



Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco

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Acronyms and Abbreviations

B2B	Business-to-business
BAT	British American Tobacco
BAU	Business-As-Usual
CEN	European Committee for Standardisation
CMO	Common Market Organisation
CN	Combined Nomenclature
DG TAXUD	Directorate General for Taxation and Customs Union
EDT	Excise Duty Tables
EMCS	Excise Movement and Control System
ENDS	Electronic Nicotine Delivery Systems
ENNDS	Electronic Non-Nicotine Delivery Systems
ENSP	European Network for Smoking and Tobacco Prevention
EPC	Excise Product Codes
FCT	Fine-cut tobacco
FCTC	Framework Convention on Tobacco Control
FETRATAB	Fédération Européenne des Transformeurs de Tabac
FMC	Factory-made cigarette
HnB	Heat-not-Burn
HTP	Heated Tobacco Products
IA	Impact Assessment
IBVTA	Independent British Vape Trade Association
IIA	Inception Impact Assessment
ITC	International Tobacco Control
ITEG	Indirect Tax Expert Group
JTI	Japan Tobacco International
LPC	Low-Price Cigarillos
MCA	Multi-Criteria Analysis
MED	Minimum Excise Duty
MPPC	Most Popular Price Category
MS	Member State(s)
MTT	Minimum Total Tax
MYO	Make-Your-Own tobacco
MYV	Make-Your-Volume tobacco
NDP	Non-duty-paid
NGO	Non-Governmental Organisation
OPC	Open Public Consultation
OST	Other Smoking Tobacco
PMI	Philip Morris International
PPACTE	Pricing Policies And Control of Tobacco in Europe
PPP	Purchasing Power Parity
RAT	Revenue After Tax
REFIT	Regulatory Fitness and Performance Programme
RSP	Retail Selling Price
RYO	Roll-Your-Own tobacco
TTB	Total Tax Burden
TPD2	Tobacco Products Directive
WAP	Weighted Average Price
WCO	World Customs Organization
WHO	World Health Organization
WPT	Water-pipe tobacco

Abstract

The purpose of this Study is to contribute to the Impact Assessment of a possible revision of Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco. The Study includes a baseline assessment of a series of issues emerged from the previous evaluation of the Directive and analyses how these problems may evolve if no EU action is taken. Secondly, the Study formulates a set of possible policy options to address these problems, assesses their likely impacts (market functioning and development, regulatory costs, tax revenues, tobacco control policies, illicit trade etc.), and compares the outcome with the baseline situation.

The main issues analysed in this Study includes: the EU-level harmonisation of the tax treatment of electronic cigarettes and heated tobacco products, the inclusion of raw tobacco in the EU excise system, the tax-induced substitution between cigarettes and fine cut tobacco or low-price cigarillos, the illicit trade of water-pipe tobacco, and the different interpretation of the rules on the 'minimum excise duty' on cigarettes across Member States. The underlying evidence is based on a vast stakeholders interview programme, the results of an open public consultation, extensive desk research and the best market database available.

1 EXECUTIVE SUMMARY

1.1 Introduction

The overall purpose of this Study is to contribute to the Impact Assessment (IA) of a set of policy options for a possible revision of Directive 2011/64 (“the Directive”). The Study takes into account the results of the evaluation of the Directive conducted in 2014, and the following Commission’s Report (2015) and Inception Impact Assessment (2016). The four main tasks of the Study involved:

- conducting a baseline analysis of the current state of implementation of the Directive with a view to assess, and where possible quantify, a number of issues identified in the previous evaluation;
- assessing how the situation may evolve in the future if no action is taken at EU level, and the likely impacts for the various stakeholders concerned;
- assessing the expected impacts of a series of regulatory and non-regulatory policy options identified, and comparing them with the ‘no change’ scenario;
- assisting the Commission in conducting an Open Public Consultation on the issues at stake and the possible options for a revision of the Directive.

The scope of the work includes six problem areas that can be summarised as follows:

- **New products:** there are disparities in the tax treatment of e-cigarettes and heated tobacco products across Member States (MS), potentially hampering the functioning of the Single Market. Tax harmonisation may solve the issue, but it may also have a series of unintended effects.
- **Raw tobacco and intermediate products:** being outside of the excise system raw tobacco and tobacco refuse can be more easily diverted to the illicit manufacturing of tobacco products or put up for retail sale avoiding taxation. Moreover, some of the current definitions may create legal uncertainties.
- **‘Borderline’ cigarillos:** certain cigarillos have characteristics similar to cigarettes but can be sold at a much lower price, due to a more favourable tax treatment, with possible adverse effects on competition, tax revenues and tobacco control policies.
- **Fine Cut Tobacco (FCT):** FCT is largely a substitute of cigarettes and its market penetration has been often driven by a more favourable tax treatment and greater affordability. Tax-induced substitution may distort competition, cause revenue losses and affect tobacco control policies.
- **Water-pipe tobacco (WPT):** there is limited information on the market and the demand for WPT. Illicit trade and tax evasion seem high, possibly caused by unsuitable tax regimes.
- **Minimum Excise Duty (MED) on cigarettes:** the Directive provisions lack of clarity and have led to different interpretation of rules across countries.

1.2 Overview of Methodology

The bulk of the data collection work was centred on a vast in-depth consultation of stakeholders, covering a total of 15 Member States, as well as EU-level institutions and organisations. Overall, 180 interviews were conducted with different types of stakeholders, namely: public authorities and administrations (tax and customs authorities, public health authorities and others); economic operators of different size and active in different segments of the market and the value-chain; non-government public health organisations; and various other tobacco experts and stakeholder groups. The interview programme was complemented by an Open Public Consultation that received a total of 7,686 responses.

