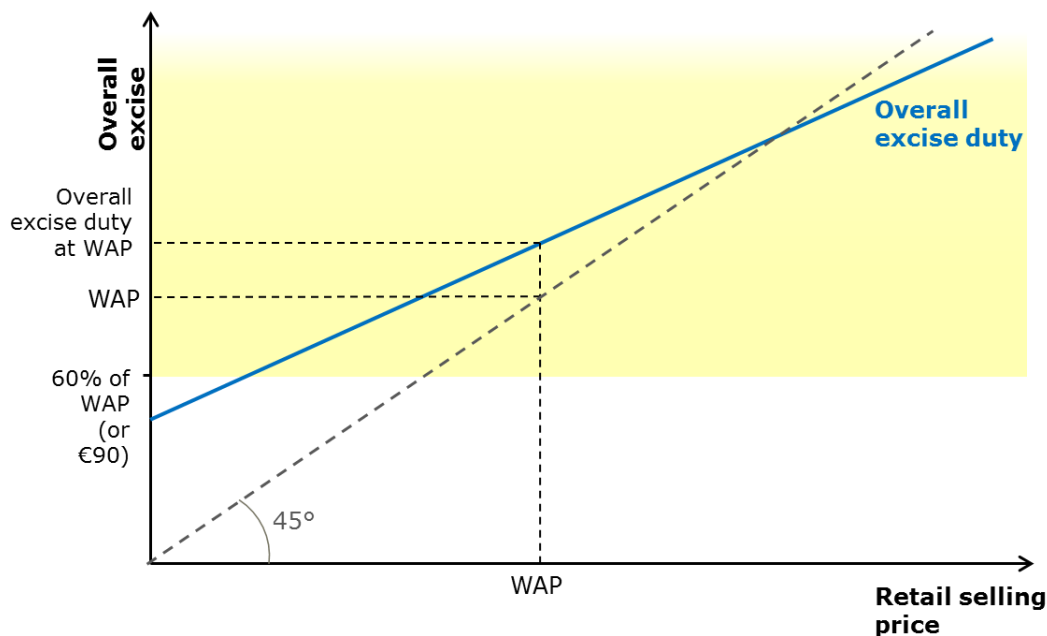
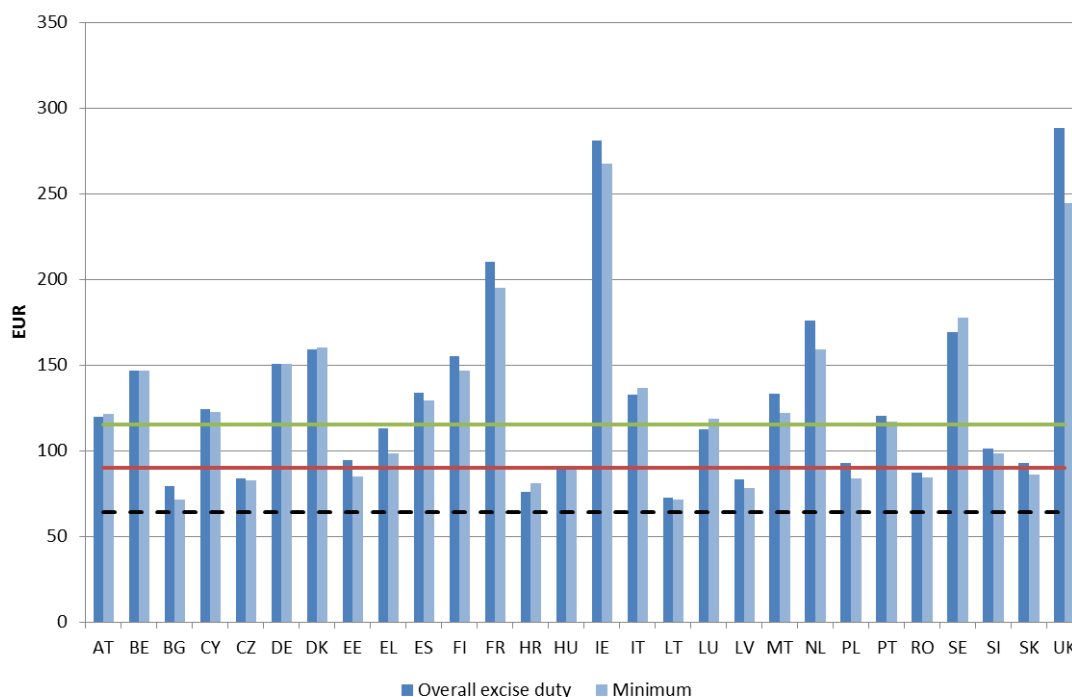


Figure 63, below depicts the situation in the different Member States as of 1 January 2014. All the countries for which the dark blue bar is lower than the horizontal red line are currently not compliant with the provisions of the Directive. The main reason for this misalignment lies in the recent change in the minimum thresholds. If one takes the level in place until 31 December 2013, i.e. EUR 64 per 1 000 items, all countries were compliant. At the same time, as the WAP is calculated by DG TAXUD using data on the releases for consumption made in the preceding calendar year, the observation of minor non-compliance may simply reflect some inaccuracy in the estimated WAP for the relevant calendar year rather than, of necessity, a failure in Member State compliance.

¹⁴⁵ Until 1 January 2014 the two limits were set at respectively EUR 64 and EUR 101 per 1,000 items.

Figure 63 Overall excise duty as a share of the WAP, calculation at WAP



Manufactured tobacco other than cigarettes

A second set of provisions encompassing Articles 13 and 14 engage with tobacco products other than cigarettes. Differently from the case discussed above, Member States are not required to apply a mixed excise duty structure, in fact while this remains an option a purely ad valorem or specific component system are also possible. Similarly to the case of cigarettes, the ad valorem component is calculated on the basis of the maximum retail selling price, while the specific component can be expressed as a fixed amount per kilogram or, in the case of cigars and cigarillos, for a given number of items.

Cigars/Cigarillos

In the case of cigars and cigarillos, 25¹⁴⁶ countries opted for a pure system featuring either an ad valorem component (11) or a specific one (14). Only three countries (DE, DK and FR) have a mixed structure in place.

The specific component is calculated either as a fixed amount per kilogram (e.g. CY and LT) or per 1 000 items (e.g. BG, CZ, DE, DK, LV, MT, PL, SE, SK, RO, and HR). Its value ranges between EUR 14 (per 1 000 items) in DE and EUR 275.36 in the UK. As for the ad valorem component, rates are comprised between 1.47% in DE and 34% in EL of the tax included retail selling price (TIRSP). The information is summarized in Figure 64 and Figure 65.

The MED is used in 6 cases, while in Germany a dynamic total tax is applied. The latter is calculated, as in the case of cigarettes, as a fixed monetary amount per item (currently set at EUR 0.576) minus the VAT.

¹⁴⁶ Empty cells, "n/a"; "n.a."; "-"; etc. In the Excise Duty Tables have been interpreted as "0".

Figure 64 Specific component for cigars/cigarillos, per 1,000 items (or kg in CY and LT)

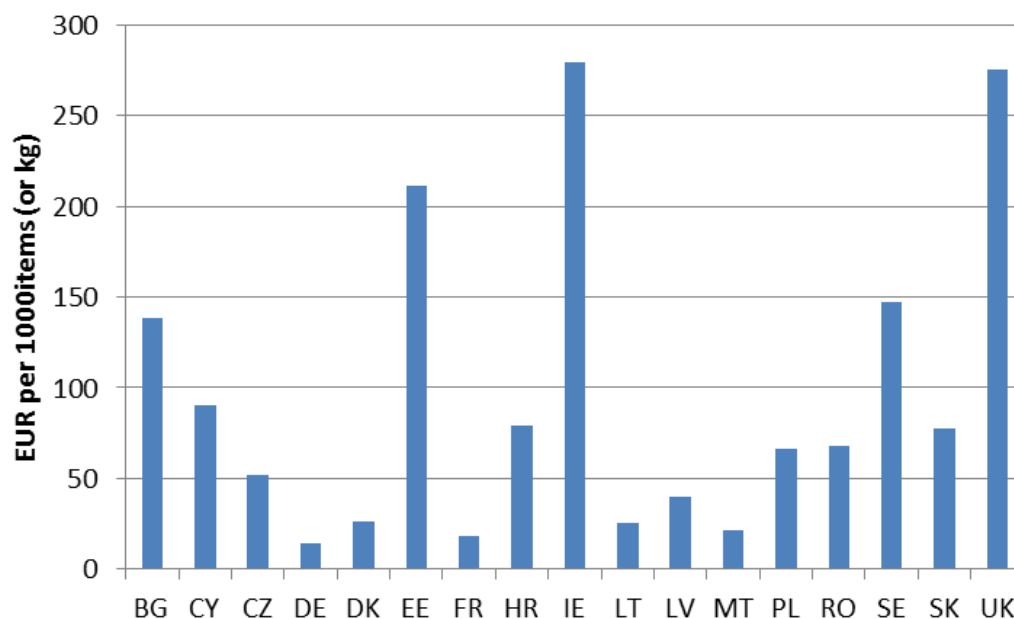
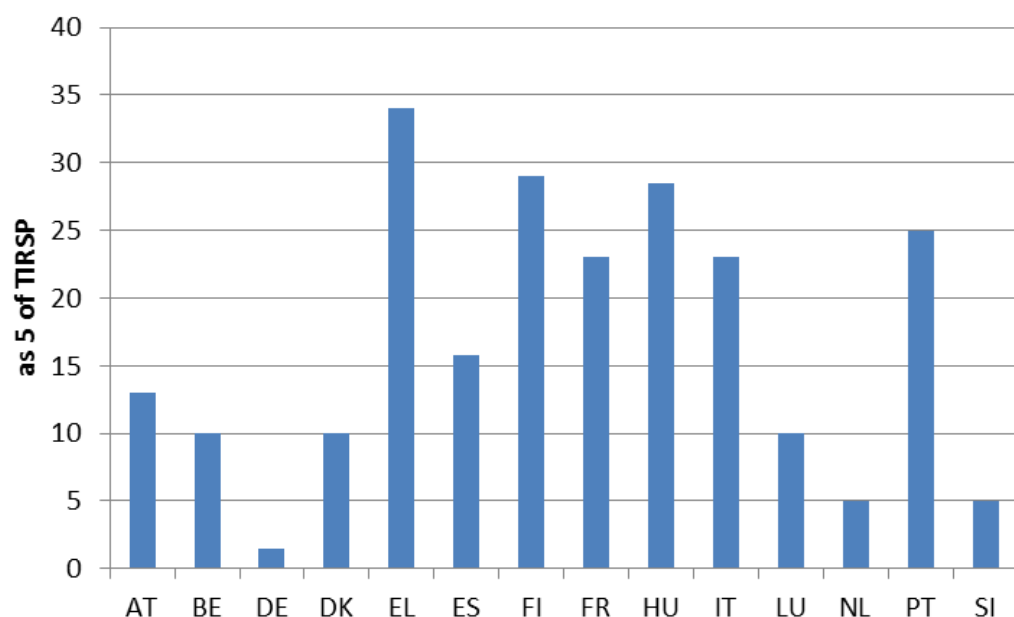


Figure 65 Ad valorem component for cigars/cigarillos, as % of TIRSP



Fine-cut tobacco for rolling of cigarettes

Fine-cut tobacco intended for the rolling of cigarettes is subject to: a mixed structure in 10 countries, a pure ad valorem structure in 3 cases (AT, HU, IT) and a pure specific structure in 13 Member States.¹⁴⁷ Compared to the case of cigars and cigarillos, it should be noted that the mixed excise duty structure is opted for by many more coun-

¹⁴⁷ The Excise duty tables do not report the information EE and EL. The previous version of the document showing the situation as at 1 July 2013 indicated that both EE and EL had a pure specific system in place.

tries thus bringing the treatment of fine-cut tobacco for the rolling of cigarettes closer to cigarettes as envisioned in the Directive.

The specific component, calculated as a fixed amount per kilogram of product, ranges between EUR 7.3 in LU per kilogram and EUR 252.22 per kilogram in IE. The rate of the ad valorem instead varies between 7.19% in NL and 58.5% in IT of the TIRSP. As many as 11 countries apply a MED, in addition to DE where the dynamic total tax is calculated as a fixed monetary amount per kilogram (currently EUR 91.63) minus the VAT. Figure 66 and Figure 67 illustrate the situation.

Figure 66 Specific component for fine-cut tobacco intended for the rolling of cigarettes, EUR per kg

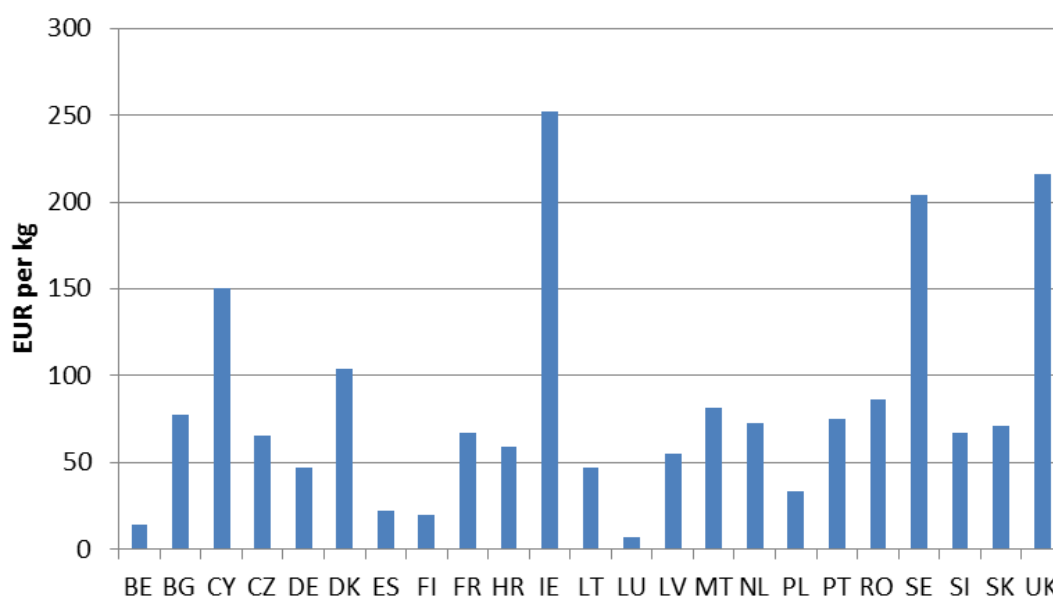
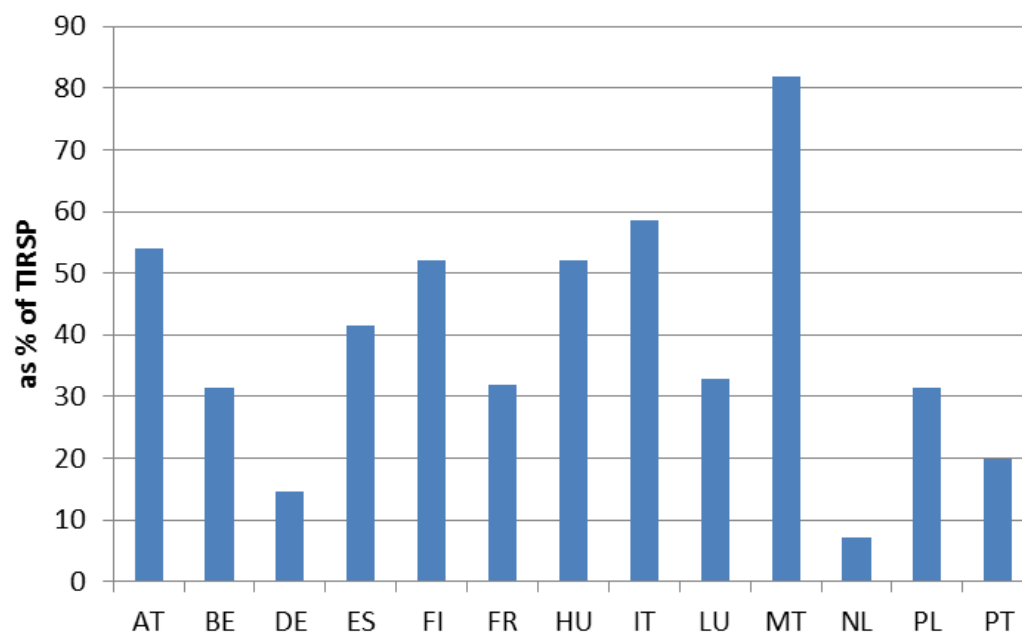


Figure 67 Ad valorem component for fine-cut tobacco intended for the rolling of cigarettes, as % of TIRSP

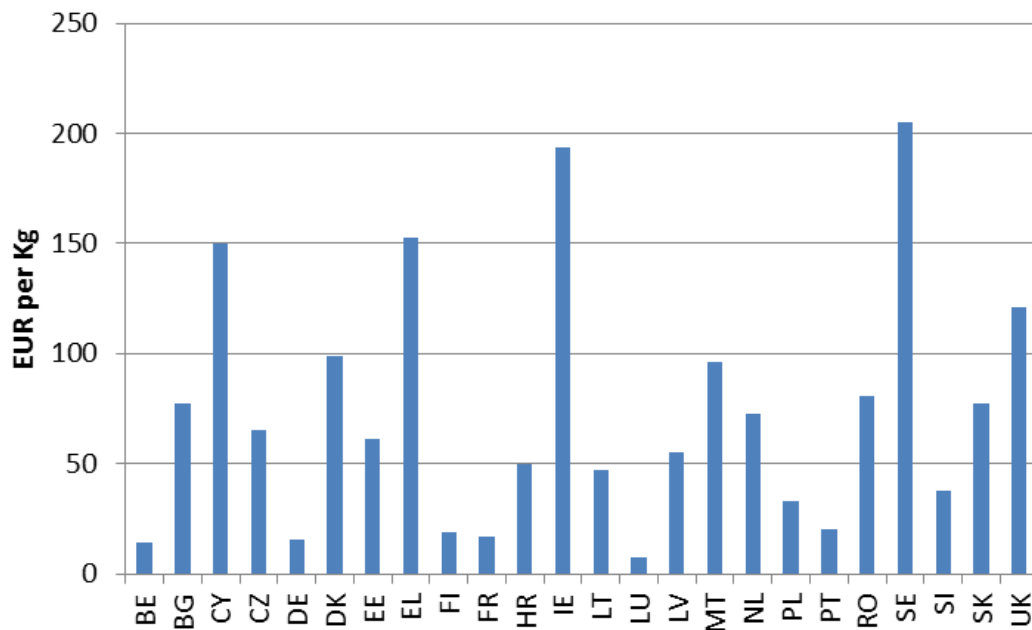


Other smoking tobacco

Finally, for products classified under the category “other smoking tobacco”, 16 countries use a pure specific structure, 6 only charge an ad valorem component, and 8 use a mixed structure. In 8 instances countries apply the MED to other smoking tobacco products.