The Study results are also based on evidence gathered through a comprehensive desk research which involved the review of over 500 documentary sources, including: EU and MS-level policy documents, scientific literature, industry and stakeholder reports and papers, commercial and institutional databases, web-sources and other grey literature, both published and unpublished.

The main focus of the analytical work was to compare the 'no change' scenario, developed on the basis of an in-depth baseline assessment, with several 'policy change' scenarios, using both quantitative (cost/benefit) and qualitative (multi-criteria) methods. The impacts considered for the comparison of scenarios belong to four main categories: (i) tax revenues and burden; (ii) regulatory costs and cost savings (including substantive compliance costs, administrative costs and enforcement costs); (iii) market effects (including Single Market functioning, distortion of competition, and SME competitiveness effects); and (iv) indirect social effects (illegal activities and fraud, and tobacco control objectives).

1.3 Summary of Key Findings

1.3.1 New Products

There are approximately nine millions regular users of e-cigarettes and half a million consumers of heated tobacco products in the EU. In 2016, the market value of new products has likely reached € 4.0 billion overall (approximately 90% from e-cigarettes and 10% from heated tobacco products), and is expected to continue growing. New products are not explicitly covered by Directive 2011/64, so various Member States have introduced non-harmonised national taxes to regulate the marketing of such products and offset the negative effects on tax revenues due to the substitution of conventional tobacco products. The impact of national taxes on e-cigarettes was often not in line with expectations: the demand severely declined, various methods to circumvent taxation emerged, and legal disputes occurred in some Member States. The legal fragmentation also hindered the overall market integration and caused competitive disadvantages for certain operators. In the case of heated tobacco products, the lack of a harmonised approach created administrative obstacles to their commercialisation and circulation in certain geographical markets.

The demand for e-cigarettes is price sensitive, so the introduction of a harmonised positive (nonzero) tax rate on e-liquids at EU level may significantly affect the market development and yield modest tax receipts. The administrative and compliance costs for economic operators of including e-cigarettes among excise goods can be estimated at about € 15,000 per annum for a typical small business. In the case of public authorities the administrative costs of adapting the excise system have been generally estimated as negligible, however the enforcement may be burdensome, since the illicit production and movement of non-taxed e-liquids are very difficult to control. A lighter approach may consist of introducing a harmonised tax category without setting a mandatory minimum tax rate at EU level, i.e. leaving Member States free to decide whether to apply a zero or a positive tax rate. This way, the impact of the EU legislation on economic operators would be limited to moderate administrative and compliance costs. In any case, before proceeding with harmonisation, tax regulators may consider to address the current information gaps and uncertainties that exist about market, consumption, impact on smoking cessation and broader societal effects of e-cigarettes.

The benefits of a harmonisation of that tax treatment of heated tobacco under the Directive appear neater. In particular, it would remove the current legal and administrative uncertainties and constraints, and give Member States more freedom to adopt suitable tax policies. Establishing an *ad hoc* tax category seems the most effective and future-proof solution, but defining heated tobacco products can be

complex especially with respect to their intended use for inhaling and not smoking. Any weak or vague definition may create regulatory loopholes for new 'borderline' products. Unlike e-liquids, heated tobacco is generally excised and moved through the EMCS system, therefore its monitoring is less problematic. However, the commercialisation of these products in the EU is very recent so there is still insufficient information at the moment to predict how the market will develop.

1.3.2 Raw Tobacco and Intermediate Products

Illicit trade of raw tobacco is estimated at approximately 10,000 tonnes per year, i.e. about 1% of the total EU raw tobacco market. Once transformed into illicit cigarettes, it may cause a tax evasion between € 1.2 and 2.0 billion. There is also an illicit trade of tobacco refuse in the EU, but on a much smaller scale.

Extending the EMCS (Excise Movement and Control System) and the other requirements of the EU excise system to raw tobacco may help monitoring movements and make illicit trade more difficult, but it may not eradicate the problem, since there would remain strong economic incentives for illegal activities, and a minute monitoring at the tobacco field level would be overly complex and burdensome. On the other hand, this approach may impose administrative and compliance costs on all legitimate growers and first processors (respectively: ca. € 3,000 and € 26,000 on average), with possible adverse effects on the competitiveness of EU-grown tobacco. The possible administrative costs for tax authorities would be limited, while limited incremental change of enforcement costs can be expected as compared to the current situation. In line with the approach adopted in various MS, the reintroduction of a common administrative regulation of the tobacco market in the EU may be considered as an alternative approach to the problem, since it would seemingly bring similar benefits at lower costs for businesses.

In the past few years, some Member States have faced the issue of non-excised raw tobacco directly sold to consumers. With few exceptions, the magnitude of the problem was generally negligible, and Member States were able to take measures to tackle it. In this sense, a revision of the Directive is not required. Instead, there is a demand for a more operational definition of tobacco refuse in the Directive, to help competent authorities and operators to clearly distinguish between the product sold in bulk (not excisable) or for retail sale (excisable).

1.3.3 'Borderline' Cigarillos

'Borderline' cigarillos is a class of products that have some similarities with cigarettes (e.g. dimension, filter, packaging, etc.), but can be sold at a much lower price, thanks to the more favourable tax treatment applied to the overall category of cigars and cigarillos. They had become popular in some EU countries a few years ago, but are now declining in most of the markets due to a combination of: (i) a revised product definition; (ii) the end of certain derogations for Germany and Hungary, and (iii) the adoption, in various countries, of tax structures and rates that reduced the incentives for low price products. It is estimated that an overall 3.7 billion pieces have been placed on the EU market in 2015 and that the number of regular smokers of these product amounted to about 0.5 million.