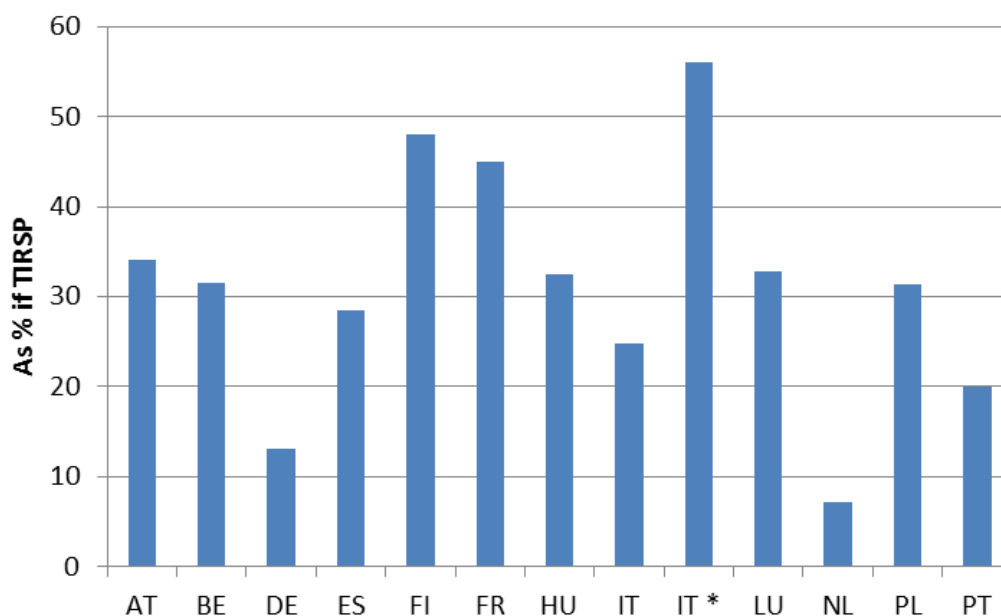
The specific component ranges between EUR 7.30 per kilogram in Luxembourg and EUR 204.41 per kilogram in Sweden, while the ad valorem rate takes values between 7.19% in NL and 56%¹⁴⁸ in Italy of the TIRSP. The information is summarized in Figure 68 and Figure 69

Figure 68 Specific component for other tobaccos, EUR per kg



¹⁴⁸ Only pipe tobacco. Other smoking tobaccos are levied a 24.78% ad valorem component.

Figure 69 Ad valorem component for other tobaccos, as % of TIRSP



*Refers to pipe tobacco

Summary

Our analysis of the structure of the excise duty on tobacco products across the EU provides the following key findings:

- Cigarettes:
 - Looking at the relative weight of the specific and ad valorem component, countries can be clustered into three groups: a large group where the structure is skewed towards the specific component; a second small group of countries where the two components are balanced; and a third group where there is a preference for the ad valorem component;
 - There is no straightforward relationship between the specific component and the MED such that, for instance, countries with high a specific component also charge a high MED. Four countries do not apply the MED;
 - Some countries appear to be non-compliant with the provisions of Article 10 of Directive 2011/64/EU on the overall excise duty. This might be the result of the recent change in the thresholds and of the fact that the calculations in the Excise Duty Tables are based on previous year data;
- Manufactured tobacco other than cigarettes: the situation is heterogeneous as no specific structure is mandated by the Directive. All three systems (pure specific, pure ad valorem and mixed) are present.

Q.1.2 What are the main features of the tobacco taxation collection systems?

This section describes general considerations about the taxation collection systems for tobacco products while highlighting and describing specific examples from Member States.

Questions	Indicators / Descriptors	Data sources
Q.1.2 What are the main features of the tobacco taxation collection systems?	Description of excise treatment and marking systems	Desk research, interviews with tax administrations, case studies

The main steps in the tobacco taxation collection systems, which will be described in the section below, are:

- Periodical reporting on the excise duty debt
- Refund of excise duties for damaged/returned/destroyed products
- Acquisition of the tax stamps
- Payment of excise duty

These steps closely mimic the logical sequence of events that authorities and economic operators must go through to respectively collect and pay excise duties on tobacco products. The exact sequence of events may differ between Member States and the description should therefore be regarded as the generic approach to excise duty collection.

Periodical reporting on the excise duty debt

According to Article 7 of Directive 2008/118/EC, excise duty shall become chargeable at the time, and in the Member State, of release for consumption.¹⁴⁹ Release for consumption means any of the following:

- The departure of excise goods from a duty suspension arrangement;
- The holding of excise goods outside a duty suspension arrangement where excise duty has not been levied pursuant to the applicable provisions of Community law and national legislation;
- The production of excise goods outside a duty suspension arrangement;
- The importation of excise goods unless the excise goods are placed, immediately upon importation, under a duty suspension arrangement.

Member States apply these definitions in overall the same way. The typical definition applied is that the duty point is when goods leave the duty suspension arrangement of the bonded warehouse. Some examples of the duty point are provided:

- The economic operator voluntarily releases the excise good for consumption through payment of excise duty (without the good leaving the tax warehouse (UK));
- The good is dispatched, i.e. removed to home consumption thus it leaves a duty suspension arrangement (UK);

¹⁴⁹ Art. 7 (1-3) in Council directive 2008/118/EC of 16 December 2008

- The goods leave the duty suspension arrangement for (DK - authorized warehouse keepers);
- Warehouse keepers' own consumption of excise goods (DK);
- When the goods are received from outside of Denmark (DK – consignees);
- When the goods depart from duty suspension (FI).

Periodical **reporting** on the amount of tobacco products released for consumption is done for a specific tax period during which the duty liability is accumulated. The tax period differs between Member States. In RO, DK, FI and PL, the tax period is a calendar month. In EL and the UK, returns on the products removed to home use must be submitted daily. UK operators can be granted a duty deferment agreement whereby reporting and payment are done over an accounting period, usually a calendar month.

Refund of excise duties for damaged/returned/destroyed products

According to Article 11 of Directive 2008/118/EC, excise duty on excise goods which have been released for consumption may, at the request of a person concerned, be **reimbursed or remitted** by the competent authorities of the Member State where those goods were released for consumption in the situations fixed by the Member States and in accordance with the conditions that Member States lay down for the purpose of preventing any possible evasion or abuse.

Generally, refund of excise duties is potentially possible if the goods are unused, damaged, unsold or destroyed. Different rules apply in the Member States. As an example, in Austria a refund is possible in all cases, whereas in Bulgaria a refund is only possible if the products are unused or damaged.¹⁵⁰

Destruction of excise goods released for consumption is either done by the economic operators or by the competent authority. In the case of Greece, a third party destructor, who must be paid, handles destruction. In DK, RO and the UK, the products are destroyed by the economic operators under the supervision of the competent authority. However, in DK and the UK, the competent authorities are merely notified of the time and place of destruction to have the option of attending.

Tax markings

Article 39 of Directive 2008/118/EC provides that Member States may require that excisable tobacco products carry **tax markings or national identification marks** used for fiscal purposes at the time when the products are released for consumption in their territory.¹⁵¹ Member States are free to decide whether and to which excise products to apply such a system. The fiscal marks are proof that excise duty is paid and is therefore a mean to prevent illegal trade. A fiscal mark may also be called a tobacco stamp, a tax stamp, an excise stamp, a tax sticker or a banderol. The name holds no indication on the characteristics of the mark.

Scope of the marking system

Fiscal marks are applied, at least for some tobacco products, by most Member States. For cigarettes all Member States besides AT, CY, FI and SE apply fiscal marks for cigarettes.¹⁵² An equivalent overview for other tobacco products has not been available.

¹⁵⁰ Overview of tax markings within Member States provided by CECCM

¹⁵¹ Art. 39 (1) in Council directive 2008/118/EC of 16 December 2008

¹⁵² Overview of tax markings within Member States provided by CECCM

Some examples of Member State differences can be highlighted. In EL, RO and PL fiscal marks are used for all tobacco category types (cigarettes, cigars/ cigarillos, fine cut tobacco and other smoking tobacco). In the UK fiscal marks are only applied on cigarettes and fine cut tobacco (intended for hand rolling). In DK, fiscal marks are applied on cigarettes, fine cut tobacco and other smoking tobacco.

Features of tax markings

A fiscal mark is typically self-adhesive, and is therefore attached directly to the products (which is the case for EL, RO, PL and DK), or they may be printed directly on the tobacco products' packaging with ink (which is the case for the UK and Spain).

Characteristics of fiscal marks differ widely across Member States and therefore it is not possible to describe a "standard" for fiscal marks at the EU level. However, an overall distinction can be made between fiscal marks according to their features and the **level of information** that they provide. A tentative classification based on whether the economic operator responsible for production/ importation can be identified based on fiscal mark has been made. The results are reported in Table 28 below. Typically, fiscal marks which allow for a high degree of identification and tracking of the product will as a minimum contain information about the economic operator.

Table 28 Overview of fiscal mark features

Type of fiscal marks	Member State examples	Information reported on the fiscal mark (at least one is present)
No possibility to identify economic operator	<ul style="list-style-type: none"> ▪ Bulgaria ▪ Czech Republic ▪ Greece ▪ Hungary ▪ Malta ▪ Poland ▪ Spain ▪ UK 	<ul style="list-style-type: none"> ▪ Product category (name or code) ▪ Retail price of pack ▪ Amount ▪ Name of country/ competent authority ▪ Year
Possible to identify economic operator	<ul style="list-style-type: none"> ▪ Belgium ▪ Estonia ▪ France ▪ Denmark ▪ Germany ▪ Ireland ▪ Italy ▪ Latvia ▪ Lithuania ▪ Luxembourg ▪ Slovakia ▪ Slovenia ▪ Romania 	(additional to the features above) <ul style="list-style-type: none"> ▪ Name or SEED number of the economic operator ▪ Serial number of product identifying product/ operator ▪ Barcode identifying product/ operator

Note: For the missing Member States, no information was available.

Source: Overview of tax markings within Member States provided by CECCM, case studies with selected Member States

In addition to the information and tracing features, fiscal marks also contain some **security features**. Examples include: watermarks, holograms, background aura, micro-text, temperature sensitive ink used on parts of the fiscal mark, design/ colour of the fiscal marks.

The features of the fiscal marks imply different possibilities to tracing the products and combating illicit trade. For instance, in LV consumers are given the possibility to get basic information about the product by using the serial number printed on the excise duty stamp: when inserted in a special internet site or sent by SMS to a dedicated number, information on the product can be obtained.

In Member States where fiscal marks have multiple security features, e.g. in EL, RO and PL, it is harder to counterfeit them. In Member States where security features are limited we would expect to see a larger extent of illegal trade. Still, in DK, where the fiscal mark contains limited security features, there have not been any known issues with forging of fiscal marks. In the UK, the fiscal mark can easily be forged as the specifications of the fiscal mark (font, size, etc.) are publicly available information. However, according to the competent authority, fiscal marking represents one among several security measures for safeguarding the financial interests of the state and is mainly aimed at preventing (licit) non-UK marked products to be systematically brought into the UK without paying the duty.

Acquisition of tax markings

Self-adhesive fiscal marks are typically supplied by the competent authority to the economic operator who attaches the fiscal marks to the products at a pre-determined stage in the production process. The acquisition of fiscal marks is done through a series of steps which can be summarized to the following:

- The economic operator applies for fiscal marks from the competent authority;
- The competent authority approves and sends the request to a security approved printing house (which may be internally or externally located);
- The printing house fabricates the fiscal marks;
- The economic operator receives the fiscal marks by delivery or collects the fiscal marks at the printing house.

When the fiscal mark is printed on the pack of the tobacco products, such as in the UK, the economic operator is responsible for ensuring that the correct mark is on the products. A manufacturer or importer dealing in unmarked tobacco products beyond the specified approved purposes (e.g. removal to other registered premises, exportation, destruction or other disposal) is liable to civil penalty and the product is liable to forfeiture.

National rules and regulation apply to the application process for fiscal marks and therefore, the overall process may vary from Member State to Member State. In some Member States, a financial guarantee is needed to obtain fiscal marks, unless paid for at the time of collection. This is the case in BE, BG, CY, DK, EE, EL, HU, IE, LU, PT and SE. It differs whether this guarantee should be set separately or as part of the guarantee for excise duties.¹⁵³

Also, the rules on the storing of fiscal marks are nationally defined, however as the fiscal marks have economic value, they will usually be stored in a safe area. In DK, RO and PL, there are no specific rules on storing the fiscal marks.

¹⁵³ Overview of tax markings within Member States provided by CECCM

Obtaining fiscal marks may or may not come at a cost for the economic operator. In EL and RO, a small fee per fiscal mark is paid, however this fee is subtracted from the excise duty payable. In DK, the fiscal marks are free of charge to the economic operators if supplied in uncut and non-adhesive sheets of paper. If cut into single pieces, printed on self-adhesive paper etc., the fiscal marks come at a minor cost.

Fiscal marks which are unused or damaged/ destroyed with the products are refundable so that the excise duty represented by the fiscal mark is no longer liable in some Member States. In all of the case study countries, it is possible to get a refund of fiscal marks. The overall process is as follows:

- The economic operator applies for refund of the fiscal marks (documentation requirements vary).
- Unused fiscal marks are returned to the authority for destruction
- Products containing fiscal marks are destroyed upon the approval of the authority and following the nationally established protocol.

In DK, where excise duty is paid through payment of fiscal marks, return of fiscal marks entail refunds of the excise duty initially paid for the fiscal marks.

The system of fiscal marks clearly implies costs for the economic operators in terms of requesting, obtaining, applying and potentially destroying the fiscal marks. However, their use brings some benefits in terms of safeguarding the budgetary interests of the state and to a lesser extent of limiting illegal trade. The size of these benefits depends on the features of the fiscal marks. If the fiscal marks are easily forged or can only be traced to a limited extent, as is the case in DK and the UK, the effects of the fiscal mark in terms of combating illegal trade are limited.

Payment of excise duty

When **excise duties become payable**, a system of forms is used through which the economic operators declare and pay excise duty. The system may either be electronic or paper-based. In DK, operators must use the tax administration's online system, TAST-SELV, to declare excise duties for a tax period. The system allows for automatic payment to the authorities through the online payment system NETS (only for cigars/cigarillos as payment of excise duties for other tobacco products are done through payment of fiscal marks).

In the UK, an XML-based tool called Alcohol and Tobacco Warehousing Declarations (ATWD) is used for the exchange of periodical reporting between tax administrations and economic operators. In case of larger manufacturers, ad hoc channels of communication are set up.

Payment of excise duty is either done at the duty point or after a credit term. A specific example is found in DK, as the payment of excise duties is done after the acquisition of fiscal marks. Sometimes a credit term applies. Examples have been identified of credit terms up to 2 months and 15 days, if the economic operator has provided a financial guarantee for the excise duty payable. In the UK economic operators benefitting from a duty deferment agreement settle the duty debt on a monthly basis and the credit term is 15 days from the end of the accounting period, i.e. within the 15th day of the following month. In EL the credit term is set at 26 days from the date of the release for consumption, while in RO the debt must be settled before the 25th of the month following the release for consumption.

Summary

Our analysis of the features of the different tobacco taxation collection system highlighted that:

- Member States overall apply the same definition of the duty trigger point, e.g. when the excise good becomes “chargeable” for payment;
- Periodical reporting of the amount of tobacco products released for consumption is done for a specific tax period during which the duty liability is accumulated: this can vary between 1 day and 1 month;
- Destruction of excise goods released for consumption is either done by the economic operators or by the competent authority;
- There is substantial cross-country variability on the issue of fiscal markings in terms of: scope of the system, technical features, modes of acquisition and reporting;
- When excise duties become payable, a system of forms is used through which the economic operators declare and pay excise duty. The system may either be electronic or paper-based.

Q.1.3 What licencing and authorisation apply to operators involved in the tobacco supply chain?

This section is aimed at mapping the current arrangements on licensing and authorisation of economic operators dealing in tobacco products with the aim of identifying relevant differences in terms of scope and requirements between Member States. The analysis distinguishes between products that are defined in the Directive and products that are not explicitly listed, namely raw tobacco and e-cigarettes.

Questions	Indicators / Descriptors	Data sources
<p>Q.1.3 Does licencing and authorisation apply to operators involved in the tobacco supply chain?</p> <ul style="list-style-type: none"> ▪ To whom and which products does it apply? ▪ What obligation does licencing imply (especially in terms of verification, identification, monitoring, stock management, tracking and tracing)? 	List of licencing and authorisation and related information obligations that apply in each MS	<p>Desk Research</p> <p>Survey to national tax authorities</p>

According to the results of the survey to economic operators, 70% of the respondents reported to be subject to some form of licencing and authorisation. As for the kinds of products falling within the scope of the authorisation/licencing system, substantial differences between Member States exist. Indeed, as discussed in more detail in Question 2, Member States can decide to extend the scope of the excise regime to goods not explicitly mentioned in Directive 2011/64/EU. As an example, tobacco leaves are treated as excisable in PL (if sold to final consumers), whereas they are not treated as such in the majority of Member States.