To further tackle tax-induced substitution, the Commission may consider introducing in the Directive a minimum excise on cigarillos aligned with that of cigarettes. This approach may be effective in reducing the consumption of 'borderline' products but it would inevitably affect also other non-target low-price cigarillos, including those commercialised by SME. The Directive already provides MS with effective instruments to address the problem where necessary. Furthermore, the proportionality of the intervention seems therefore dubious. It is nonetheless important to monitor the development of this market, especially as far as flavoured cigarillos are concerned.

There are differences in the definition of cigars and cigarillos used in the excise and customs classifications, so that certain products are currently classified as cigarettes for customs purposes and as cigarillos for excise purposes. This is a possible source of legal uncertainty, (rare) disputes and inconsistencies in the use of the EMCS system. An alignment of definitions or a modification of the EMCS is recommended.

1.3.4 Fine Cut Tobacco

At EU level, the market for fine-cut tobacco (FCT) has seen a considerable growth in the period 2006-2012, followed by a relative stabilisation in the 2013-2016 period. At present, annual sales amount to some 87-88 million tonnes, i.e. nearly 20% of the total tobacco consumption, but the market share varies significantly across MS. The analysis confirmed that FCT is largely a substitute of cigarettes - certain varieties, like 'volume tobacco', seemingly more than others - and its penetration is mostly driven by more favourable tax treatments and greater affordability.

The Study assessed the possible impact of increasing the current minimum excise level on FCT in order to approximate it to the minimum excise of cigarettes, thus mitigating the incentive for substitution. Various scenarios have been considered, with results ranging from very modest impacts to more profound market effects. Tax revenue trends would be determined by market trends, and in the best case scenario the net increase would hardly reach € 400 million (including the additional revenue generated by consumers possibly shifting back to factory-made cigarettes).

The current text of the Directive already envisages a staged increase of the minimum excise on FCT until 2020, which would bring the minimum rate closer to that of cigarettes. In reality, most of MS have set FCT excise duties well above the minimum rate established in the Directive, and in a few cases the national FCT rate is nearly aligned with that of cigarettes (e.g. Sweden). In this sense, an intervention on the EU minimum rates may have little practical effects on the actual taxation of FCT in most of MS. More profound impact on consumption levels and tax revenues can be achieved if MS actually 'peg' the tax treatment of FCT to cigarettes, but this is an option that MS may pursue voluntarily, and it would be disproportionate to impose it in the Directive. The results of the stakeholder consultation indicate that a radical increase of the tax rate applied to FCT may encourage smoking cessation in a small share of current consumers. This positive effects should be carefully considered in the light of a likely FCT market collapse and an increased demand of other cheap products, including illicit cigarettes and the so-called 'bulk tobacco'.

1.3.5 Water-pipe tobacco

There is a notable scarcity of data on the trade and consumption of water pipe tobacco (WPT) in the EU. This sector seems characterised by high level of informal and illicit trade. Overall consumption in the EU can be estimated at some 5,000 tonnes per year, two-thirds of which are estimated as non-duty paid. There is a strong economic incentive for tax evasion due to the relatively high tax burden on WPT. The amount of tax evaded is estimated at about € 200 million.

The policy option analysed in this Study consists of the creation of a new, separate excise category specific for WPT. This solution may allow a more effective monitoring of the WPT market, addressing the current information needs. Moreover, it may allow MS to modulate the WPT tax rate so as to remove the incentives for illicit trade, while avoiding that a tax reduction may translate into a greater consumption. At the same time, defining WPT for tax purposes can be complex and there is a risk that a weak definition may create unintended incentives for the development of new 'borderline' products.

1.3.6 Minimum Excise Duty on Cigarettes

Article 8(6) of the Directive allows MS to levy a Minimum Excise Duty (MED) on cigarettes, provided that the mixed structure (*ad valorem* and specific component) is respected. The Directive does not provide further clarifications on the criteria to ensure the MED is applied consistently with these requirements, and there is room for different interpretation across Member States.

The MED is used in nearly all MS to discourage down trading and to ensure stability and predictability of tax revenues. It reportedly works well in all MS analysed, according to both tax authorities and economic operators. In this sense, setting an upper limit that caps MED level to the excise duty level applicable at the weighted average price of cigarettes, is not required. Moreover, it would have limited concrete impacts only in a handful of countries, and may result in an unintended greater affordability of cigarettes. If any, a possible clarification of the MED may on the one hand confirm the current flexibility of the mechanism, on the other hand explain if and in which conditions a MED exceeding the amount of excise duty applicable at the weighted average price may still respect the rules on the mixed structure.

1.4 Conclusions

According to Study findings, the issues identified in the evaluation study do not present critical situations requiring major revisions of Directive 2011/64. Tax-induced substitution across products have been mostly addressed over the past few years using the instruments envisaged in the Directive, and it represents now only a minor threat to tax revenues or tobacco control policies. Stricter interventions in the area of cigarillos or fine-cut tobacco may yield modest benefits, but would affect the competitiveness of SME *vis-à-vis* big tobacco companies.

More significant tax revenue losses derive from illicit manufacturing and trade. The value chain and the movements of raw tobacco may require an enhanced monitoring, but its inclusion in the excise system may not be cost-efficient and would hamper the competitiveness of EU-grown tobacco, so alternative approaches should be devised. The illicit trade of water pipe tobacco is low in absolute terms but high as a share of the total, and would require closer monitoring and possible *ad hoc* measures.

Some legal and classification uncertainties remain, especially in the area of non-excised tobacco products (e.g. tobacco refuse) and as concerns the interpretation of the MED provisions. These may cause a certain administrative burden, but the number of judicial cases is very limited. With a minor exception (i.e. certain cigarillos), the existence of a dual classification of tobacco products for customs purposes and for excise purposes is not problematic.