For the time being, for the sake of clarity a rough distinction is worth making between products that are explicitly defined in the Directive and products which are not defined. As for the latter, the focus will be put on raw tobacco and e-cigarettes.

Products not defined in the Directive

As far as **raw tobacco** is concerned, in 15 countries this product is in free circulation meaning that it is not subject to any licencing or authorisation the reason being it is not regarded as an excisable product. In 9 countries some forms of authorisation or licencing is in place with a substantial variance in the scope of the licencing and the information an economic operator must submit.

A tentative categorisation of the systems distinguishes between:

- **Systems where none of the operators are subject to authorisation:** in such systems warehousekeepers authorised for manufacturing tobacco products are also allowed to receive raw tobacco. Usually the authorisation to manufacture tobacco products requires the economic operator to keep detailed records of the use of raw material, e.g. in a production account;
- **Systems where only one type of economic operator is subject to authorisation:** normally this would be either the tobacco grower (e.g. ES, BE, LI) or the warehousekeeper authorised for manufacturing tobacco products (e.g. DK, FI¹⁵⁴). In FI raw tobacco can be moved under duty suspension in the national territory provided it is under coverage of a commercial document. It is not uncommon that registries of tobacco growers are kept by the authorities responsible for agricultural policy, such as the Ministry of Agriculture (e.g. ES), however there are instances where licencing systems are specifically designed for excise duty purposes (e.g. LT, BE);
- **Systems where several economic operators are subject to authorisation:** these systems would usually imply that both the supplier of raw tobacco, i.e. the grower, and the purchaser (e.g. first processor, manufacturer) hold an authorisation. In NL, SK, HU, for instance, all operators willing to trade with it (growing, drying, fermenting, receiving, storing and dispatching) must register at customs office and notify the customs office of any movement. In SK, in addition the initial registration, traders are also required to keep records of tobacco raw material (received, dispatched). In HR growers are issued a licence on the basis of a contract with the registered company which processes raw tobacco (the operator must be registered in the Register of Tobacco Processors with the Ministry of Agriculture).

In some countries (e.g. NL, PL, RO) transported raw tobacco must be accompanied by a document that provides information about the origin of the movement and the destination.

In CY, EL, RO and PL raw tobacco can only be traded between authorised operators. In CY trade can only occur between operators holding a licence for trading in native tobacco in premises authorised as "native tobacco warehouses".¹⁵⁵ Similarly, in RO raw tobacco or partially processed tobacco can only be sold to authorised warehouse keepers. In PL, as raw tobacco is considered as excisable, a duty suspension arrangement is granted only if raw tobacco is traded between an operator running a tax warehouse, a tobacco sale intermediary and a grower and it is marked and packaged in close boxes. In EL have to conclude contracts with first processors of raw tobacco which, in turn, have to be registered in the unified register for traders of agricultural products kept by the Ministry of Agriculture.

¹⁵⁴ Authorised warehousekeepers and registered consignee can deal in raw tobacco as part of their licence. The category of "raw tobacco importer" exists on paper, however in practice no such operator exists.

¹⁵⁵ This is a theoretical issue as no growers exist in CY.

Some of the countries where there is no system of authorisation for dealing in raw tobacco are considering introducing tighter controls of the supply chain. This is mainly due to the rise in the size of illicit trade.

With respect to **e-cigarettes**, at present they are not subject to excise duties in all but one Member State. Where they are treated as a medicinal product, such as in CZ, DK, SE and (if containing nicotine) in EE, they require an approval and can only be sold in pharmacies. In these cases the competence belongs to the Ministry for Health. Interestingly, in Greece, the production and trade of e-cigarettes may only be done “*subject to licensing by the Ministry of Health*”, the lack of methodological rules applicable for obtaining authorisation implies that no operators have been able to apply for licenses. As a result, all e-cigarettes sold on the Greek market lack the appropriate license. In IT, a recent change in the law,¹⁵⁶ determined that e-cigarettes (and each of their components) should be treated as a surrogate tobacco product (“*prodotto succedaneo dei prodotti da fumo*”) and should be levied a consumption tax of 58.5% of the retail selling price. Economic operators dealing in such products must obtain an authorisation by the Agency for Customs and State Monopolies. The requirements are the same as those imposed on warehouse keepers.

Products explicitly defined in the Directive

As made clear in Directive 2008/118/EC, **establishing** a system **of authorisation** where economic operators involved in the supply chain of tobacco products are subject to authorization by the competent authorities is instrumental in monitoring and facilitating the collection of tax revenue.¹⁵⁷ The same Directive lays down the basic principles and the minimum requirements applicable to all Member States for setting up a system of authorisation.

The scope of the provisions laid down in the Directive in terms of tobacco products subject to excise duty is defined by other Directives as specified in Article 1. In the case of tobacco products, the definitions of the exact categories were laid down in Directives 95/59/EC, 92/79/EEC and 92/80/EEC, which have been then replaced by Directive 2011/64/EU. The latter serves as the reference point.

As far as the types of economic operators subject to authorisation, a minimum set is defined in Article 4 of Directive 2008/118/EC. The definitions are reported in Table 29 below.

Table 29 Legal definition of economic operators, from an excise duty point of view

Legal definition of economic operators	Definition
Warehouse keeper	A natural or legal person authorised by the competent authorities to produce, process, hold, receive or dispatch excise goods under a duty suspension arrangement in a tax warehouse
Tax warehouse	A place where excise goods are produced, processed, held, received or dispatched under duty suspension arrangements by an authorised warehouse keeper
Registered Consignee	A natural or legal person authorised by the competent authorities to receive excise goods moving under duty suspension arrangement from another Member State
Registered Consignor	A natural or legal person authorised by the competent authorities to only dispatch excise goods under a duty suspension arrangement upon their release

¹⁵⁶ Legislative Decree n.76 28 June 2013

¹⁵⁷ Paragraphs 15 and 16 of the preamble to Directive 2008/118/EC

Legal definition of economic operators	Definition
	for consumption
Temporary registered consignee¹⁵⁸	For a registered consignee receiving excise goods only occasionally, the authorisation referred to in Article 4(9) of Council Directive 2008/118/EC shall be limited to a specified quantity of excise goods, a single consignor and a specified period of time. Member States may limit the authorisation to a single movement.

Source: Directive 2008/118/EC Art.4 and Art.19 (3)

In general, Member States have built on this minimum framework by broadening the scope (in terms of products and types of economic operators) of the authorisation regime and by adding more specific provisions on the procedures and obligations each authorisation entails. Table 30, below provides an overview of the typologies of economic operators which need an authorisation but which are not explicitly mentioned in Directive 2008/118/EC.

Table 30 Categories of economic operators not defined in Directive 2008/118/EC

Type of economic operator	Activities that can be performed within the scope of the licence	Examples of country
Tobacco retailer	Retail sale of tobacco products.	ES, IT, FI, EL, UK (Scotland)
Duty representative	Legal or natural person responsible authorised to act as an agent for non-domestic based operators	DK, UK
Owner of excise goods	A person who has been authorised and registered to deposit their duty-suspended goods in an excise warehouse	UK
Registered Commercial Importer	Import duty-paid excise goods	RO, UK

As a consequence, provisions vary a great deal between countries and types of economic operators. While it is impossible to provide a complete mapping of all the activities, a high level analysis has been conducted in a systematic manner in the case study countries through desk research and interviews. Some information is also available for a broader set of Member States.

For a purpose of clarity, activities and obligations have been grouped into two broad categories, i.e. those aimed at gaining an authorisation for the first time and those related to the conduction of the business once the authorisation has been granted.

Gaining an authorisation

At a general level, the activities carried out in this phase are aimed at verifying that the business is **genuine** and that the economic operator has the (technical, operational, financial) **ability** to deal in excise goods. In all cases it is the responsibility of the economic operator to initiate the process of requesting an authorisation by contacting the relevant authorities. In some countries, such as Italy and Spain, tax administrations would have local offices dealing with different phases of the monitoring and collection of excise duties, including authorisations.

In the case of **warehouse keepers**, information to be provided by the economic operator to the satisfaction of the tax authority would include:

¹⁵⁸ Article 19(3) Council Directive 2008/118/EC

- information on the company (e.g. legal form, place of business, business plan, financial viability);
- information on the relevant people in the company (e.g. criminal records of the administrators);
- description of the premises where the activity would take place (e.g. blue-prints, security arrangements and proof of ownership and/or rental of the premises, description of the types of activities to be performed, the types of tobacco goods that will be dealt in, the record keeping system);
- (in some cases) economic need underlying the request.

The vetting of the request in most of the cases entails **on-site visits of the premises** to check the correspondence of the declared information in the documents. This is not the case in DK, where premises are not inspected in this phase, so as not to overburden the economic operator and delay the approval. Additionally, financial securities shall be provided to cover for potential losses in the running of the business. The size of the latter is related to the outcomes of a risk assessment and to the average size of the stocks. In some countries the quantification of the guarantee may take up to 4 months, thus the tax authority would usually require a minimum security in order to prevent delays.

As for the typology of the **consignor** and the **consignee**, information requirements are generally less stringent than in the case of warehouse keepers. In addition to providing information on the business to verify the compliance with the legal, financial and technical requirements, operators seeking to become registered as consignors/consignees would need to demonstrate their ability to keep records and would be requested to provide a financial security. The same holds for a temporary registered consignee. It is possible for the same operator to hold multiple licences: this is often the case of larger manufacturers which would normally act as authorised warehouse keepers, consignees and consignors.

The whole process of granting a licence by its very nature entails a significant degree of **interaction between the tax authority and the economic operator**. For this reason, some countries set up dedicated units, as is the case in the UK, where the National Registration Unit acts as the single contact point for the matter of authorisation. Failure to comply with one or more requirements need to lead to a definitive refusal of the application, in fact recommendations can be issued on how to address the most problematic aspects.

When the tax administration judges the applicant to fulfil the requirements, a new entry is created on the European register of operators (**SEED**¹⁵⁹), an EU-wide database currently integrated into the EMCS where information on economic operators authorised to deal in duty-suspended goods are stored and automatically matched. Since 2009, any economic operator established in the EU also needs to have an **EORI** number,¹⁶⁰ which enables the identification of economic operators within the entire EU customs territory and has become mandatory for all engaged in import or export of goods, transit transportations or when performing other customs related activities.¹⁶¹

In countries like IT and ES, where the sale of tobacco products is a state monopoly, and in a few other countries such as DK, EL and FI, actors further down the supply chain, such as **wholesalers and retailers**, are also required to hold a licence to deal

¹⁵⁹ System for the Exchange of Excise Data (SEED)

¹⁶⁰ Economic Operators Registration and Identification number (EORI)

¹⁶¹ http://ec.europa.eu/ecip/security_amendment/who_is_concerned/index_en.htm

in tobacco products. In Spain, the production intended for the national market must be sold to the authorized distributors (which in turn will supply it to the network of retailers).

Not only economic operators must be registered, but also **premises** where production/holding is carried out must be duly authorized. The process resembles the one warehouse keepers must undertake. A pre-approval on-site visit is envisioned in order to verify that the premises are secure and suitable for the purpose and to assess potential risks to the revenue. There exist different types of authorised premises across Member States depending on the types of activities carried out (e.g. manufacturing/storing) and the excise duty status of the products (e.g. duty suspended/duty-paid). In Cyprus excise warehouses can be classified into three categories: general tax warehouses, where it is possible to receive, hold and dispatch commodities owned by more than one authorized warehouse keepers; private tax warehouses, owned by a single authorised warehouse keeper; and special tax warehouses which can be further distinguished in tax free shops and other premises to cover special activities.

Typologies of authorised premises in the UK

In the UK, for instance, a premise might be authorised as:

- a registered factory where tobacco can be manufactured and final products can be stored in duty-suspension for up to 24 hours;
- a registered store where UK-manufactured goods intended for the home market, for export or duty free can be stored in duty suspension;
- an excise warehouse where UK-manufactured goods intended for export or duty free can be hold in duty suspension; and
- a customs warehouse where imported products are hold.

The same area of an authorized premise cannot be a registered store and an excise warehouse, while both of them can be at a time a customs warehouse. Registered store can only be applied for by manufacturers, whilst warehouse keepers not authorised for the manufacturing of tobacco goods can only apply for registering their premises as an "excise warehouse" (and a "customs warehouse" when trading with third countries). In the case when an economic operator trades with EU countries, the facility is also authorised as a "tax warehouse". For all new approvals an initial maximum period of 12 months is granted during which checks can be carried out.

As far as the **scope** of the licence is concerned, in some instances authorisations come with a **time** limit. In some countries (e.g. FI) newly registered operators might be granted an initial temporary authorisation during which the tax administration may conduct frequent checks. This is the case, among others, for warehouse keepers in RO where licences need to be renewed every 3 years. In other cases, such as in EL and FI, an authorisation is valid as long as the operator complies with the requirements, unless otherwise specified the approval agreement. In any case, whenever a change occurs, the tax administration should be duly informed and the authorisation is amended.

In the case of Temporary Registered Consignee, the provisions of the Directive leave substantial room for national administrations to decide on the scope of the authorisation. In some countries (e.g. RO, DK) the registration is valid for either a given period, a given quantity of shipment or shipment from a specific manufacturer or a combina-

tion, while in the UK an authorisation known as Temporary Consignment Authorisation (TCA) must be obtained on a consignment-by-consignment basis.

In terms of the **types of products** a licence authorises to deal in, again provisions differ between countries. Once an authorization is granted, any kind of tobacco product allowed by the UK law can be dealt in by a UK-registered economic operator. In contrast, in DK, RO and FI the approval agreement specifies the product categories.

Authorisations usually feature a high degree of **customisation** also where **allowed activities** are concerned. For instance, certain operators might be authorised to conduct certain activities (e.g. bulk breaking, repackaging), while others would not. For instance, in the UK, the agreement between the tax administration and the economic operators defines what "bulk breaking" should be done, the premises where it should take place, as well as how it should be done. The same holds for the procedure to be followed when removing goods for tests and when returned products are to be destroyed.

After obtaining the authorisation

Even though Directive 2008/118/EC provides a (high-level) description of the requirements and obligations for different types of economic operators, procedures are far from being harmonized across the EU. Indeed, as explained in the previous section with reference to obtaining an authorisation, Member States have adopted **specific arrangements** that are a better fit for the specificities of the national market and the overall functioning of the administration.¹⁶²

At a general level, the manufacturing, storing and movement of tobacco products must be properly accounted for by means of an adequate **record keeping system**. At any time it should be possible for the tax administration to calculate the amount of excise debt and verify the excise status of each product. In the UK, for example, all excise goods must be marked so that they can be identified in the stock accounts in a univocal manner from their arrival to their removal from the duty suspension. Warehouse keepers are requested to take the stock of all excise goods in the warehouse once or twice a year, while periodical returns must be compiled for the calculation of the excise debt. These are to be filed to the tax administration at pre-defined dates: daily (as in the UK, unless an economic operator benefits from a duty deferment agreement whereby reporting is made monthly), monthly, or quarterly (as in Denmark). **Manufacturers** are obliged to keep control of all incoming raw tobacco, of all partly finished tobacco used in production, of all disposed tobacco and of stock of finished tobacco goods, so that the input volume of raw tobacco can be matched with the output finished tobacco products.

As for the **movement of tobacco products**, since 2011 the **EMCS** has replaced the paper document that previously accompanied excise goods moving under duty suspension. Movements to approved premises in the EU now require an electronic declaration (**e-AD**) to be made and accepted by the EMCS system, which also generates a unique code known as Administrative Reference Code (ARC).

¹⁶² A detailed description of the activities carried out by both tax administrations and economic operators is provided Question 4

Obligations under for the movement of excise goods under duty suspension arrangement

The EMCS is a platform on which all movements of excise goods under a duty suspension arrangement must be recorded. The consignor must prepare the e-AD and submit it to the national administration in the Member State of departure. The consignor cannot start the dispatch before the date stated in the e-AD and before a validated e-AD and an ARC has been returned to the consignor. When the goods arrive, the registered consignee is required to generate a **report of receipt** and submit it to the Member State of destination within five days. Movements under duty suspension shall occur under the cover of a financial guarantee and must be recorded in the EMCS.

Goods already released for consumption (duty paid), do not move under EMCS procedures. Instead, economic operators are obligated to have goods accompanied by a **SAAD**¹⁶³ in cross-border movements.¹⁶⁴

Different provisions apply to other types of economic operators. For instance, given the non-continued nature of the business in tobacco products, Temporary Registered Consignees are usually required to undertake additional steps when moving tobacco products. These can range from applying for a separate authorisation for each shipment (as in the UK), to providing notification of the movement prior to its commencement (as in DK), to paying the excise duty in advance. At the same time, this type of operators only needs to keep records of product delivery.

Summary

Our analysis of the architecture of the authorization and licencing systems across the EU provides the following key findings:

- There exists a significant degree of customisation in the design of licencing systems across the EU: Member States have usually built on the provisions laid down in the relevant EU law and then adapted it to the specificities of their markets;
- Systems differ under a variety of aspects ranging from scope (products and economic operators) to the sequence of activities to be undertaken;
- Heterogeneity is particularly high in the case of tobacco products not explicitly defined in Directive 2011/64/EU;
- Warehouse keepers are generally regarded as a key economic operator to which particular attention is paid in terms of thoroughness and frequency of the controls performed when issuing a licence.

Q1.4 What are the processes / activities performed by Member States authorities to ensure the collection of tax revenue (e.g. in terms of monitoring, tax assessment, collection, authentication and verification, auditing, etc.)?

This section provides a mapping of the processes/activities performed by Member States' authorities to ensure the collection of tax revenues. When possible, high level descriptions of the different steps involved in each activity are provided together with concrete examples from Member States.