The situation of new products, like e-cigarettes and heated tobacco products, is more complex, and the prospected market growth may require in a not so distant future a clarification of their tax treatment. The lack of an EU-wide harmonisation and the current fragmentation of national approaches are not conducive to a level-playing field and Single Market integration. At the same time, the novelty of the market and its largely unforeseeable evolution, combined with uncertainties on the risk and benefits of non-combustible products, requires a light touch and a cautious approach. The risk of a disproportionate impact on SME and the creation of incentives for illicit trade should not be underestimated. More robust monitoring and data on market and consumption seem required in order to take an informed decision.

2 INTRODUCTION

2.1 Nature and Purpose of the Report

This Final Report (the "Report") has been prepared in the framework of the assignment titled "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco" (the "Assignment" or the "Study"). The Report is submitted to the European Commission – Directorate General for Taxation and Customs Union (DG TAXUD) by a grouping led by Economisti Associati s.r.l. and including the Centre for European Policy Studies (CEPS), CASE - Center for Social and Economic Research, wedoIT-solutions GmbH, and ECOPA (hereinafter collectively referred to as "the Consortium" or "the Consultant").

The overall purpose of this Study is to contribute to the Impact Assessment (IA) of the policy options for a revision of Directive 2011/64 ("the Directive"). The Study has four main objectives, namely:

- **Baseline Analysis** - to gather and analyse evidence on the state-of-play with the implementation of the Directive, especially in areas considered problematic, with the main focus on assessing and where possible quantifying the scale of the issues identified in the previous evaluation.
- **Assessment of the 'No Change' Scenario** - to assess the evolution of the problems if no further action is taken at EU level (dynamic baseline scenario), and the likely impact.
- **Assessment of the Policy Change Scenario** - to assess the economic, social and environmental impacts of the possible options to address the problems identified, and to compare them with the 'no change' scenario.
- **Open Public Consultation** - to assist the Commission in conducting an Open Public Consultation (OPC) eliciting stakeholders' comments and feedbacks on the issues identified and the possible options for a revision of the Directive.

In accordance with its objectives, the Study focused on a set of specific issues that emerged from a previous evaluation completed in 2014¹ and were taken up in the following Commission Report to the Council². The Council discussed the Commission Report and adopted conclusions on 8 March 2016.³ In these conclusions the Council has requested the Commission to carry out an impact assessment on the possible revision of Directive 2011/64/EU. In June 2016, DG TAXUD adopted an Inception Impact Assessment (IIA) on "*Possible proposal for revision of Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco*".⁴

¹ Ramboll Management Consulting, The Evaluation Partnership, Europe Economics, "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", 2014.

² "Report from the Commission to the Council on the REFIT evaluation of Directive 2011/64/EU and on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 21.12.2015, COM(2015) 621.

³ "Council conclusions on the structure and rates of excise duty applied to manufactured tobacco", 08.03.2016.

⁴ DG TAXUD, "Inception Impact Assessment on a Possible proposal for revision of Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", 16.06.2016.

2.2 Background to the Initiative

2.2.1 The Legal Framework

In 2011, the Council adopted the **Directive 2011/64** “on the structure and rates of excise duty applied to manufactured tobacco” (also known as ‘Tobacco Excise Directive’ – TED), which updated the common fiscal legislation on tobacco products in the EU.⁵ The purpose of the Directive is to ensure a proper functioning of the internal market, while contributing to the broader tobacco control and health protection objectives enshrined in EU policy and international treaties (WHO Framework Convention on Tobacco Control – FCTC).⁶ The Directive provisions are essentially of four kinds:

- Provisions aimed at defining the different manufactured tobacco products that are subject to a harmonised treatment, namely: cigarettes; cigars and cigarillos; and smoking tobacco (consisting of fine-cut tobacco for the rolling of cigarettes and ‘other smoking tobacco’, which includes e.g. pipe tobacco and water-pipe tobacco).
- Provisions on the tax structures applicable to the various products defined, i.e. the *ad valorem* component, the *specific component* (per quantity or per weight), and the rules and limits for the application of a *mixed structure*, where requested. It also laid down the rules for applying an optional *minimum excise duty* (MED) on certain products.
- Provisions on the rates applicable to the different product categories, setting the minimum amounts of the excise duty applicable. It includes also the mechanism to calculate the weighted average retail selling price (WAP) for cigarettes and fine-cut tobacco. In the case of cigarettes the WAP replaced the previous most popular price category (MPPC) as the reference to fix the minimum excise duty.
- Exemptions and derogations for certain countries or territories.

The tax regimes established in the Directive for different manufactured tobacco products in the scope of the Directive are summarised in **Table 1** below.

Table 1– The Tax Provisions applicable to Manufactured Tobacco

Product	Tax Structures and Rates
Cigarettes	<ul style="list-style-type: none"> • Mandatory mixed structure including both an <i>ad valorem</i> excise duty and a specific excise duty, which must be b/w 7.5% and 76.5% of total tax burden (since Jan. 2014). • At least 60% of WAP and no less than EUR 90 per 1,000 cigarettes; or EUR 115 per 1,000 cigarettes. • A minimum excise duty (MED) may apply (i.e. a fixed monetary amount per quantity applicable if the amount of the excise duty falls below a minimum floor).
Fine-cut smoking tobacco	<ul style="list-style-type: none"> • 46% of WAP or EUR 54 per Kg (as of 2015). Staged increases until 2020 up to: 50% of WAP or EUR 60 per Kg. • A minimum amount of excise duty can be established.
Cigars and cigarillos	<ul style="list-style-type: none"> • 5% or more of the retail selling price or EUR 12 per 1,000 items or Kg. • A minimum amount of excise duty can be established.
Other Smoking Tobacco	<ul style="list-style-type: none"> • 20% or more of the retail selling price or EUR 22 per Kg. • A minimum amount of excise duty can be established.

The EU excise system is regulated by **Directive 2008/118** (also known as the ‘Horizontal Directive’), which laid down the general provisions applicable to harmonised excise goods, and leaving Member States free to establish non-

⁵ “Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco”, Official Journal of the European Union L 176/24, 5.7.2011.

⁶ “WHO Framework Convention on Tobacco Control”, World Health Organization, 2003.

harmonised consumption taxes on other goods.⁷ Among other things, it fixed the principles regulating how and where excise duties are paid and collected, the regime applicable to operators under duty suspension (warehouse keepers), the rules for distant selling, and it laid the basis to create a computerised procedure to monitor the movement of excise goods. This was further developed and adopted under the European Parliament and Council Decision 1152/2003 with the name of **Excise Movements and Control System (EMCS)**.⁸ Since January 2011, all movements of excise goods under suspension of excise duties are carried out under the EMCS.

On the side of tobacco control policy, EU institutions have implemented over the years a series of initiatives and measures aimed at protecting citizens from the hazardous effects of smoking and encouraging the reduction in the consumption of tobacco (especially among young people). The **Tobacco Products Directive** (also known as 'TPD2') of 2014 laid down the rules governing the manufacturing, presentation and sale of tobacco and related products.⁹ The TPD2 covers a broader range of products than Directive 2011/64, including smokeless tobacco, herbal products for smoking, and in particular electronic cigarettes and their refill containers, and other novel tobacco products. The TPD2 revised a series of previous rules and introduced new ones, concerning – among other things: (i) pictorial health warnings; (ii) a ban on characterising flavours and on promotional packages; (iii) a revised labelling and mandatory reporting of ingredients; (iv) specific requirements for electronic cigarettes' packaging, labelling, safety, monitoring and reporting; (v) measure to combat illicit trade; (vi) optional ban of cross-border distance sales. The TPD2 was transposed and become fully operational in May 2016, except certain parts for which a different transposition deadline applies.

2.2.2 The Evaluation of Directive 2011/64 and the Issues at Stake

In 2012 the Commission started the evaluation of the Directive under the Regulatory Fitness and Performance Programme (REFIT). Within this context, an independent evaluation study was completed in 2014 by a consortium led by *Ramboll Management Consulting* (hereinafter the 'Ramboll Evaluation').¹⁰ The recommendations and findings of the Ramboll Evaluation have been taken into account in the Commission report submitted in December 2015 to the Council (hereinafter the 'Commission Report').¹¹ According to the Commission Report, there was scope to improve Directive 2011/64 in order to reduce administrative burden for both Member States and operators and distortions in the internal market. The Commission Report was discussed in the ECOFIN Council. The Conclusions adopted in March 2016 confirmed the need to explore possible revisions of the Directive and requested the Commission to carry out the relevant underlying studies, consultations and impact assessment.

In June 2016, the Commission published the Inception Impact Assessment on a possible revision of the Directive, and laid down the problem areas to be assessed and a preliminary set of potential policy options. The issues at stake can be structured into seven problem areas, as outlined in **Table 2** below.

⁷ "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.

⁸ "Decision No 1152/2003/EC of the European Parliament and of the Council of 16 June 2003 on computerizing the movement and surveillance of excisable products", Official Journal of the European Union L 162/5, 1.7.2003.

⁹ "Directive 2014/40/EU of the European Parliament and of the Council of 3 April 2014 on the approximation of the laws, regulations and administrative provisions of Member States concerning the manufacture, presentation and sale of tobacco and related products and repealing Directive 2001/37/EC", Official Journal of the European Union L 127/1, 29.4.2014.

¹⁰ Ramboll Evaluation (2014).

¹¹ COM(2015) 621, "Report from the Commission to the Council on the REFIT evaluation of Directive 2011/64/EU and on the structure and rates of excise duty applied to manufactured tobacco", 2015.

Table 2 – The Issues at Stake

Problem area	Problem outline
New Products	<p>The so-called 'electronic cigarettes' are not covered by Directive 2011/64. Various Member States have introduced national taxes for electronic cigarettes and refill containers, adopting different structures and rates. The lack of a harmonised approach across countries may affect competition and the functioning of the internal market, and may also encourage informal (cross-border and online) trade. A precise estimation of such effects is made difficult by the lack of robust market data for these products.</p> <p>The so-called Heat-not-Burn (HnB) or Heated Tobacco Products (HTP) are alternative nicotine-delivery systems that heat but do not burn tobacco, which have been very recently launched in a few Member States. Their categorisation under the Directive is not clear, and various MS have adopted <i>ad hoc</i> and special tax regimes. These however create uncertainties, burden and potential distortions in the commercialisation and movement of these products.</p>
Raw Tobacco, Tobacco Refuse, and Reconstituted Tobacco	<p>Directive 2011/64 does not apply to raw tobacco and to intermediate tobacco products (e.g. tobacco refuse and reconstituted tobacco), unless they are in a 'smokeable' form. However, the definitions set out in the Directive contain some subjective elements, which might cause classification uncertainties between excisable and non-excisable products, disparities of treatment across countries, and disputes.</p> <p>A second issue is that raw tobacco and intermediate products can be diverted to the illicit manufacturing of smoking products or, in some MS, sold in small quantities to consumers for 'home processing'. Since raw tobacco does not fall in the scope of the EU excise system the tools envisaged to prevent and fight tax fraud, including the EMCS, cannot be used to monitor and control movements.</p>
'Borderline' cigarillos	<p>In some EU countries, so-called 'borderline' cigarillos (or 'eco-cigarillos') have appeared on the market since the early 2000s. These products have some characteristics similar to cigarettes (e.g. dimension, filter, packaging, etc.), but can be sold to a much lower price, thanks to a more favourable tax treatment applied to the entire category of cigars and cigarillos. Given their affordability, there are concerns they may induce the substitution from cigarettes, with adverse effects on proper market functioning, tax revenues, and tobacco control targets.</p>
Fine-cut tobacco	<p>The minimum excise rates set in the Directive for fine-cut tobacco (FCT) are lower than those for factory-made cigarettes (FMC). This may encourage consumers to substitute cigarettes with more affordable FCT, thus undermining revenue targets and tobacco control goals, and potentially distorting the market. The issue is made more urgent by the presence on various EU markets of the so-called 'make-your-own' (MYO) tobacco, which is in many respects more similar to cigarettes than the typical 'roll-your-own' (RYO) tobacco. MYO tobacco is used to fill pre-made filter tubes with a simple machine to produce on a small scale cigarettes that can barely be distinguished from factory-made cigarettes. Some products – known as 'volume tobacco' – contain expanded tobacco, which may further increase their value-for-money as compared to FMC. In the current Directive, there is no specific definition of MYO or 'volume tobacco'.</p>
Water-pipe tobacco	<p>Water-pipe tobacco (WPT) falls in the category of 'other smoking tobacco' of Directive 2011/64. As compared to the other products in this category (e.g. pipe tobacco), only a minor percentage of the WPT weight actually consists of tobacco, the rest being molasses and other components. Therefore, WPT results taxed more heavily (in relative proportion to the actual tobacco content) than other products in this category. High taxes on WPT seemingly have encouraged illicit or informal trade in several MS. Also due to a lack of a separate category, monitoring data on WTP are very</p>