¹⁶³ Simplified Accompanying Administrative Document (SAAD)

¹⁶⁴ Commission Regulation (EEC) No 3649/92 of 17 December 1992

Questions	Indicators / Descriptors	Data sources
Q1.4 What are the processes / activities performed by Member States authorities to ensure the collection of tax revenue (e.g. in terms of monitoring, tax assessment, collection, authentication and verification, auditing, etc.)?	List of processes / activities / functions performed by MS authorities to ensure the collection of tax revenue	Desk research (for a selected number of MS only, depending on language availability) Survey to national tax authorities

The activities carried out by Member States authorities to secure the collection of tax revenues cover the **whole value chain** of tobacco products.

Authorisation

The first step is represented by the **authorisation**. In all countries a licencing/authorisation system is in place and serves the aims of (i) distinguishing genuine businesses from fraudulent activities and (ii) providing the tax administration with intelligence on the risk profile of the different actors involved in the value chain. As already explained, the information provided during registration should allow the administration to get a full picture of the legal, financial, business situation of the operator. In ES and PT, for example, a warehouse keeper authorized for production must submit a detailed description of the production plant (including machines and processes) and communicate the yields deriving from the quantity of raw materials used in the production process. This represents the basis for identifying possible differences in the volume of the final output. At the same time, the ability to **keep the commercial records** (either in manual or electronic form) of the excise goods received, stored and removed is regarded as a pre-requisite for gaining the necessary authorisation for many of the typologies of operators. Such an arrangement represents a first defence against possible threats to the budgetary interests of the state. In some countries licenses are subject to time limits, thus they need to be periodically renewed. In other instances, periodic controls are carried out with the aim of verifying the continued compliance with the requirements by the authorized economic operator. In both cases the aim is to have an updated picture of the situation.

Record keeping and reporting

As the production of any tobacco product starts with the availability of the raw materials, in some Member States the monitoring of the logistics of tobacco products starts at the stage of cultivation/import of **raw tobacco**. As pointed out before, in the majority of countries it is in free circulation, thus economic operators trading in raw tobacco are not subject to a specific licencing regime. The obligations in terms of authorisations and reporting vary a great deal between countries and range from providing a minimum set of information on the identity of the operator upon registration (as in HU with growers) to keeping detailed records (as in SK, RO and NL).

Monitoring the early stages of the tobacco value chain in SK and other countries

In Slovakia the flows of raw tobacco are closely monitored as traders are not only required to keep records of raw tobacco received and delivered but also to notify the customs office prior to any receipt of such raw tobacco material in the tax territory from another Member State, dispatch to another Member State, import from third countries or export to third countries. Information to be provided include: the operator's identification data, the quantity, brand name and the respective code of the combined nomenclature of raw tobacco, identification data of the supplier or purchaser of tobacco raw material, identification data of a person to/from whom it sells/purchases tobacco raw material, and the place of delivery of tobacco raw material.

Similarly, in Romania, the Netherland and Finland raw tobacco can only move under the cover of a commercial accompanying document. In Cyprus although raw tobacco is not subject to excise duties, it must be placed in an authorised customs warehouse or tax warehouse upon importation or entry into the territory.

At a more advanced stage of the value chain, warehouse keepers represent a critical node, thus their operations are usually kept under tight control. Virtually all interviewed countries reported that they exert controls on warehouse keepers involved in the manufacturing and holding/storing of tobacco products. These controls entail the keeping of **detailed records** of all the tobacco products produced/stored/released for consumption/received/dispatched to a level of detail that allows for the correct calculation of the excise duty debt at each point in time. For these reasons, warehouse keepers are required to keep copies of the document accompanying the goods, e.g. delivery notes, EMCS clearances, importation documents. In general records encompass a minimum set of information including: date, type of tobacco product, the brand, the size of retail pack, the description of the goods, the duty status, the current location within the warehouse, the name/address/VAT registration number of the owner. The ability of the record keeping system to live up to certain minimum standards, i.e. to include a minimum set of information, is assessed as part of the controls performed when issuing the authorisation. Records must be kept for a number of years (e.g. 4 years in PT, 6 years in the UK and in MT, 7 years in CY, 10 years in EL) as they may be used by administrations when conducting audits, investigations and checks.

In addition to this, warehouse keepers are often requested to provide the national tax administration with **periodical reports** giving details of excise goods stored/released from the tax warehouse. The submission of these reports often coincides with the end of the accounting period which might or might not correspond to a calendar month. In SI, for instance, the customs authority is provided with monthly excise duty accounts and monthly stock lists. In some countries, the communication between the tax administration and the larger economic operators is simplified by creating **preferential channels of communication**. In the UK, the Large Business Service (LBS) within Her Majesty's Revenues and Customs (HMRC) acts as the single contact point for large businesses on any matter concerning taxation, whereas in IT, given that the distribution is dominated by one single firm, the tax administration is connected with the operator's IT systems in such a way that allows for getting real time data on the stocks of tobacco products in the different premises.

In the case of **manufacturers**, obligations in terms of record keeping and reporting are even more demanding. Operators are requested to keep appropriate records showing the quantities and description of all materials received, all materials used in each manufacturing batch, all materials disposed of, any refuse deriving from materials used, all refuse disposed of and all tobacco products in possession prior to the

commencement of the production. These documents should allow for a full reconciliation of the inputs and the outputs, an exercise which might be conducted by tax administrations periodically (as part of audits) or based on the results of risk assessment.

Thanks to the way in which the market is structured, in some countries controls can cover the whole value chain and reach out to the **retail level**. In Spain, where the sale of tobacco products represents a state monopoly whereby retailers act as authorized dealers on behalf of the state, the sale of cigarettes can only be performed through the use of machines which need to be registered. Similarly, in Hungary, retailers are requested to submit daily reports on the level and composition of their sale to enable the tax authority to monitor the consumption patterns.

Fiscal markings

As pointed out in Q.1.2, fiscal markings, in addition to serving as proof for the payment of excise duties, might well serve the aim of securing the collection of tax revenues. Indeed, in those instances where economic operators must request the stamps from the tax administration, checks on the stocks of stamps provide an additional security measure against tax evasion. In PT and HU, an economic operator willing to get tax stamps needs to file an on-line request: in this way real-time data on the number of tax stamps available to each operator is available to the tax authority.

Financial securities

Additionally, tax administration in order to secure the payment of the duty debt require economic operators to provide **financial security** (e.g. in the form of a guarantee or a promissory note) to cover possible losses. These guarantees are usually calculated on the basis of the average periodical size of the stocks and of a risk assessment of potential excise duty loss. Sometimes, a single guarantee can be valid for a variety of premises belonging to the same operator. This type of guarantee is additional to the one that must be provided when tobacco products move under a duty suspension arrangement.

Physical inspections and checks

Physical inspections and **audit-based checks** are performed either on a regular basis, based on risk assessments or randomly. In DK, for instance, the monitoring is conducted following a categorization of economic operators based on track record of compliance with excise duty law. This kind of checks are aimed at verifying the correctness of the reported figures by cross-checking the correspondence between the actual stocks of tobacco products and the supporting documentation; at assessing the compliance with the terms and conditions of the approval; and at evaluating the quality of the accounting systems in place.

Not only do tax administrations perform controls in the premises where tobacco products are manufactured and stored, but checks are also carried out on vehicles and suspicious movements. In this case, the selection is made based on the results of risk assessments or randomly. The German tax administration reported that over 600,000 controls of vehicles involving some 900,000 people were conducted in 2012 alone.

Permanent controls at the manufacturer's premise in IT and CY

In IT and CY, government **officials are permanently stationed** at the manufacturer's premises to keep track of the movements (inflows/outflows/losses/destruction) of all the products/raw materials and calculate the amount of products (i.e. the excise duty debt) released for consumption.

Officials are responsible for keeping track of all the operations of production, storage, receipt and dispatch; for checking the quantity of the excise goods that flow through the plants and for inspecting trucks and wagons. The kind of controls performed encompass: (i) formal controls at the entry points of the facility to verify the accompanying document; (ii) substantial checks to verify that the characteristics of the goods are the same as those indicated in the documents; (iii) surveillance of the perimeter of the facility; (iv) during closing times, the government officials seal the entry points used by vehicles.

In IT, officials are hosted in separate, high-security rooms equipped with the necessary IT tools and structured in a way such that they have a complete control of all the areas of the facility. The warehouse keeper shall bear the costs related to provide the facilities and the equipment.

Summary

Our analysis of the activities performed by Member States to ensure the collection of tax provides the following key findings:

- Activities related to the defence of the budgetary interests of the state may cover the whole tobacco product value chain starting from tobacco growers;
- Activities can be grouped into 5 broad categories: authorisation, record keeping and reporting, fiscal markings, financial securities, and inspections and checks;
- The objective of an authorisation regime is twofold: to select economic operators; to maintain an updated overview of the actors involved in excise goods;
- The ability to keep records of tobacco products received/produced/dispatched/released for consumption is an important requirement when it comes to securing the payment of the excise duty debt. The level of detail as well as the frequency to which information must be reported to tax administration depends on the type of economic operator and may vary across the EU. It is greatest in the case of warehouse keepers.
- Data on the stocks and use of fiscal markings can be used to cross-check the record submitted by an operator and might be used to estimate excise revenues;
- Financial securities represent a buffer against potential losses in the conduction of an excise business;
- Physical checks and inspections are conducted either regularly, randomly or on the basis of a risk assessment.

Q1.5 What IT technologies are used by tax authorities to combat illicit trade and ensure the collection of tax revenue?

IT technologies play a pivotal role in supporting tax authorities in the fight against illicit trade. The increasing use of IT tools is unanimously pointed at as a means for ensure effective and efficient use of scarce resources such as time and human capital. The present section is dedicated to explore to what extent tax administrations throughout Europe make use of IT technologies. For the purpose of clarity, the issue of data availability is discussed before moving on to describing the IT systems currently in place for combating illicit trade. A separate subsection is dedicated to the discussion of tax marking systems and track and trace systems.

Questions	Indicators / Descriptors	Data sources
<p>Q1.5 Are IT technologies used by tax authorities to combat illicit trade and ensure the collection of tax revenue? How?</p> <ul style="list-style-type: none"> What marker types enable coding for improved collection of tax revenue (through verification, identification, monitoring, stock management, tracking and tracing)? 	Description of the use of IT technologies by MS authorities	Survey to national tax authorities

All tax administrations interviewed stated that their effort to curb illicit trade and safeguard the budgetary interests of the state is inherently a resource-consuming exercise. Given that resources are by definition scarce, the most widely employed tool for maximising the efficiency and the effectiveness of the controls is represented by **risk assessment**. Risk assessment can be defined as a composite set of activities aimed at identifying, evaluating and estimating the levels of risks involved in a process or situation and at determining an acceptable level of risk. In this context, IT technologies, i.e. hardware and software solutions, serve the aim to transform raw data into intelligence, i.e. usable information.

Data sources

Data sources in the context of excisable products can be broadly split into two categories: supranational-level databases and national-level databases.

At the supranational level, databases are compiled and made available to national tax administration by organisations such as the European Commission, the OLAF, and the World Customs Organisation for the aim of curbing illicit trade. A non-exhaustive list includes:

- The **Customs Enforcement Network** (CEN) system by the World Customs Organisation (WCO);
- The **Excise Movement and Control System** (EMCS) - a computerised system for monitoring the movements of excise goods under duty suspension arrangement. The platform includes other web-based applications such as the System for Exchange of Excise Data (SEED) a centralised database where information on traders who are approved to hold, move or receive goods under excise duty suspension is collected; the Early Warning System for Excise (EWSE) and the Movement Verification System (MVS). The latter allows for integrating the movement of duty-paid goods into EMCS. The platform further allows the sharing of control reports and interruption reports which result from physical control activities and the exchange of event, alert and rejection reports;

- The **Anti-Fraud Information System** (AFIS) by OLAF - a secure communication system which supports and facilitates the exchange of anti-fraud information among the relevant authorities of the Member States and between them and the Commission. AFIS encompasses a number of web-based applications such as the AFIS Mailing (structured & unstructured communications), the Customs Information System (CIS), the FIDE System, the Mutual Information System with the Russian Federation (MIS), the virtual-OCU supporting Joint Surveillance Operations and the WCO-CigInfo system for the exchange of data on seizures of smuggled cigarettes between the Member States and the World Customs Organisation.
- The **Customs Information System** (CIS) - a common computer network system consisting of a database which centralises customs information across Member States to help to prevent, investigate and prosecute breaches of Community customs or agricultural legislation by facilitating dissemination of information and cooperation of authorities across Member States in an effective manner. CIS also contains specific information on excise duties and the system can therefore be used by excise duty departments to exchange information pertinent to their work;
- The **FIDE** - an EU-wide database that contains information related to cases concerning excise products, and therefore also tobacco products. The database consists of files on persons and businesses that have been suspected of or found guilty of offences of Community customs legislation. The database is applied in connection with new investigations as it allows investigating authorities to identify whether a business or person is currently being investigated and has been investigated in the past;
- The **New Computerised Transit System** (NCTS) - an electronic system of declaration which provides fast and efficient processing of transit goods through computerization. The system specifically covers all customs duties, like excise duties and VAT. In addition, the system has enabled communication and coordination between the customs administration with the centralised access to data and faster data exchanges;
- The **Export Control System** (ECS) and the **Import Control System** (ICS), which represent EU-wide platform for the exchange of customs declarations between customs (office of export/import and office of exit/entrance) and economic operators for the fulfilment of the obligations related to importing and exporting goods into and out of the European Community.

EMCS

EMCS is a computerised system for monitoring the movements of excise goods under a duty suspension arrangement within the EU. It was introduced in April 2010 (Milestone a), when the paper-based Administrative Accompanying Documents (AADs) and related exchanges of information were gradually replaced with electronic Information Exchange (IE) messages from the consignor to the consignee via Member State administrations. Electronic filing of all EMCS messages became mandatory from 01/01/2011 (Milestone b), meaning the paper-based AADs lost their legal basis from this date.

The objectives of this system are both to eliminate the weaknesses of the former paper-based system (thus **reducing the room for fraud**) and to provide all partners with complementary services, in particular to bring real-time information during the excise movement to all actors of the EMCS project community. Since 1 January 2012 (Milestone c), the range of functionalities was expanded to include more administrative cooperation, replacing e-forms and paper-based communication for certain arrangements such as alert or rejection of an e-AD. The EMCS has been fully integrated with the SEED. Each time a new trader's approval is added to SEED, a unique 13 digit reference number is allocated called the 'Excise ID' or 'Excise Registration Number'. The Excise ID is recorded on the excise trader's approval certificate and this enables each excise trader to be uniquely identified. In addition to serving as a database of the excise traders, after being incorporated into the EMCS, SEED performs **automatic checks** by matching the excise numbers of the consignor and of the consignee against the register of operators, before the goods are approved to move under duty suspension. If these details do not correspond with the contents of the electronic-Administrative Document (e-AD), then the goods cannot be moved.

The EMCS is used by more than 80,000 economic operators.

As far as national-level databases are concerned, they are usually compiled for customs purposes but they are also used by tax administrations for monitoring excise goods. This is the case, among others, of UK's Customs International Trade and Excise (CITEX) and Customs Handling Import and Export Freight (CHIEF) databases. In EL, the tax administration employs ICISnet, while the Latvian State Revenue Service is currently building a list of companies involved in the excise field with the specific aim to fight illicit trade in excise goods.

There are two major **challenges** on the way towards ensuring a full exploitation of the potential of these data. The first is represented by the integration of different sources into a coherent system. The importance of this aspect is proved by the fact that one country is currently undertaking a significant effort to build a centralised database by integrating currently separated datasets regarding different aspects of taxation. The second challenge, which is closely related to the previous one, is to make the information intelligible and usable. This is precisely where IT technologies kick in.

From raw data to intelligence

A variety of IT solutions have been developed with the aim to enhance the ability of tax administrations to fight against illicit trade and to safeguard the budgetary interests of the Member States.

As pointed out before, platforms such as EMCS and AFIS are much more than databases in that they enable the performance of a variety of tasks. The majority of tax administrations interviewed maintained that **EMCS** represents a significant improvement if compared to the previous paper-based system, as it reduces the room for fraud and provides real time information on the movements of excise goods. With the exception of two countries (NL and UK) where the platform is currently being opti-

mised to allow for an easier access and analysis of the data, in all other Member States tax authorities make systematic use of the data contained in EMCS for risk assessment purposes.

While acknowledging the benefit accruing from the introduction of EMCS, several respondents highlighted that it is not well-suited for monitoring the flow of products that never entered the legal circuit. In order to **upgrade its functioning**, a number of proposals have been put forward:

- Extending the scope of EMCS to include other tobacco products (such as raw tobacco) and/or duty-paid tobacco goods;
- Increasing the level of detail of the information to be provided by economic operators, e.g. container numbers, description of the route of movement, brands of the tobacco products. At the same time, more thorough controls before registering a new economic operator into the SEED would greatly reduce the risk of non-genuine businesses;
- Integrating EMCS with the other national EMCS platforms to identify ties between operators and criminal cross-national networks or with customs systems (e.g. NCTS, CIS);
- Extending the functionalities of the system, for example, by including a uniform risk analysis tool or a channel for exchange of information between Member States.

As a consequence, the intelligence work by national tax administration is not limited to the analysis of the data provided by EMCS. On the contrary, data coming from other sources are integrated with each other by using **IT tools** that enable the creation profiles of shipments/traders for better targeting physical checks. IT solutions for performing risk assessment are usually developed at the national level as they need to be customised and integrated into the functioning of the tax administration. While pursuing the same general objectives, i.e. the detection and curbing of illicit trade, different technologies might be better suited for certain specific objectives such as:

- Providing **real-time information** and reporting on risks: this is the case of the data mining procedures performed by ES and PT or the Maltese Customs Electronic System (CES) which includes a module for the real-time monitoring of tax warehouses stocks as well as two modules for the movements (import and export), populated by information uploaded by economic operators. Daily analyses of the volumes of sales of cigarettes are conducted in HR at the retail level. In FI, the customs have developed an electronic system that allows for identifying certain shipments according to the pre-defined criteria (e.g. tariff heading, country of origin/dispatch), so as to be able to better target inspections;
- Enhancing **coordination** between different departments within the tax authority. As an example, PL developed a comprehensive set of tools making use of the information available in international-level databases to facilitate the exchange of information among Customs Service officers and to coordinate inspection activities;
- Support **investigative activity** as is the case of AT's Analyst's Notebook software which is used for customs investigations. Similarly, in HU the investigative activities are facilitated by the availability of a documentation-based searching and analysing facility with all the data in connection with misuse of excise (tobacco) products.

Tax marking system and track and trace systems

Tax marking systems and track and trace (T&T) systems deserve separate treatment. The issue of tax marking has been extensively discussed in a previous section (Q.1.2), however it is worthwhile to make a comparison between this and a closely related aspect of the tobacco universe, namely Track and Trace (T&T) systems.

The comparison between fiscal marking systems and T&T systems can be made at different levels. A first level is represented by the **objectives** the two systems pursue. Fiscal marks serve as a proof that excise duty has been in the Member States where the product is released for consumption. In some countries (e.g. RO, EL), economic operators are required to pay a fee which will then be subtracted from the total duty debt. Differently, T&T systems should allow for a systematic monitoring by competent authorities of the route or movement taken by tobacco products through the respective supply chains, both ex-ante (tracking) and ex-post (tracing). Thus, they are meant to help in the identification of the points of diversion. Given these differences, the two systems are regarded by tax administrations as not mutually excluding and, in most of the cases, as complementary. However the degree to which complementary occurs depends on the technical features of both systems.

A second level of comparison is represented by the **coverage** of the two systems in terms of countries and tobacco products. Tax marking systems are national-level systems whose coverage varies a great deal across Member States: in some countries (i.e. AT, CY, FI, SE) tax markings are not used, while in other countries they only cover specific products (cigarettes and fine-cut tobacco in UK; cigarettes, fine-cut tobacco and other smoking tobacco in DK), while in others they cover all types of tobacco products (i.e. EL, RO, PL). T&T systems instead mainly apply to cigarette manufacturers (and a few other economic operators). According to the results of the survey, it is mainly affiliates to a single transnational tobacco company that apply this kind of system.

The **set of information** that can be retrieved from the two systems represents another level on which the comparison can be performed. Tax stamps, as made clear in Q.1.2, contain a limited amount of information. For instance the tax mark used in RO, which seems to be among the most developed in the EU, contains the name and the SEED number (or Country code and the VAT number in the case of registered consignees) of the economic operator, a generic product code, a unique serial number and a barcode which, if scanned, allows metadata encrypted in the stamp to be accessed.

T&T systems should include a wider set of information such as brand category, production date, place of production, machine/time/shift of manufacturing, market of retail sale, warehousing and shipping. As pointed out by Joossens (2011) "tracking and tracing is more than the unique, secure and non-removable identification markings on the packages of tobacco products. It implies reading or scanning the codes, linking the codes between packs, cartons, master cases and pallets, uploading the information to a database, recording of any shipping and receiving events along the supply chain and interconnecting the different databases".¹⁶⁵

In practice, the set of information available from the inventory and logistics management systems used by the big tobacco manufacturing companies (e.g. Codentify) is more limited. Indeed, the 12-character number contains information on brand category, production date, place of production, machine/time/shift of manufacturing but does not allow for going further down the value chain than the first purchaser.

¹⁶⁵ Joossens, L, 2011, *Industry and Market Response Deliverable 5.2.: Illicit tobacco trade in Europe: issues and solutions*. PPACTE research project.

A fourth level of comparison is the **technical specifications**. As the design of tax marks and inventory and logistics management systems can vary a great deal, a theoretical comparison is not possible. Nevertheless, it is still interesting to compare two real-world cases, namely the tax marks used in RO and LV and Codentify. The tax mark employed by the Romanian tax administration consists of an adhesive stamp featuring a unique serial number, a bi-dimensional bar code, a hologram against counterfeiting and other security features such as background aura and microtext. In LV, consumers are given the possibility to get basic information about the product by using the serial number printed on the excise duty stamp: by typing the code in a special internet site or by sending it by SMS to a dedicated number, information on the product can be obtained.

Codentify instead consists of a machine-scannable barcode labels (with human readable translation) at the master case level and a unique encrypted 12-character number to identify and authenticate the product. Information is stored in a database to which tax administrations might be granted access based on bilateral agreements. One tax administration pointed out that economic operators have only granted access to a limited set of information that only enables users to verify the authenticity of the product. Another respondent made clear that as codes are visible they can be easily reproduced and placed on counterfeited goods. Moreover, codes at the pack, carton and master case level are not linked to each other.

The information contained in a fiscal mark and/or those made available by existing inventory and logistics management systems is (or has the potential to be) used for **combating illicit trade**. In countries like BE, EE, HR and HU, electronic data on use of tax stamps are used in combination with the system for the declaration of payment to secure the collection of revenues. As for T&T systems, the practical experiences of countries are highly heterogeneous: one country reported that they are finalising a piloting phase with Codentify and see a great potential for improvement of their effectiveness in identifying illicit trade, while another country reported that they have been provided with the devices to read the bar code but the information available is of scarce utility.

At the same time, as many as 15 respondents pointed out that T&T systems have the potential to enhance the ability of tax administration to fight against illicit trade provided that:

- The T&T system has a global coverage including countries such as Brazil, India and China where part of the counterfeited products originate;
- A balance should be stricken between information needs and burden on tax administrations and operators;

Other countries are more sceptical of the utility of T&T systems. Some maintain that they would not allow for monitoring or gaining intelligence on counterfeit or illegally manufactured tobacco products which never entered the legal circuit. Others regard as a major limitation of the systems that it is not possible for consumers to use them to find out if the product is genuine. Finally, some fear that such a system would entail excessive costs.

Joossens (2011) claims that until 2004 the transnational tobacco companies (TTCs) were heavily involved in cigarettes smuggling in Europe. This led the European Commission to file a civil action in New York against Philip Morris and RJ Reynolds in November 2000. In the subsequent decade, the European Union reached agreements with all the major TTCs in the field of controlling illicit trade of cigarettes. One of the arrangements commits the companies to undertake "commercially reasonable efforts

to implement product tracking and tracing measures.”¹⁶⁶ OLAF, the European Commission’s Anti-Fraud Office, has been entrusted with the supervision of the agreements and endowed with the power to impose sanctions in case of failures to meet the targets.

At present, TTCs apply unique, machine-scannable barcode labels (with human readable translation) at the master case level for all of the factories belonging to the signatory parties. The coded information includes: brand category, product date, place of production, the machinery, the shift and the exact time of manufacturing. At the same time, the industry reached an agreement to adopt PMI’s in-house marking system on cigarettes packs, known as Codentify. This verification system consists of a unique encrypted 12-character number to identify and authenticate a pack of cigarettes. This system is already in use on some countries, among which France, Germany, Italy, Netherlands, Portugal, Spain and Sweden.¹⁶⁷

The identified weaknesses of the current systems relate to:

- The visibility of the unique labelling of cartons makes it easy for smugglers to decrypt (and replicate) the complete marking;
- The lack of any link between the codes reported on packs, cartons, master cases and pallets through which a parent-child relationship can be established;
- The pivotal role paid by the interested economic operators in collecting and managing the information.

Summary

Our analysis of the IT technologies used by Member States authorities to ensure the collection of tax revenues provides the following key findings:

- The most widely employed tool for maximising the efficiency and the effectiveness of the controls is represented by risk assessment;
- Data sources in the context of excisable products can be broadly split into two categories: supranational-level databases and national-level databases. There exist two major challenges, namely the effective integration of different sources into a coherent system and the creation of intelligence from raw data;
- IT solutions for performing risk assessment are usually developed at the national level as they need to be customised and integrated into the functioning of the tax administration;
- The information contained in a fiscal mark and/or those made available by T&T systems is (or has the potential to be) used for combating illicit trade however the degree of complementarity/substitution of the two systems varies across Member States. Also, opinions on the potential development for T&T systems differ across the EU.

Appendix 6 – Research note on e-cigarettes

What are e-cigarettes?

An electronic cigarette, commonly referred to as e-cigarette or even e-cig, is a hand-held battery-powered device consisting of an atomizer, a battery and a disposable cartridge. Contrary to ordinary cigarettes, e-cigs do not work through combustion, in fact they use heat to vaporise the solution in the cartridge and create an aerosol (or mist) that the vaper inhales.¹⁶⁸ Some of the devices are featured with a LED to mimic the glow of a real cigarette, while the humectants in the liquid are used to produce the vapour. The design of the device is an important feature of the product. For instance, a post in blog specialized on e-cigarettes, when commenting on a new type of e-cigarette introduced by BAT stated that “[the e-cigarette] was designed to look and feel like a real tobacco cigarette. It’s exactly the size of a cigarette, it’s very light-weight, the LED tip lights up red when the device is in use and the filter is soft and squishy like that of an analog.”¹⁶⁹

As reported by Palazzolo (2013), who conducted an extensive review of the existing literature on e-cigarettes, cartridges contain a relatively small number of substances if compared to traditional tobacco products.¹⁷⁰ Cahn and Siegel (2011) claim that “we already have more comprehensive knowledge of the chemical constituents of electronic cigarettes than tobacco ones”,¹⁷¹ and indeed, only a small fraction of the estimated 10,000 to 100,000 chemicals in cigarette smoke have ever been identified. On the contrary, the solution in the cartridges is mostly made of propylene glycol¹⁷² or glycerol (up to 90%), flavourings, nicotine and/or other medications. Nicotine is a potent psychoactive drug that stimulates the production of neurotransmitters like dopamine and it is the main responsible for the sensation of reduced stress and improved wellbeing that smokers report to experience when they light a cigarettes (Palazzolo 2013). The nicotine content can range between 0 and 48 mg/ml according to the consumer’s taste. The liquid does not contain tobacco except for minuscule quantities either due to the tobacco flavouring or to the process of extraction of nicotine from tobacco leaves.

E-cigarettes are intended to imitate ordinary cigarettes not only in their appearance but also in their reproducing the “hand-to-mouth” movement. Hence, their use, which is often mistakenly compared to that of nicotine replacement therapies (NRT), retains a physical and psychological aspect deemed important to smokers. Moreover, as NRTs entail a controlled release of nicotine into the body by means of patches, gums, sublingual tablets, inhalers and lozenges, they lack the traditional “nicotine hit” which, on the contrary, is found in vaping.¹⁷³

Use of e-cigarettes

The use and marketing of e-cigarettes is the matter of a contentious debate between regulatory agencies, governments, legislators on one side, and e-cigarette manufac-

¹⁶⁸ *Vaper* is the term used to describe the users of e-cigarettes, analogues to “smokers” in relation to traditional cigarettes

¹⁶⁹ *Vape Ranks*. <http://vaperanks.com/europes-largest-tobacco-cigarette-maker-launches-its-own-e-cigarette/>

¹⁷⁰ Palazzolo, Dominic L. 2013. *Electronic cigarettes and vaping: a new challenge in clinical medicine and public health. A literature review*. *Frontiers in Public Health* 1 (56)

¹⁷¹ Cahn, Zachary, and Michael Siegel. 2011. “Electronic cigarettes as a harm reduction strategy for tobacco control: A step forward or a repeat of past mistakes?” *Journal of Public Health Policy* 32(1): 16-31.

¹⁷² This solvent is used in food processing, cosmetics, pharmaceutical products.

¹⁷³ The action of inhaling the vapour generated by the heating of the liquid is commonly referred to as vaping to distinguish it from smoking, which entails combustion.

turers and distributors on the other. For instance, in the US e-cigarettes were initially marketed as smoking cessation tools and cheaper and safer alternatives to tobacco products before the Food and Drug Administration (FDA), the US regulatory agency, issued some distributors a letter for "violation of good manufacturing practices" motivated by the fact that they were making "unsubstantiated drug claims"¹⁷⁴.

In a 2012 Eurobarometer survey,¹⁷⁵ more than two thirds of Europeans were found to know about the existence of e-cigarettes, 46% knew what this device is and 7% had already tried it at least once. Interestingly, an earlier version of the Eurobarometer survey conducted in 2006¹⁷⁶ did not even mention the term "e-cigarette". Another survey investigating the perceptions of Europeans about tobacco conducted in 2010¹⁷⁷ found that 3% of the citizens tried products containing nicotine (but not tobacco), such as drinks and e-cigarettes, at least once. The questions asked allowed for recreating the profile of the average nicotine users:¹⁷⁸ they are mainly smoker or ex-smoker males, aged between 25 and 39, with a medium level of education. Similarly, data from an open answer questionnaire posted on popular blogs and websites about e-cigarettes and smoking cessation (Etter 2010¹⁷⁹) found that vapers are relatively young (37 years old) males (77%) most of whom were former smokers. Moreover, the study found that users took 175 puffs per day (median value) and the preferred flavour was tobacco. Another study (Suftin et al 2013¹⁸⁰) surveyed 4444 students from eight North Caroline colleges and found that 12% of those reporting to have used an e-cigarette had never been smokers, while 69% were either smokers or former smokers. Among those who never tried the device, figures are 53% and 37% respectively.

Surveys among vapers found that it is not uncommon for them to regard the use of e-cigarettes as either an NRT to help reducing or quitting the habit or as a less harmful alternative to tobacco cigarettes. In an internet survey conducted in Etter (2010) among 81 e-cigarette users, respondents indicated the following reasons as being the main ones: quit smoking, reduce the cigarette consumption, not to disturb other people and to be able to smoke in smoke-free environments. Some studies reported in Palazzolo (2013) found that vaping reduced the consumption of traditional cigarettes by 80% after 6 months and 50% after 24 months, while other works reported in the same paper are less optimistic of the effectiveness of e-cigarettes as a smoking cessation aid. Even though Etter (2010) claims that e-cigarettes have "the potential to be as effective as currently approved Nicotine Replacement Therapy (NRT) products", since they allow nicotine to rapidly enter into the blood (through the lungs) and they retain the psychological aspects of smoking, the absence of scientific evidence induced regulatory agencies to take a cautious stance. The FDA and the World Health Organization warned companies against making any therapeutic claim on their products. Still, the fact that distributors present them as an alternative to smoking more or less implicitly suggests that e-cigarettes can be used as a cessation aid (Etter 2010).

Moreover, the attractive design and the possibility to use them (when not explicitly prohibited) in smoke-free environments make e-cigarettes an appealing recreational activity. According to qualitative data from focus groups of vapers in Barbeau et al

¹⁷⁴ Palazzolo (2013), p.1

¹⁷⁵ Eurobarometer. 2012. *Attitudes of Europeans towards Tobacco. Special Eurobarometer 385.* http://ec.europa.eu/public_opinion/archives/ebs/ebs_385_en.pdf

¹⁷⁶ Eurobarometer. 2007. *Attitudes of Europeans towards Tobacco. Special Eurobarometer 272*

¹⁷⁷ Eurobarometer. 2010. *Tobacco. Special Eurobarometer 332.*

http://ec.europa.eu/health/tobacco/docs/ebs332_en.pdf

¹⁷⁸ The group also contains people that used nicotine drinks, not only e-cigarettes

¹⁷⁹ Etter, Jean-François. 2010. *Electronic cigarettes: a survey of users. BMC Public Health 10:231*

¹⁸⁰ As in Palazzolo (2013)

(2013),¹⁸¹ social and behavioural aspects are important components of smoking addiction, including the use of e-cigarettes. The study, while acknowledging the limitation of the research strategy based on self-selected vapers responding to an invitation posted on a popular blog, suggests that vaping is regarded as a hobby, a topic of discussion in online forums, and the object of ad hoc “vaping clubs”. Furthermore, it is reported to yield social benefits in the form of a sense of belonging to a (online) community where you can “ask question and find support and encouragement from fellow users.”¹⁸² The very fact that users call themselves “vapers” and not “smokers”, suggests that a redefinition of the personal identity has occurred.

Size and structure of the market

E-cigarettes were first patented in 2003 in China by Hon Lik, a pharmacist, and became widely available in the US starting from 2006. Between 2010 and 2012, the market has grown exponentially registering a compound annual growth rate of 57%¹⁸³ and gained the interest of many long-term smokers. This robust growth trajectory is expected to continue in the near-to-medium term and it may lead the market to hit the threshold of US\$3.3 billion in sales by 2015.¹⁸⁴ According to tobacco industry analyst Bonnie Herzog of Wells Fargo, a bank, the market currently stands at about USD 2 billion worldwide¹⁸⁵ and has the potential to overtake sales of the ordinary products within a decade.¹⁸⁶ According to the economic press, in 2012 alone, the US market doubled its size increasing its revenues from \$250M to \$500M.¹⁸⁷ According to a report issued by the European Parliament’s Library (Erbach 2013) based on a 2009 study commissioned by the Executive Agency for Health and Consumer,¹⁸⁸ the EU market alone is worth between €400 and €500 million. The same figures are reported in a study¹⁸⁹ conducted by Roland Berger, a consultancy firm, for PMI, and a study carried out for the Commission in 2012.¹⁹⁰

While the market is still populated by a high number of small and medium enterprises (Erbach 2013¹⁹¹), economic newspapers¹⁹² report that, at least in the US, a concentration process is under way with the three biggest companies controlling 85% of the market. In addition to pioneer, independent companies like Joytech, Logic, Njoy and Vapor, traditional tobacco companies (also referred to as Big Tobacco) have been investing in this market since 2011 by purchasing already established e-cigarette manu-

¹⁸¹ Barbeau, Amanda M., Jennifer Burda, and Machael Siegel. 2013. *Perceived efficacy of e-cigarettes versus nicotine replacement therapy among successful e-cigarette users: a qualitative approach*. *Addiction Science and Clinical Practice*, 8:5.