Problem area	Problem outline
	scarce.
MED	Directive 2011/64 permits Member States to levy a Minimum Excise Duty (MED) on cigarettes, i.e. a sort of minimum excise floor intended to discourage down trading and the adverse effects of low-cost brands on tax revenues and tobacco control policies. The provision is formulated generically and only requires that the rules on the mandatory mixed structure are respected, which leave MS with some freedom on how to interpret and apply the MED and its possible limits.
Customs & Excise	<p>The disparity between the customs classification (Combined Nomenclature) and the excise classification (Excise Product Codes as defined in Annex II of Commission Regulation No 684/2009¹²) may result in uncertain classification of certain products, disparity of treatment and disputes. This is for instance the case with certain products that are currently classified as cigarettes for customs purposes and as cigarillos for tax purposes, as well as with some uncertainties in the distinction between excisable and non-excisable tobacco.</p> <p>Beside these issues, which have been addressed in the corresponding product-related sections, the other issues identified in the Ramboll Evaluation turned out either resolved or marginal therefore they have not been further investigated in this Study.</p>

2.3 Overview of methodology

2.3.1 Data Collection Methods

2.3.1.1 In-depth Consultation of Stakeholders

➤ THE INTERVIEW PROGRAMME

The bulk of the data collection activities was centred on a vast in-depth consultation of stakeholders, through field work in several Member States and at the EU level. Overall, **180 interviews** were conducted for an estimated total of over 250 individual informants consulted (many interviews were attended by multiple participants). This largely exceeded the initial minimum target of 140 interviews. Similarly, the geographical coverage has resulted greater than envisaged. In addition to the sample of 7 MS selected for general fieldwork (DE, FR, HU, IE, IT, PL, SE) and the *ad hoc* 6-country samples selected specifically for the research on new products and raw tobacco, stakeholders from five other countries were consulted on specific themes. The extension of the fieldwork allowed to ensure a better match between the issues at stake and specific national markets (or regulation), examples include: the coverage of MED in Portugal, of FCT in the UK, of e-cigarettes in HU, of cigarillos in DK, of raw tobacco in BG etc. the geographical distribution of interviews is provided in **Table 3** below.

With respect to the typology of informants involved in the interview programme, attention was paid to ensure an appropriate balance between different stakeholders and in particular:

- (i) public authorities and private sector players;
- (ii) industry representatives and public health representatives (NGOs and experts);

¹² COMMISSION REGULATION (EC) No 684/2009 of 24 July 2009 implementing Council Directive 2008/118/EC as regards the computerised procedures for the movement of excise goods under suspension of excise duty.

- (iii) large players and SMEs;
- (iv) players operating in different product segments (cigarettes, fine-cut tobacco, cigars/cigarillos, water-pipe tobacco, other tobacco products – including intermediary products – and novel products);
- (v) different value-chain operators (from growers/first processors, to manufacturers, to wholesalers/distributors, to retailers/vendors).

The organisation and implementation of the interview programme was generally smooth in all MS with public authorities, large manufacturers and industry associations. More challenging was the identification and consultation of small players especially in the segment of small import, distribution, and retail, and in particular for water-pipe tobacco (also due to the large informality dominating this segment). A breakdown of the interviews conducted, by type of respondent is provided in **Table 3** below.

Table 3 – Breakdown of interviews by type of respondents and country of origin

Respondent Type	No. of interviews	Country of origin	No. of interviews
Public authorities	42	United Kingdom	22
- European Commission	7	Italy	23
- Tax/customs authorities	23	Germany	23
- Public Health authorities	4	Poland	16
- Other (Ministry of Agriculture, etc.)	8	France	13
Industry operators and associations	115	Hungary	11
- Big tobacco manufacturers	37	Ireland	10
- Other tobacco manufacturers	20	Sweden	9
- New products operators	31	Romania	9
- First processors / growers	19	Portugal	8
- Import / distribution / retail	8	Belgium*	3
NGOs	17	Latvia	2
- Public Health NGOs	15	Slovakia	2
- Other (e.g. vapers etc.)	2	Bulgaria*	2
Others (e.g. experts etc.)	6	Austria*	1
		Finland*	1
		Denmark*	1
		<i>EU level</i>	24
Grand Total	180		180

Note: (*) Additional countries not initially selected for fieldwork.