¹⁸² *Ibid*, p.3

¹⁸³ Wharton, University of Pennsylvania. <http://knowledge.wharton.upenn.edu/article/e-cigarettes-lighting-france-beyond/>

¹⁸⁴ *Ibid*

¹⁸⁵ As reported in *Washington Post*, <http://www.washingtonpost.com/blogs/govbeat/wp/2013/10/29/awaiting-fda-states-pursue-their-own-e-cigarette-rules/>

¹⁸⁶ As reported in *The Economist*, <http://www.economist.com/news/business/21573985-challenge-big-tobacco-vape-em-if-you-got-em>

¹⁸⁷ As reported in *Business Insider*. <http://www.businessinsider.com/how-a-tax-court-decision-could-lead-to-the-rise-of-the-e-cigarette-era-2013-3#ixzz2qVWPac1V>

¹⁸⁸ *Matrix Insight*. 2009. *Economic analysis of the EU market of tobacco, nicotine and related products*. http://ec.europa.eu/health/tobacco/docs/tobacco_matrix_report_eu_market_en.pdf

¹⁸⁹ Roland Berger. 2013. *The New Tobacco Products Directive- Potential Economic Impact*.

¹⁹⁰ European Commission, SWD(2012) 452 final and COM(2012) 788 final; *Directive of the European Parliament and of the Council on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products*.

¹⁹¹ Erbach, Gregor. 2013. *Electronic cigarettes*, Library Briefing, Library of the European Parliament. <http://www.europarl.europa.eu/eplibrary/Electronic-cigarettes.pdf>

¹⁹² *Forbes*, <http://www.forbes.com/sites/danielfisher/2013/10/02/will-taxes-and-regulation-rein-in-the-booming-e-cigarette-market/> and *Washington Post*, <http://www.washingtonpost.com/blogs/govbeat/wp/2013/10/29/awaiting-fda-states-pursue-their-own-e-cigarette-rules/>

facturers or by developing their own lines of product. As early as 2011, JTI invested in a San Francisco-based company producing a nicotine vaporiser called Ploom.¹⁹³ The device is described as being neither a conventional nor an electronic cigarette as it heats tobacco contained in pods at a constant temperature and vaporizes the nicotine and the flavouring without burning it.¹⁹⁴ Lorillard Inc., the third largest tobacco player in the US, acquired the brand Blu eCig in 2012 for \$135 million¹⁹⁵ and SKYCIG, a UK-based premium e-cigarettes brand in 2013.¹⁹⁶ According to market analysts, this move secured the company a leading role in the global market with a reported share of 49%.¹⁹⁷ BTI, in addition to acquiring CN Creative Limited, a UK-based start-up company specialised in the development of e-cigarette technologies,¹⁹⁸ launched its own brand in the UK (Vype) in 2013. PMI has been reported to enter the market during the second half of 2014, while the Altria Group, previously Philip Morris Companies Inc. and the producer of Marlboro, created MarkTen which was put on sale in Indiana in 2013. Reynolds American Inc., the second largest tobacco player in the US, launched its Vuse e-cigarettes and succeeded in gaining a 55.6% market share in Colorado in less than 20 weeks.¹⁹⁹ It remains open to discussion whether the decision of investing in the business is determined by the willingness to avoid competition or by the belief that e-cigarettes represent the future in the tobacco industry. The EU market is characterised by a large number of distributors rather than manufacturers. Many of these are still SMEs, but the interest is growing from bigger companies to enter into this business. Similar to the moves observed from Philip Morris International, British American Tobacco has also launched its own subsidiary with the purpose of developing non-tobacco nicotine products.²⁰⁰

The rapid expansion of the market has been made possible by the extensive use of e-commerce that has long represented the preferred (and exclusive in the early days) distribution channel. More recently, specialised boutiques have been opening in many cities. According to a report by the French Office for Tobacco Prevention,²⁰¹ in the city of Paris there are 100 dedicated stores and the number is expected to grow. Moreover, where not banned or strongly regulated, e-cigarettes are also sold in convenience store, pharmacies and consumer-electronics stores making them easily available to consumers.

A hot public policy debate

The sudden boom registered by the e-cigarette market found governments, legislators and regulatory agencies around the world unprepared as the legislation in place did not allow for classifying these products in a univocal way. As a consequence, current attempts by public authorities to regulate the phenomenon (i.e. to agree on how to classify this product) have sparked a contentious debate. In the US, the FDA is still conducting the necessary analysis and a substantial package of regulation is expected to be issued in 2014. In the meantime, a cautious approach has been taken by having manufacturers and distributors abstain from making any therapeutic claim about their

¹⁹³ Bloomberg Businessweek. <http://www.businessweek.com/articles/2013-11-21/plooms-e-cigarettes-vaporizers-use-real-tobacco>

¹⁹⁴ JTI Press Release. <http://www.jti.com/media/news-releases/jti-macdonald-corp-reaches-an-agreement-regarding-illicit-trade-of-cigarettes-in-canada-2/>

¹⁹⁵ Lorillard Inc. http://investors.lorillard.com/phoenix.zhtml?c=134955&p=irol-newsArticle_print&ID=1687024&highlight=

¹⁹⁶ Forbes, <http://www.forbes.com/sites/agoodman/2013/12/05/e-cigarettes-are-smoking-hot-4-ways-to-approach-them/> and The Wall Street Journal, <http://blogs.wsj.com/corporate-intelligence/2013/11/18/big-tobacco-begins-its-takeover-of-the-e-cigarette-market/>

¹⁹⁷ Ibid

¹⁹⁸ British American Tobacco.

http://www.bat.com/group/sites/UK__3MNFEN.nsf/vwPagesWebLive/DO935CVT?opendocument&SKN=1

¹⁹⁹ Ibid

²⁰⁰ European Commission, SWD(2012) 452 final and COM(2012) 788 final; pp.16-17.

²⁰¹ As reported in <http://knowledge.wharton.upenn.edu/article/e-cigarettes-lighting-france-beyond/>

products. In the absence of a federal-level framework, states are pursuing their own strategies. In Utah, a Republican-sponsored bill was presented for discussion at the chamber for taxing e-cigarettes at a level that would have brought them closer to cigarettes and in line with other tobacco products such as cigars, roll-your-own tobacco and pipe tobacco.²⁰² Other states are expected to follow.

In the EU, the European Commission conducted an impact assessment²⁰³ accompanying a proposal for a directive modifying the current Tobacco Product Directive.²⁰⁴ Discussions have been going on between the Council and the European Parliament. Member States agreed on a compromise text in December 2013 that has been presented at a meeting after the Parliament decided that e-cigarettes should be regulated but not be subject to the same rules as medicinal products.²⁰⁵ At present, just like in the US, the situation looks patchy with different Member States taking as different stands as a complete ban on the sale of the product (e.g. Greece) and free availability (e.g. UK and Germany). A full overview of the treatment of e-cigarettes in the EU is seen below in Table 31 Treatment of e-cigarettes in the EU.

Table 31 Treatment of e-cigarettes in the EU²⁰⁶

Treatment:	Member State:	Comments:
Tobacco product	BE and LU	E-cigarettes are to be treated the same as tobacco cigarettes if they contain tobacco extract (if only containing nicotine, BE and LU treat e-cigarettes as a medical product)
Medical device/product	AT, DE, DK, EE, HU, SE, FI, PT, LU and BE	EE treats e-cigarettes as a drug/medicine if containing nicotine and requires some sort of registration (e.g. pharmacy). In SE e-cigarettes are not taxed but classified as pharmaceuticals and require an approval. In FI, e-cigarettes are not considered an excisable product as not containing tobacco. If, however, it contains more than a certain limit of nicotine, then the ampule is treated as a medical product. In DE, e-cigarettes are treated as medical devices if they contain nicotine.
No specific Provisions /Consumer product (apart from general product safety legislation)	CY, DE, EE, HU, FI, CZ, MT, ES, IE, NL, LV, PL, RO, SI, SK and UK	In these Member States, e-cigarettes are not subject to the excise duty legislation and are in free circulation. In EE and HU, e-cigarettes are treated as a consumer product as long as they do not contain nicotine. In FI, this product is treated as a normal consumer product if the nicotine level is below the threshold, still imposing a consumption tax on the ampule. In CZ e-cigarettes are regulated under the health legislation. ES report that e-cigarettes are not taxed if not combusting. If, however, the product is intended for smoking and combusts, it will be taxed. Currently IE has limited experience with e-cigarettes in the market and express concern as to how to treat it in the future. In PL no excise duty is payable on e-cigarettes. However, PL has banned their advertising. In CY and SK, classifica-

²⁰² According to the website of the State of Utah, the bill was eventually turned down in March 2013.

²⁰³ European Commission, Impact assessment accompanying the document Proposal for a Directive Of The European Parliament And Of The Council on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products. SWD(2012) 452 final

²⁰⁴ Directive 2001/37/EC of the European Parliament and of the Council on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco products of 5th June 2001

²⁰⁵ European Parliament. Press release. <http://www.europarl.europa.eu/news/en/news-room/content/20131004IPR21539/html/Tobacco-larger-warnings-flavours-banned-e-cigarettes-regulated>

²⁰⁶ In three countries has not been possible to identify the treatment of e-cigarettes either due to conflicts among sources (e.g. LT, HR) or because the relevant law is under development (EL). In EL the manufacture, sale, promotion, marketing, and sale of e-cigarettes is subject to licencing however the Ministry of Health has not issued the decree defining the process yet.

Treatment:	Member State:	Comments:
		tion is under CN code 8543 according to Regulation (EC) no.1143/2008.
Substitute for tobacco products	IT	In IT, e-cigarettes are considered a surrogate product, i.e. a substitute, for tobacco products. According to the law, starting from 1 January 2014, products (containing nicotine or other substances) suited for substituting the consumption of manufactured tobaccos together with the mechanic and electronic devices (including spare parts) which make their consumption possible are subject to a consumption tax equal to 58.5% of the retail selling price." Moreover, economic operators need to comply with the same requirements as those applicable to warehouse keepers dealing in tobacco products.

Source: Survey to national tax administrations

E-cigarettes are not treated as an excisable product in any Member States today, even though in the case of IT the consumption tax produces similar effects to the imposition of an excise duty and is aimed at aligning the treatment to that of cigarettes. The regulation and treatment varies in the Member States, from being banned to being regarded as a normal consumer good, which does not require any registration at all.

Just like the other tobacco products, e-cigarettes have propelled a heated policy debate which touches upon many different aspects such as classification, taxation, health issues, quality and safety. These are analysed in depth below.

Categorization

As pointed out by Etter et al (2013), the success of e-cigarettes poses a structural challenge to current legislation that allows nicotine only in tobacco products and nicotine medications which are both subject to specific laws.²⁰⁷ According to Article 2(1) Council Directive 2001/37, tobacco products are defined as "products for the purposes of smoking, sniffing, sucking or chewing, inasmuch as they are, even partly, made of tobacco, whether genetically modified or not". Palazzolo (2013) reports that only trace amounts of tobacco are present in liquids with tobacco flavouring. According to the same author, the decision by the US Court of Appeals to classify e-cigarettes as smokeless tobacco product subject to the same rules and regulations of other tobacco products is contentious. In the case of the EU such a decision would entail restrictions on sales, marketing and advertising, and would require the product to be subject to heavy excise duties. This would undermine the price advantage e-cigarettes currently enjoy over traditional cigarettes.

In the EU, the legislation in place is not clear about what should be taxed. On the one hand, Article 2 Council Directive 2011/64/EU refers to the presence of tobacco as the discriminating factor. However, on the other hand, Article 3(1) of Council Directive 2001/37/EC, while not engaging directly with taxation, mentions other substances, i.e. tar, nicotine, and carbon dioxide. In the case of e-cigarettes this latter limit is only partially applicable as none of the papers consulted mentioned the presence of tar in e-cigarettes and only one reported very little concentrations of carbon monoxide. The only anchorage would be represented by nicotine which is present in virtually all e-cigarettes and refill liquids. According to Etter et al (2013), the rise of e-cigarettes gives the opportunity to open the debate on the role of nicotine in the society and to revise the regulatory framework for a wide array of harmful products including tobacco

²⁰⁷ Etter et al.; *Analysis of refill liquids for electronic cigarettes*, *Addiction* 2013, p 1671-1679

products. Other authors (Chapman 2013²⁰⁸) and anti-tobacco activists fear that allowing e-cigarettes a competitive advantage against traditional tobacco products by excluding them from the tobacco product category may become “the tail that wags the dog of tobacco control policy, putting at risk the massive gains we have achieved.”²⁰⁹

As reported in Erbach (2013), fourteen Member states regard at least some e-cigarettes or e-liquids as “medicinal products by function,”²¹⁰ thus creating a level playing field between these and the other NRTs. According to the impact assessment conducted by the Commission, regulating e-cigarettes in this fashion would increase their safety by requiring industrial processes to comply with stricter parameters, would make them less accessible to smokers and would require manufacturers to obtain a marketing authorisation. However, the classification has been challenged in court several times. The Tartu Administrative Court (Estonia), the Gerechtshof's-Gravenhage Court (the Netherlands), the Cologne Administrative Court and the Sachsen-Anhalt Higher Administrative Court (Germany) all ruled against regulating e-cigarettes as medicinal products. The scientific community is split on the issue as the work conducted so far does not allow drawing final conclusions on the health risks of vaping and on the effectiveness of e-cigarettes as a smoking cessation aid.

A third option would be to classify e-cigarettes as consumer products which, according to Erbach (2013), is the industry's most preferred one. This would amount to subjecting the product to the General Product Safety Directive (Council Directive 2001/95/EC²¹¹). However, the absence of restrictions on the design, packaging and promotion is thought to be counterproductive to the objective of “denormalising” the use of tobacco.

Finally, the product might be granted separate treatment as advocated by Michael Siegel, an American tobacco-control expert, whereby “companies and products would be registered with the competent authority, all ingredients would be declared, and the purity and safety of products would have to be demonstrated.”²¹²

Taxation

Excise duties are indirect taxes on the consumption or the use of certain products. All EU member states apply excise duties to at least three categories of products, namely alcoholic beverages, manufactured tobacco products and energy products.²¹³ A first rationale for applying taxes on certain goods and services is to be found in the relatively inelastic demand for that product which makes it an easy source of revenue (Chaloupka and Kenneth 1999)²¹⁴. In the case of tobacco products in addition to the revenue generating capacity, the willingness by the public authority to influence (i.e. decrease) the level of the demand coming from consumers has also represented a main driver especially in more recent years. As maintained by modern economic theory, consumers' choices on how to spend their money lead to an efficient allocation of an economy's resources under two conditions: that consumers are rational and fully in-

²⁰⁸ Chapman, *Should electronic cigarettes be as freely available as tobacco cigarettes? No*, *BMJ: British Medical Journal* 346 (2013)

²⁰⁹ *Ibid*, p.2

²¹⁰ According to an Orientation note published by DG SANCO in 2008, a product is regarded as a human medicine by function in so far as it qualifies as “restoring, correcting or modifying physiological functions in a significant manner. Differently, it should be regarded as a human medicine by presentation if it is presented as a remedy to get rid of nicotine addiction, Available at:

http://ec.europa.eu/health/ph_determinants/life_style/Tobacco/Documents/orientation_0508_en.pdf

²¹¹ Directive 2001/95/EC of The European Parliament And of The Council of 3 December 2001 on general product safety

²¹² Erbach (2013), p.6

²¹³ Europa Website.

http://ec.europa.eu/taxation_customs/taxation/excise_duties/gen_overview/index_en.htm

²¹⁴ Chaloupka, Frank J, and Kenneth E. Warner. 1999. *The Economics of Smoking*. In *The Handbook of Health Economics*, Joseph Newhouse and Anthony Culyer, editors

formed about the costs and the benefits of their choice; and that all costs are internalized (Cnossen 2006²¹⁵; World Bank 1999²¹⁶). Evidence suggests that neither of these is fully satisfied.²¹⁷ For instance, the rationality assumption ceases to be valid when consumers act myopically by discounting the net benefits in the near-term future more than those in the long-term (Cnossen 2006²¹⁸). Information failures occur every time consumers do not possess the full set of information concerning the risks, costs and benefits of their choices thus they fail to properly factor them in. Furthermore, external costs are present and include the direct medical costs of preventing, diagnosing, and treating smoking-related diseases (affecting both smokers and non-smokers) and the indirect mortality costs related to the loss of future earnings due to premature death of smokers (Chaloupka and Kenneth 1999). These facts point to market failure and call for a public intervention.

Taxes represent one of the tools public authorities can resort to in order to correct the resource misallocation by reducing the divergence between the private and the social costs of smoking (Pigouvian tax) and by filling the informational gap. The effectiveness of taxes in steering the behaviour of consumers depends on two factors: the degree to which taxes are passed on to final consumers in the form of increased prices (which in turn depends on the relative price elasticity of the demand and the supply) and the price elasticity of the demand for the product. According to the WHO,²¹⁹ there is compelling empirical evidence that an increase in taxes on tobacco products translates into an increase in prices. Several studies (Lewit and Coate 1982²²⁰; Keeler et al 1993²²¹) demonstrated that excise duties are effective in reducing the consumption of tobacco products as the price elasticity of demand is negative ranging between -0.3 and -0.6 meaning that a 10 per cent increase in the rate would translate into a decrease of the demand by 3% to 6%. In a comparable study conducted by the World Bank between 1997 and 1999 involving 40 economists, epidemiologists and tobacco control experts, the elasticity is found to be around -0.4²²² in high-income countries and taxes are reported to be the single most effective intervention to reduce demand. Lewit and Coate (1982)²²³ also found that a tax-induced increase in prices operates on the decision to smoke rather than on the quantity. No comparable studies have been found for e-cigarettes and the reason may be due to the relatively recent explosion of the phenomenon and the scarcity of quantitative data.

Given these premises, it remains open to debate whether there exists a basis for imposing a tax on e-cigarettes. In the case of tobacco products negative health effects (e.g. lung cancer, ischemic heart diseases, emphysema, chronic bronchitis, strokes) are well documented and back the choice of levying excise duties on them. However, as pointed out in previous paragraphs, the paucity of empirical studies on the health

²¹⁵ Cnossen, Sijbren, *Tobacco Taxation in the European Union (May 2006)*. CESifo Working Paper Series No. 1718

²¹⁶ World Bank. 1999. *Curbing the epidemic: governments and the economics of tobacco control*. Tobacco control 8: 196-201.

²¹⁷ *Ibid*

²¹⁸ Cnossen, Sijbren, *Tobacco Taxation in the European Union (May 2006)*. CESifo Working Paper Series No. 1718

²¹⁹ WHO Europe. 2004. *Taxation of tobacco products in the WHO European Region: practices and challenges*. European Tobacco Control Policy Series 2.

²²⁰ Eugene M. Lewit, Douglas Coate, *The potential for using excise taxes to reduce smoking*, *Journal of Health Economics*, Volume 1, Issue 2, August 1982, Pages 121-145

²²¹ Theodore E. Keeler, Teh-Wei Hu, Paul G. Barnett, Williard G. Manning, *Taxation, regulation, and addiction: A demand function for cigarettes based on time-series evidence*, *Journal of Health Economics*, Volume 12, Issue 1, April 1993, Pages 1-18

²²² World Bank. 1999. *Curbing the epidemic: governments and the economics of tobacco control*. Tobacco control 8: 196-201

²²³ Eugene M. Lewit, Douglas Coate, *The potential for using excise taxes to reduce smoking*, *Journal of Health Economics*, Volume 1, Issue 2, August 1982, Pages 121-145

effects of vaping makes the case for imposing excise duties on e-cigarettes rest on weak foundations as it is not certain yet whether externalities exist. Gruber and Koszegi (2002)²²⁴ in the context of an economic model featuring time inconsistent agents claim that there is a role for a government intervention even in the absence of external costs in so far as smoking causes "internalities", i.e. damages on the users of an addictive bad. Nevertheless, this aspect is still unexplored.

Another prominent problem is represented by the fact that the current regulation (Council Directive 2011/64/EC) makes explicit reference to the presence of tobacco to quantify the amount of taxes to be paid. In the absence of specific provisions, e-cigarettes would seem to fall outside the scope of the Directive and this is why Member States only charge the sales tax. The state of Minnesota found a way around this problem by classifying e-cigarettes as "other tobacco products" and imposing a sales tax of 95% of the wholesale price that acts as an excise duty.²²⁵

Health risks

E-cigarettes are often regarded by users as a cheaper and safer smokeless alternative and/or a smoking cessation tool. While marketing campaigns by manufacturers and distributors used to emphasize these two aspects, in the US a warning by the FDA backed by a ruling of the US Court of Appeals put an end to this practice. In the European context, the situation is fragmented as different Member States took different stances and classified this product in different manners. As the work conducted so far on the health implications of vaping is judged insufficient and not conclusive (Palazzolo 2013), further research on this is warned by virtually all authors. The scarcity of results affects both the claims, i.e. e-cigarettes as a safer alternative and e-cigarettes as a cessation tool. Nevertheless, it is worthwhile to investigate the two aspects separately.

Chemical analyses of the solutions contained in the cartridges and the vapour generated suggest that the number of ingredients is relatively small if compared to traditional tobacco products (Cahn and Siegel 2011). Some contaminants which are known to induce or promote carcinogenesis have been found in cartridges, solutions and mist but only a minority of the studies report them to be at such levels as causing risk to human health. For instance, Burstyn (2013) summarizes the finding of different studies and concludes that "there is no evidence that vaping produces inhalable exposures to contaminants of the aerosol that would warrant health concerns by the standards that are used to ensure safety of workplaces."²²⁶ Moreover, no known toxicological synergies among compounds in the aerosol were found and the exposure of bystanders to the ingredients and the contaminants does not warrant concerns. Similar conclusions are reached by Goniewicz et al (2013) who analyses four groups of chemical compounds²²⁷ in the vapour in 12 models of e-cigarettes.²²⁸ Cartridges are found not to contain (or to contain trace amounts of) toxic compounds, while vapor is reported to display concentrations 9 to 450 times lower than in normal cigarette smoke. The findings

²²⁴ Gruber, Jonathan, and Botond Koszegi. 2002. *A Theory Of Government Regulation Of Addictive Bads: Optimal Tax Levels And Tax Incidence For Cigarette Excise Taxation*. *Journal of Public Economics*, 2004, v88(9-10, Aug),

²²⁵ *Washington Post*, <http://www.washingtonpost.com/blogs/govbeat/wp/2013/10/29/awaiting-fda-states-pursue-their-own-e-cigarette-rules/> and *USA Today* <http://www.usatoday.com/story/news/nation/2013/12/09/stateline-e-cigarette-revenue/3918913/>

²²⁶ Burstyn (2013), p.1.

²²⁷ These are: Carbonyl compounds (e.g. formaldehyde, acetaldehyde, acrolein), volatile organic compounds (e.g. benzene, toluene, aniline), tobacco-specific nitrosamines (e.g. benzo(a)pyrene, benzo(a)anthracene) and metals (Cadmium, lead, mercury).

²²⁸ Goniewicz et al, *Levels of selected carcinogens and toxicants in vapour from electronic cigarettes*, *Tob Control* 2013

are claimed to be consistent with the idea that “substituting tobacco cigarettes with e-cigarettes may substantially reduce exposure to selected tobacco-specific toxicants”.

At the same time, other studies point to opposite conclusions. Schober et al (2013) assessed the inner and outer exposure of e-cigarettes emissions in a real-world setting, and found that substantial amounts of propylene glycol, glycerine and nicotine as well as particulate matter and fine and ultrafine particles (which might deposit in the lungs) are present in the gas-phase.²²⁹ The concentration of putative carcinogenic Polycyclic Aromatic Hydrocarbon (PAC) and aluminium increased. They conclude that e-cigarettes are not emission-free and their pollutants could be of health concern to for users and second-hand smokers. It has been noted that many studies, when analysing the limitations of their experimental designs, point to a possibly different puffing profile of e-cigarette use which, if not properly controlled for, could bias the estimates. However, no agreement exists at present of how the “puffing profile” looks like. On the contrary, it is said to vary from individual to individual (Palazzolo 2013).

As pointed out in the introductory part, nicotine is an essential ingredient of e-liquids, made exception for nicotine-free solutions. Nicotine is a tobacco-derived substance and a potent parasympathomimetic alkaloid. It acts on the central nervous system by stimulating the production of several neurotransmitters (e.g. dopamine) which in turn are responsible for the sense of relaxation and euphoria as well as for the addiction. In addition to creating addiction, it has been reported to be related to apoptosis, angiogenesis, inflammation and cell proliferation. Moreover, given its chemical properties, this compound is highly absorbable through the skin and the mucous membranes and the contact with the liquid contained in a single cartridge is fatal for both adults and children.

The incomplete risk profile of this product has led both parties (pro- and anti-industry) to invoke the precautionary principle (PP) as laid down in Article 191 TFEU. As pointed out by Bates et al (2003) in their discussion on the issue of smokeless tobacco, the PP “usually challenges those defending the status quo with uncertainties about the impact of change.”²³⁰ They conclude that instead of a ban,²³¹ a regulation should be adopted to shape the market and ensure that the products placed on the market are compliant with the objective of protecting human and consumers’ health. Similarly, Flahault (2013) maintains that “the lack of full scientific certainty (on E-cigs) shall not be used as a reason for postponing recommending the use of electronic cigarettes in addition to other tobacco control measures to prevent further smoking tobacco devastation.”²³²

As far as the debate over the effectiveness of e-cigarettes as a cessation tool is concerned, empirical works are split. As pointed out by Erbach (2013), smoking cessation, i.e. abandoning the use of tobacco products, is not the same as nicotine cessation, i.e. interrupting the absorption of the substance. A major limitation of the studies concerned with the effectiveness of e-cigarettes vis-à-vis other NRT products is that they generally report only the smoking cessation rate. Studies in this strand include Bullen et al (2013), who conducted a randomized controlled trial with over 600 smokers willing to quit and concluded that e-cigarettes are “modestly effective at helping smokers

²²⁹ Schober, Wolfgang, et al. 2013. *Use of electronic cigarettes (e-cigarettes) impairs indoor air quality and increases FeNO levels of e-cigarette consumers. International Journal of Hygiene and Environmental Health*

²³⁰ Bates, C et al. 2003. *European Union policy on smokeless tobacco: a statement in favour of evidence based regulation for public health. Tobacco Control* 12: 360-367, p.363.

²³¹ They explicitly refer to smokeless tobacco products such as oral tobacco

²³² Flahault, Antoine. 2013. *E-Cigarettes a disruptive public health phenomenon: Ethics, risk and the precautionary principle. Presentation at the conference Science, Regulation and Public Health. The Royal Society, London, November 12th 2013.*

to quit, with similar achievement of abstinence as with nicotine patches, and few adverse events.”²³³ As reported in Palazzolo (2013), surveys suggest that it is not uncommon for users to switch to e-cigarettes as a first step to quit smoking. When compared to NRT products, e-cigarettes are reported to possess some advantages. Firstly, the nicotine delivery profile closely matches that of traditional cigarettes thus it is more easily accepted as substitute by smokers. The “hand-to-mouth” movement and the “throat hit” perceived by the user mimic the effects of a tobacco product thus they help fulfilling both biochemical and behavioural aspects of smoking. Secondly, the amount of nicotine reaching the blood stream has been shown to be less than a comparable tobacco product (Palazzolo 2013). Thirdly, an experiment reported by the same author concluded that the pharmacokinetic profile of an e-cigarette is very similar to that of a FDA-approved nicotine inhaler but participants found that the former was more pleasant to smoke and entailed less irritation to the mouth and throat. An additional aspect, highlighted by Barbeau et al (2013) relates to the social benefits of feeling part of a community with a strong identity, a feature that is not present in NRTs.

When it comes to the effectiveness of e-cigarettes in stopping nicotine dependence, Palazzolo (2013) judges it to be insufficient to draw any conclusion. Chapman (2013) reports that, while harm reduction and smoking cessation are often claimed by users as the reasons for switching to e-cigarettes, the difference in the quit rates among users and non-users is not statistically significant. Some physicians fear that e-cigarettes simply act as an alternative delivery mechanism for nicotine while not eradicating the problem of its consumption which has been proven to contribute to endothelial dysfunctions, thrombogenesis and systemic inflammations (Palazzolo 2013). At the same time, users of e-cigarettes were reported to decrease their consumption of cigarettes and the side effects to be less annoying than with other FDA-approved NRTs (Palazzolo 2013). Bates et al (2003) warn that “the aspiration to tackle both the addiction and the physical harm by complete tobacco cessation may work for a subset of users [...] or it may end it tackling neither.”²³⁴

A related issue, often pointed out in the literature is represented by the so called “gateway effect”. As explained by Bates et al (2003), smokeless alternatives may serve as a “lead-in to smoking for people who would not otherwise smoke.” It is still open to debate whether this phenomenon (and in what direction) applies to e-cigarettes. Currently there is little or no evidence for this claim, however to the extent that e-cigarettes are ineffective in curbing nicotine addiction their wide availability may result in a rise in the number of nicotine addicts worldwide (Palazzolo 2013). The same concern is expressed by the FDA which fears that e-cigarettes could be particularly appealing to young consumers thanks to their design, the availability of different flavours, their price and may thus lead to smoking conventional cigarettes. In a study conducted by Goniewicz and Zielinska-Danch (2012), a survey among high-school and university students in Poland indicates that between 20% and 25% of the students ever tried e-cigarettes, and only a minority (3.2%) is represented by non-smokers.²³⁵ Comparable studies reported in Palazzolo (2013), indicate that there is increase awareness about e-cigarettes, especially in young cohorts, however it is not clear if and to what extent awareness is linked to usage.

Product quality and safety

²³³ Bullen, Christopher et al. 2013. *Electronic cigarettes for smoking cessation: a randomised controlled trial. The Lancet, Volume 382, Issue 9905, Pages 1629 - 1637*

²³⁴ Bates et al (2003), p.361

²³⁵ Goniewicz, Maciej Lukasz and Wioleta Zielinska-Danch. 2012. *Electronic Cigarette Use Among Teenagers and Young Adults in Poland. Pediatrics; originally published online September 17, 2012*

The literature review allowed for singling out some aspects related to the quality and safety of the products. It should be noted that at present there exist no international standards regulating the production of e-cigarettes, cartridges and refill liquids.

A prominent issue often pointed out by the literature is the reliability and accurateness of labelling in reporting the type and the quantity of substances contained in the liquids. Trehy et al (2013) and Schober et al (2013) conclude their analyses by stating that wrong information is reported in several cases.²³⁶ Traces of nicotine were also found in purported nicotine-free brands. Opposite conclusions are reached in Etter et al (2013) where 20 models of refill liquids of 10 popular brands are analysed. The same study found the quality of the products to be "surprisingly good."²³⁷ Impurities were detected in several brands above the levels for nicotine products (according to the European Pharmacopoeia standards), but below the levels where they would be harmful. There are several reasons explaining the presence of impurities including unstable formulations, adding of flavourings, undesirable interaction with the packaging material, incorrect handling and/or storing.


A second potential threat to consumers' safety is represented by the high concentration of nicotine in the liquids. The studies consulted (Schober et al 2013; Etter et al 2013) unanimously point to the risks linked with an incorrect handling of the liquid. Indeed, given that nicotine is quickly absorbed through the skin and mucous membranes and given that a vial of liquid can contain up to 720 mg of nicotine, accidental contact and/or swallowing by both adults and children is fatal. This calls for standards to be imposed on packaging to make them child-safe.

²³⁶ Trehy, Michael L., et al, 2011, *Analysis of electronic cigarette cartridges, refill solutions, and smoke for nicotine and nicotine related impurities*, *Journal of Liquid Chromatography and Related Technologies*, 34: 1442:1458

²³⁷ Etter et al (2013), p.1678

Appendix 7 – Analysis of products whose classification requires subjective interpretation of the law

Table 32 Analysis of products whose classification requires subjective interpretation of the law


Name and description	Nature of the dispute	Outcome and treatment
<p>Partner cigarillos</p> <p>A Philip Morris International-product, wrapped by a thin tobacco leaf.</p>	<p>At the apparent level of the dispute lay the different interpretations of the definitions of cigarillos in customs and tariff legislation on the one side and excise duty legislation on the other side.</p> <p>More specifically, application of the objective criteria of "outer wrapper of natural tobacco" in (Art. 4(1)(a)) of the Directive 2011/64/EC) played a central part in the dispute as well.</p> <p>According to Art.4(1)(a), cigars/cigarillos are rolls of tobacco with an "outer wrapper of natural tobacco."</p> <p>According to the new explanatory notes for CN code 2402 10 00 cigars and cigarillos "rolls of tobacco with an outer wrapper of natural tobacco covering the product in full including, where appropriate, the filter"</p> <p>As a result, for custom purposes, a product with an outer wrapper of tobacco not covering the filter would have to be classified in a different category (e.g. 2402 20). The customs classification would, on the other hand, not legally bind the classification for excise purposes.</p> <p>At the core of the dispute, however, lays the understanding of Art 4(1) "given normal consumer expectations, are exclusively intended to be smoked as it is" – and whether this article can be interpreted as referring to the consumption of the product "as a cigar" or without any further "handling".</p>	<p>This product has been disputed in several Member States, including the NL, DE, LT and PT, LV</p> <p>Cigarillos Partner that were released for consumption in Latvia: 125 526 thousand pieces (2010) and 116 375 thousand pieces (2011).</p> <p>Cigarettes (in thousand): approximately 2,294,348 (2009)</p> <p>1,770,518 (2010)</p> <p>(22.83% change)</p> <p>Cigars and cigarillos: approximately 6088 (2009)</p> <p>133,275 (2010)</p>
<p>BREAK cigarillos</p> <p>A cigarillo which has a further layer of paper that covers the outer wrapper of natural tobacco.</p> 	<p>The essence of this dispute is similar to that described above, at apparent level it results from the differentiated definitions between the new explanatory notes of CN code 2402 10 00 and Art. 4 of the Directive.</p> <p>This product fulfils the specific provision of the Directive, but they do not fulfil the corresponding provisions of the explanatory notes to the combined nomenclature, as was the case with the Partner Cigarillos.</p> <p>The authorities are also concerned about the fact that, given the characteristics of the product, it is expected to be smoked as a cigarette, and as such, it should be treated as equivalent product.</p>	<p>EL: At the moment of data collection the product was being marketed in Greece as a cigarillo, a classification that is being contested by the authorities.</p> <p>A Binding Tariff information (BTI) had been requested and the results were not available at the time of data collection.</p>