All interviews were based on the checklists for discussion with stakeholders developed in the inception phase – and further refined and consolidated in the data collection phase. In various instances, the standard checklists were further customised to better address the nature of the respondent and the specific MS legal framework. The checklists were generally sent to interviewees a few days ahead of the meeting in order to allow for the preparation of the discussion. The vast majority of the interviews were conducted face-to-face (91%) and lasted more than one hour (up to 2.5 hours in a few cases).

➤ **GROUP DISCUSSIONS AND CONFERENCES**

In addition to one-to-one interviews the Consultant organised and participated in collective consultations in the framework of international conferences or ad hoc focus groups discussions with industry or consumers representatives. These included in particular:

- *The 35th Unitab Congress* (17th - 19th October 2016), hosted by the Bulgarian Tobacco Growers Association (NAT 2010) in Sofia. On the sidelines, the Consultant organised with the support of Unitab and Fetrtab, a collective

meeting with national federations of tobacco growers and representatives of first processors from all producing MS.

- Launch of the Report "*The Economics of Tobacco and Tobacco Taxation in Romania in the Framework of EU Directive 2011/64 revision process*", hosted by the European Network for Smoking and Tobacco Prevention (ENSP) on the 22nd of November in Bucharest. The Event brought together representatives of public, academic and medical institutions and NGOs, both national and international, with focus and activities in tobacco control.
- *Focus group discussion with the UK Independent E-Cigarette Industry*, organised with the support of IBVTA and involving various economic operators (manufacturers and vendors) including from Ireland.
- *Focus group discussion with UK vapers*, organised with the support of IBVTA and involving representatives of the New Nicotine Alliance consumers' organisation and other e-cigarettes consumers.

In the initial phase of the assignment, the Consultant also participated to two separate round tables organised by DG TAXUD, which involved respectively 43 industry representatives and 11 NGOs representatives. The Round tables were structured in three main parts: (1) an introduction where the Commission explained the purpose of the meeting and illustrated the ongoing process and the timeframe of the review of the Directive 2011/64; (ii) a brief presentation of the Study and the stakeholder consultation process; and (iii) an interactive session where participants could comment on the initial problem analysis and preliminary policy options laid down in the Inception Impact Assessment.

2.3.1.2 Open Public Consultation

The Consultant assisted DG TAXUD in the preparation and implementation of an Open Public Consultation (OPC) aimed at gathering the views of EU citizens and stakeholders on a set of possible options for the revision of Directive 2011/64/EU.¹³ The questionnaire included an overall 58 questions divided into nine thematic sections. Questions primarily concerned (i) the respondents' perception of the problem; (ii) the agreement / disagreement with a subset of possible options and approaches to the problem, and (iii) respondent's expectation about the impact that may derive from the adoption of certain measures.

To respond to the disparity of background among respondents, each thematic section included general questions suitable for all type of respondents, and more specific questions for respondents with a more in-depth knowledge of (or specific interest in) the technical functioning of Directive 2011/64. Respondents could also complete only one or a few sections of the questionnaires they were more interested in or familiar with and skip the other thematic sections. At the beginning of the questionnaire a 'respondent's profile' section was added to determine the nature and geographic localisation of the respondent as well as whether the respondent had a specific interest in the matter discussed.

The OPC was launched on 17 November 2016 and remained open until 16 February 2017, for a total of 13 weeks. A total of 7,686 responses have been received, from all the EU28 MS, testifying the strong interest and involvement of stakeholders in the issues at stake. The huge majority of respondents are private individuals (i.e. 7,317 – 95.2%) and in particular consumers of electronic cigarettes (5,203 responses). In addition, respondents included also some 230 economic operators/industry associations, 81 NGOs, 14 MS public authorities, and other 44 miscellaneous respondents.

¹³ https://ec.europa.eu/taxation_customs/consultations-get-involved/tax-consultations/public-consultation-excise-duties-applied-manufactured-tobacco_en

2.3.1.3 Desk Research

The desk research involved a vast range of different sources including EU and country-level policy documents, scientific literature, industry and stakeholder reports, and other grey literature, both published and unpublished. Over 500 documentary sources were reviewed throughout the Study, including:

- i. **EU Policy and Initiatives.** This included all materials related to the Directive 2011/64, as well as to the other relevant pieces of EU legislation directly concerned, i.e. Directive 118/2008, Directive 40/2014, the Combined Nomenclature codes and the relative explanatory notes. The desk work involved taking stock of preliminary impact assessment documents, implementation reports, and other EU-mandated studies in this framework. This category also included the outputs of the work of advisory and expert groups. Further information was sought from other EU-funded studies and initiatives, including the Eurobarometer surveys (no. 385 and 429), JRC studies¹⁴, and relevant projects funded under the Framework Programme and the Public Health Programme (such as PPACTE¹⁵).
- ii. **Member States documentary sources.** At MS level the desk research concerned: (i) specific policies, by-laws and procedural documents (e.g. guidelines) on the issues at stake – including also ex ante studies, implementation reports and evaluations; (ii) monitoring data collected by tax/customs authorities and/or tobacco control centres (beyond those transmitted at EU level); (iii) market and consumers data collected and published by non-State actors (industry, trade, public health and consumers organisations); and (iv) any other programme, pilot initiative and research study deemed relevant. In some cases, the research included policies and documentary sources published in the USA, since trends in this market often help predicting future trends in the EU.
- iii. **National and International Policies and Initiatives.** At the global level, a vast repository on knowledge and research data on tobacco trade and consumption is available under the WHO Framework Convention on Tobacco Control (FCTC). These include implementation reports, database, technical publications, as well as the related International Tobacco Control (ITC) project reports.
- iv. **Databases.** The Consultant has accessed a variety of EU and international databases to collect quantitative data on the products at stake, including *inter alia* DG TAXUD's datasets, Eurostat and DG TRADE statistics, the BTI database and the OLAF's *CigInfo* database. When official data were unavailable the Consultant complemented the research using the *Euromonitor* database, and other ad hoc datasets provide by some industry representatives.
- v. **Scientific and 'Grey' Literature.** Many of the issues at stake had been addressed in the literature, although not always in a systematic or comprehensive way. Several scholar's publications have been used in this Study, which helped clarifying controversial evidence, and ensured that the analytical models used were based on the best science available. These regarded specific aspects of the policy, market dynamics, consumer behaviours etc. In addition to scientific publications, other 'grey' literature, like industry and NGO reports, market studies and the like, were used as complementary sources, in case of paucity of robust data and after a careful assessment of possible biases and inaccuracies.