Name and description	Nature of the dispute	Outcome and treatment
<p>L&M cigarillos</p> <p>A filter cigarillo with an outer wrapper of tobacco leaf not covering the filter</p> 	<p>With the outer wrapper of natural tobacco the L&M cigarillo fulfils the specific provision of the Directive from an objective point of view.</p> <p>However, the outer wrapper of the L&M cigarillos does not cover the filter, which according to the explanatory notes of CN code 2402 10 00 would have to be classified as a cigarette.</p> <p>Similarly to the BREAK cigarillos, the authorities also consider that the fact that this product is smoked as a cigarette should be reflected in its tax treatment.</p>	<p>EL: As a result of the dispute, the economic operator redesigned the product, which now includes a wrapper of tobacco on the filter.</p> <p>BTI was requested which concluded that this product should be classified as a cigarillo</p> <p>The product is also marketed in DE, but under a different brand name, it is also treated as a cigarillo there as a result of a BTI</p>
<p>West cigarillos</p> <p>A filter cigarillo with an outer wrapper of tobacco leaf not covering the filter</p>	<p>Similar to the products described above, this product is a roll of tobacco with an outer wrapper of tobacco</p> <p>The nature of the dispute centred around the excise treatment of this tobacco product in light of its characteristics similar to those of a cigarette and the claim of the operator that it should be treated as a cigar</p>	<p>EL: Based on a BTI request it was concluded that this product was classified as a cigarillo.</p>
<p>Gullivers</p> <p>A cigar-like stick filled with fine-cut-tobacco and wrapped in a roll of tobacco.</p> <p>Each stick contains enough tobacco to make approximately 12 cigarettes.</p> 	<p>This dispute centred on the fact that the authorities considered this product not to be a cigar, but just a means of selling RYO tobacco and avoiding to pay the appropriate excise duty.</p> <p>From a legal point of view, the provisions of Art 4 (1), and in particular the meaning of "<i>given their properties and normal consumer expectations are exclusively intended to be smoked as they are</i>"</p> <p>The opinion of the authorities is that this product cannot be smoked "as is" as it fails to light and disintegrates during smoking.</p> <p>It is the opinion of the authorities that the product is in fact bulk tobacco packs to be used for RYO cigarettes.²³⁸</p>	<p>The issue described concerns LV, however additional research has shown that this product is also present in CZ, PL and SK</p> <p>In LV, the problem is still not resolved due to the fact it is centred around a subjective criteria which, according to the authorities, is difficult to prove in court</p>
<p>RYO filling stations</p>	<p>The RYO filling stations have been developed as an alternative to slow, low volume home RYO machines.</p> <p>The speed of the new RYO filling stations is 8 minutes per 200 cigarettes²³⁹</p>	<p>FI: Finish authorities ruled that this is considered as commercial manufacturing of cigarettes and therefore excise duty on cigarettes must be paid.</p>

²³⁸ <http://cigarencyclopedia.com/news-views/cigar-news?start=884>

Name and description	Nature of the dispute	Outcome and treatment
	<p>The issue reported with the RYO filling stations is that these machines are located in small tobacco shops, where consumers can buy fine cut tobacco, cigarette papers and filters and then use the machine to make cigarettes.</p>	<p>The process is still ongoing; an audit control on the company will establish the quantities sold and impose excise duty.</p>
<p>Melasa Herbal Hukka</p> <p>Herbal molasses for hookah, without tobacco and nicotine. Produced by SOEX India Pvt Ltd</p> 	<p>The nature of this dispute centres around the excise treatment of "water pipe tobacco" not containing tobacco,</p> <p>Legally speaking it regards the interpretation of Art. 5 (1) (a) read in conjunction with Art. 2 (2)</p> <p>A sample was analysed by gas chromatography with NP detector method and results showed the pattern of nicotine traces (less than 10 ppm) where the content of tobacco and tar regarding the consistency of the sample could not be determined.</p>	<p>HR:</p> <p>The result of the BTI concluded that Melasa Herbal Hukka should be classified and taxed as other smoking tobacco</p> <p>In HR, during 2012, 29 kg of molasses were released for consumption, while in 2013; 94 kg were released for consumption.</p>
<p>Dried tobacco leaves and Grossly cut tobacco leaves</p> 	<p>The issue of bags of raw tobacco leaves) concerns the interpretation of Art. 5 (1) (a), and in particular the wording "can be smoked" and "without further industrial processing".</p> <p>It Italy, the product, was being advertised as a home fragrance, although it was clear that the product could be smoked by the user with little processing (cutting up the leaves).</p> <p>Similarly in nature, the issue of grossly cut tobacco leaves was raised by an economic operator wishing to launch the product on the market. They voluntarily requested the IT administration for an opinion regarding the tax treatment of the product.</p> <p>In addition, other cases involving raw or partially</p>	<p>Concrete cases presented regard Italy and Poland, however, similar cases have been reported in other countries, including EL, HU, CZ, etc.</p> <p>Outcomes:</p> <p>In Italy, the tax administration acknowledged the lack of a specific definition of raw tobacco, but decided that the products should be subject to excise duty under the category of</p>

²³⁹ <http://ryofillingstation.com/about.php>

Name and description	Nature of the dispute	Outcome and treatment
	<p>processed tobacco have taken place, with economic operators claiming that the products should be marketed freely, while administrations claiming that the product could be smoked and required only marginal handling by consumers for this purpose, a particularly interesting case is the one of Poland:</p> <p>In Poland, in the aftermath of the deregulation regarding the circulation of raw tobacco taking place in 2010 (Council Regulation 73/2009) and before introducing the legislative on the taxation of raw tobacco [PTES: on January, 1st 2013] tax authorities received a lot of calls from economic operators for giving out administrative interpretations to confirm that raw tobacco leaves independent of their degree of processing, e.g. "dried tobacco leaves without stalks" are not considered as tobacco that can be smoked.</p> <p>According to the operators' view, such tobacco leaves cannot be smoked without further industrial processing.</p>	<p>"other smoking tobacco" following the interpretation of Art.5 in Council Directive 2011/64/EU.</p> <p>In Poland, as a result of the extent of the problem a complete overhaul of the treatment of raw tobacco was undertaken in order to introduce controls on the growing and processing of raw tobacco, in addition, the polish authorities consider dried tobacco leaves as other smoking tobacco, in the meaning of Art 5, as they are capable of being smoked.</p>
<p>Tobacco refuse</p> <p>CN 2401 30 00 or CN 2403 10 10</p>	<p>Another issue of concern regarding Art. 5 (1) (a), and in particular the wording "<i>can be smoked</i>" was reported.</p> <p>As the excise treatment of tobacco refuse (CN 2401 30 00 or CN 2403 10 10) depends on whether it is "put up for <u>retail</u> sale", there would be legal uncertainty with respect to the treatment of tobacco refuse sold in <u>bulk</u>, but otherwise capable of being smoked as it is.</p>	<p>EL: Tax exemption of tobacco refuse is granted only when it is denaturalised</p> <p>PL, RO and CZ expressed concern about this issue, warning that there are uncertain on how they would treat this product if faced with a concrete situation</p>
<p>Reconstituted tobacco</p> <p>CN 2403 91 00</p>	<p>The dispute in Romania centred on the excise treatment of reconstituted tobacco (and whether it should fall under "other smoking tobacco" or not).</p> <p>The product was not put up for retail sale, but it's treatment had an impact on the monitoring function, as any movement would have had to be done under the EMCS.</p>	<p>RO – considers the product as an excisable tobacco product</p>
<p>Tobacco extracts and essences</p> <p>CN 2403 99 90</p>	<p>These aromatic products were marketed as air refreshers, but actually the ingredients of these aromatic products are used for water-pipes. Moreover, some of those aromatic products contain tobacco and therefore, practically, are not suitable for refreshing air, while at the same time some of those products do not contain tobacco and hence can be used for water-pipes as well as for refreshing air.</p>	<p>PL: <u>outcome</u>: considered as smoking tobacco if containing tobacco. However, if not containing tobacco, unclear how to treat it.</p>
<p>Tobacco rolling paper</p> <p>Consisting of a mix of</p>	<p>On the subject, two aspects are to be taken into account:</p>	<p>DK</p> <p>Outcome: Ruling con-</p>

Name and description	Nature of the dispute	Outcome and treatment
<p>paper and tobacco</p>	<p>The first regards the effect on the monitoring and control function, which could be affected if this product, (a tobacco raw material) would not be subject to monitoring and control as a result of its non-inclusion as an excisable tobacco product.</p> <p>The second aspect relates to the methods of ensuring the application of (Art. 4 (1) (b) , "<i>Outer Wrapper of the normal colour of a cigar, of reconstituted tobacco</i>" and specifically the methods of verifying if the wrapper is indeed composed of reconstituted tobacco</p> <p>According to Forensic Institute of NTCA (Hungary) the analytical control of the outer wrapper from reconstituted tobacco is difficult. The identification of nicotine in the wrapper is not enough to demonstrate whether it is totally produced from reconstituted tobacco.</p>	<p>cluded that it should be treated as smoking tobacco</p> <p>HU</p> <p>Outcome: (not specified)</p>

Appendix 8 – Overview of national definitions and treatment of raw tobacco

Table 33 Overview of national definitions and treatment of raw tobacco

Country	Definition for fiscal purposes	Treatment of raw tobacco
Austria	Raw tobacco not specifically defined	Not excisable and not subject to any authorisation or licensing requirements.
Belgium	Raw tobacco not specifically defined	Producers of raw tobacco exist and are subject to an authorization. Production and destination of leaves must be declared.
Czech Republic	Raw tobacco not specifically defined	Raw tobacco is not subject to any licensing or authorisation. However, this issue is under discussion due to recent increase of illicit trade in raw tobacco.
Denmark	Raw tobacco not specifically defined	Only operators authorised for manufacturing of tobacco products are entitled to acquire and trade with raw tobacco. Raw tobacco may only be sold to such companies.
France	Data not available	Not answer to survey.
Estonia	Raw tobacco not specifically defined	Not excisable and not subject to any authorisation or licensing requirements. No data collected on the movement of raw tobacco.
Finland	<i>"Non-manufactured products falling under CN classification 2401"</i>	Excise duty must be paid within 10 days after importation unless the importer is an authorised warehouse keeper or registered consignee.
Germany	Raw tobacco not specifically defined	Trading raw tobacco is not subject to authorization, limitations or monitoring measures.
Lithuania	<i>"Nicotiana (Nicotiana tabacum, Nicotiana rustics and other species) of the Solanaceae family, whether genetically modified or not, as well as the leaves and other parts of the tobacco plant"</i>	Tobacco growing is subject to licensing, however, in practice, not a single licence has been issued for tobacco growing.
Latvia	<i>"The tobacco in the form of whole plants or leaves in natural state or in the state of dried or fermented leaves, whole or with a cut-out vein, cut or uncut, broken or cut (including the pieces cut in a particular way but unfit for smoking)"</i>	No licencing or other kind of authorisation regarding the raw material for manufacturing the tobacco goods is applied in Latvia.
Poland	<i>"tobacco, irrespective of its grade of humidity, which is not joint with the living plant"</i>	Raw tobacco is an excisable good in Poland, operators involved in trading in raw tobacco are subject to authorisation.

Country	Definition for fiscal purposes	Treatment of raw tobacco
	<i>and is not classified as a manufactured tobacco product</i>	<p>tion.</p> <p>Raw tobacco may circulate under suspension if traded to a tax warehouse or a "tobacco sale intermediary" by the grower.</p> <p>Excise duty is charged on the acquisition or possession of raw tobacco by operators other than "operators running a tax warehouse", "tobacco sale intermediaries" or tobacco growers (farmers) cultivating raw tobacco if the appropriate amount of excise duty was not paid by these and if it is not possible to identify the economic operator that had sold the raw tobacco.</p> <p>For the purpose of being able to exercise monitoring activities on the circulation of raw tobacco being subject to excise duty, Polish rules/legislation foresee(s) the obligation of marking such products with tax stamps as well as wrapping it in closed boxes.</p>
Portugal	<i>"garden / green leaf/dried leaf sold directly to the public".</i>	Raw tobacco became an excisable good in January 2014.
Romania	<i>"the product resulting from initial transformations of the tobacco leaf taking place in authorised units to carry out this first transformation"</i>	<p>Economic operators who wish to sell raw tobacco or partially processed tobacco originating from any import operations, intra-community acquisitions or from own production may only do so on the basis of an authorisation handed by competent authority</p> <p>Raw tobacco or partially processed tobacco can only be sold to authorised warehouse keepers, directly to the premises of the fiscal warehouse</p> <p>Any movement of raw tobacco on the territory of Romania must be done under cover of a commercial document containing the name and number of the authorised operator</p> <p>When the following are not observed, the concerning person is liable to pay excise duty corresponding to the excise duty for other smoking tobacco (81 EUR/kg)</p>
Sweden	Raw tobacco not specifically defined	Raw tobacco is in free circulation and not subject to licensing or authorisation
Spain	Raw tobacco not specifically defined;	The cultivation of tobacco is controlled by the Ministry of Agriculture, for the purposes of fulfilling the obligations of the agricultural sector
Slovenia	Raw tobacco not specifically defined	Raw tobacco is in free circulation and not subject to licensing or authorisation

Country	Definition for fiscal purposes	Treatment of raw tobacco
		No information is collected regarding its movements
Slovakia	<p><i>"Naturally or artificially dried or fermented tobacco leave from plant Nicotiana tabacum and its parts"</i></p> <p><i>"The rest of tobacco leaves originated from its processing and manipulation or by the tobacco products production",</i></p> <p><i>"Homogenised or reconstructed tobacco (not excisable) made of finely cut tobacco, processed tobacco refuse and tobacco dust"</i></p> <p><i>"Tobacco refuse or tobacco foil if it is not a tobacco product."</i></p>	<p>Person who wants to trade (growing, drying, fermenting, receiving, storing and dispatching) must register at custom office.</p> <p>The holder of the tobacco raw material trading authorisation is required to keep records of tobacco raw material</p> <p>It is required, not later than two working days prior to any receipt of such tobacco raw material in the tax territory from another Member State, dispatch to another Member State, import from third countries or export to third countries, to notify the customs office</p>
	<p><i>"the leaves of a cultivated plant species Nicotiana tabacum L. in all forms and at all levels of cultivating, processing and packaging not intended for final consumption"</i></p>	<p>Growers are subject to registration may only sell to processors of raw tobacco or authorised warehouse keepers.</p> <p>"Processors of raw tobacco" must be registered in the Register of Tobacco Processors with the Ministry of Agriculture</p> <p>The tobacco which has been cut or otherwise chopped, bended or pressed into blocks and suitable for smoking without further industrial processing (Article 5 paragraph 1a of Directive 2011/64/EU) is found with the legal or physical person that does not have the status of a tobacco manufacturer within the meaning of the Tobacco Act shall be subject to excise duty as smoking tobacco and a misdemeanour proceeding shall be initiated</p>
Netherlands	<p><i>"Raw tobacco is every type of tobacco which cannot be considered as an excisable tobacco product as defined in the law"</i></p>	<p>Raw tobacco is subject to licensing.</p> <p>The transport of raw tobacco needs to be accompanied by a document that provides information about the origin.</p> <p>These requirements are also applicable for tobacco which is partly prepared for consumption (non-excisable good).</p>

Country	Definition for fiscal purposes	Treatment of raw tobacco
	Raw tobacco is defined "by exclusion" as a tobacco product that does not fall within the scope of any of the other categories	Raw tobacco is not excisable and it is not systematically controlled for at the moment. However, the UK authorities have commissioned a study to pin down the size of the problem of raw tobacco and find ways to tackle it.
Luxembourg	Raw tobacco not specifically defined	Raw tobacco is in free circulation and not subject to licensing or authorisation, however, Raw tobacco is only imported by one company producing manufactured tobacco which is registered as a warehouse-keeper for this manufacturing purpose
	Data not available	Has not responded the questionnaire
Greece	Reference in national law made to CN code 2401 and respective explanatory notes	<p>In Greece, tobacco growers are not bound to receive authorization prior to commencing operations, however they required by law to declare production to the ministry of agriculture.</p> <p>In addition to that obligations Growers have to conclude contracts with first processors of raw tobacco</p> <p>First processors of raw tobacco have to be registered in the unified register for traders of agricultural products, supplies and inputs, The register is an electronic database; currently, the ministry of agriculture is elaborating new rules on the conditions and procedures necessary for this register.</p>
	Raw tobacco not specifically defined	It is not an excisable good and hence it is not subject to excise licensing or authorisation
Cyprus	<i>"tobacco in any form including stalks and tobacco waste not falling under the definition of manufactured tobacco"</i>	<p>Raw tobacco is not subject to excise duty,</p> <p>Imported raw tobacco must be placed in an authorised customs warehouse or a tax warehouse upon importation.</p> <p>For the time being, raw tobacco is not cultivated in Cyprus, however, the legislation provides that any tobacco growers must be licensed and that only licensed "native tobacco warehouses" may purchase raw tobacco manufactured in Cyprus.</p>
	Raw tobacco not specifically defined	In IT raw tobacco is a free circulation product, thus it is not subject to excise duties nor its production and/or movement subject to any control or licensing.
Hungary	'Cured tobacco' shall mean raw tobacco as removed from the stem, and unmanufactured tobacco or tobacco refuse of heading	Those who import, export, store, sell, possess 'cured and fermented tobacco' shall be registered at the customs authorities.

Country	Definition for fiscal purposes	Treatment of raw tobacco
	<p>2401;</p> <p>'Fermented tobacco' shall mean tobacco processed to induce changes to make it suitable for consumption</p>	<p>Tobacco importers and suppliers shall keep accurate trade records, and shall notify all tobacco shipments to the customs authority broken down per consignments, at the latest by the time of the commencement of the given import and trade transaction</p> <p>Fulfilment of registration, monitoring and oversight, and the related administrative proceedings are treated as excise matters</p>
	<p><i>"Anything that falls to be classified as such under the combined nomenclature of the European Communities"</i>²⁴⁰</p>	<p><i>"Where any unmanufactured tobacco is found in the State and where that unmanufactured tobacco is not shown to the satisfaction of the Commissioners to be kept, or to be in the course of delivery—</i></p> <p><i>(i) under a customs procedure within the meaning of Council Regulation (EEC) No. 2913/92 of 12 October 1992 ,</i></p> <p><i>(ii) for use as raw material for the production of tobacco products in a tax warehouse,</i></p> <p><i>(iii) for use as raw material for the production of any product or thing other than a tobacco product, or</i></p> <p><i>(iv) for any other use that is not contrary to this section,</i></p> <p><i>then it shall be presumed until the contrary is proved that the unmanufactured tobacco is prohibited goods".</i>²⁴¹</p>

²⁴⁰ As defined in section 71 of the Finance Act 2005, amended by section 56 of the Finance Act 2013

²⁴¹ Finance Act 2013 (Section 56).

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