2.3.2 Data Analysis and Judgment

¹⁴ E.g. Otmar Geiss, Dimitrios Kotzias, "Tobacco, Cigarettes and Cigarette Smoke", JRC, 2007.

¹⁵ PPACTE: Pricing Policies and Control of Tobacco in Europe. <http://www.tri.ie/ppacte.html>

2.3.2.1 Structuring the Work

The initial phase of the Assignment was dedicated among other things to structuring the analytical framework of the Study. In addition to various preliminary data gathering activities and a stakeholder analysis, the main focus consisted of refining the two main scenarios for comparison for all the issues at stake, i.e.:

- i. The **'no change' scenario**, i.e. no amendment of the Directive. This scenario coincides with the business-as-usual (BAU) situation. However, since markets evolve and MS may continue regulating the above matters at national level, the impact of the Directive would inevitably change, even if the text were not modified ('dynamic baseline').
- ii. The **'policy change scenario'**, i.e. a formal amendment of the Directive and/or non-regulatory measures. In some instances, this may introduce new provisions and norms, in others it may consist of clarifications of the existing provisions and/or other supporting measures for their proper implementation.

Firstly, this entailed conducting a problem analysis to determine the nature, relevance and magnitude of the specific issues considered. Secondly, it required a critical assessment of the policy options under consideration with a view to clarify them and to firm-up the list of those that qualify for a more in-depth impact assessment. Thirdly, it envisaged a preliminary identification of the relevant impacts that can be expected from those options, as well as of their salient features. The results of this analytical work were provided in the Inception Report.

2.3.2.2 Baseline Analysis

The baseline analysis is an essential cornerstone of the analytical work, since it sets out the terms for comparison of the proposed policy options. The implementation of the Directive had been extensively assessed in the Ramboll Evaluation, whose findings are at the basis of this Study. In the baseline analysis these findings were further investigated and in particular: (i) certain issues have been quantified (based on the evidence available); (ii) some information has been updated and verified due to evolving legal and market frameworks; and (iii) the expected trends, in the absence of policy changes, have been projected.

The implementation of the baseline analysis involved various dimensions, which varied across the issues at stake, including among other things: the tax treatment of certain products (legal and procedural provisions), the monitoring system in place in the MS, the market structure, size and trends (including on the side of consumers), the estimated amount of excise duty collected and possible tax 'gaps', the extent of illicit trade and of tax avoidance practices, the trends and outcomes of general tobacco control policies (see **Table 4** below).

Table 4 – Overview of issues for the baseline assessment in specific problem areas

Problem Area	Issues for the dynamic baseline assessment
New Products	<ul style="list-style-type: none"> • Market value of e-cigarettes products and heat-not-burn products, and trend. Industry and market structure. • Number of consumers, and consumption patterns (frequency, extent of substitution of traditional products, price sensitivity) • MS tax treatment of new products. Implementation and enforcement. Estimated tax revenue (based on countries that have introduced a specific tax on new products) • Estimated cross-border shopping and illicit trade. • Legal and administrative uncertainties. Functioning of the single market.
Raw tobacco, tobacco refuse, and intermediate	<ul style="list-style-type: none"> • Trade volume and market value of raw tobacco, tobacco refuse and reconstituted tobacco. Overview of the value chain. • Regulatory and monitoring frameworks for raw tobacco and tobacco

Problem Area	Issues for the dynamic baseline assessment
products	<ul style="list-style-type: none"> • refuse existing at national level • Estimated volume of illicit trade of raw tobacco and intermediate products. • Legal uncertainty and disputes created by the definitions of smoking tobacco and tobacco refuse
'Borderline' cigarillos	<ul style="list-style-type: none"> • Market value of cigarillos and 'borderline' products, and trends. • Consumption patterns and estimated substitution of cigarettes (including among youth) • Tax levels and revenue from 'borderline' products. Estimated tax 'gap'. • Overview of inconsistencies between coding systems. Related burden and frequency of disputes.
Fine-cut Tobacco (FCT)	<ul style="list-style-type: none"> • Demand and product characteristics for FCT, including roll-your-own, make-your-own and 'volume tobacco'. • Conversion rate between FCT and cigarettes • Tax-induced substitution between FCT and cigarettes; FCT market drivers. • Tax-advantage of 'volume tobacco'.
Minimum Excise Duty (MED)	<ul style="list-style-type: none"> • Economic rationale and functioning of MED • Use of MED by MS: legal provisions, purposes of MED, impact on cigarettes market structure • Legal uncertainty due to MED provisions
Water-Pipe Tobacco	<ul style="list-style-type: none"> • Estimated import and consumption of water-pipe tobacco, and trends. • Tax levels and revenue from water-pipe tobacco. • Estimated volume of illicit trade.

2.3.2.3 Impact Analysis and Comparison of Scenarios

The proposed policy options for the revision of the Directive may determine a variety of different economic and social impacts for various different stakeholder groups, primarily MS competent authorities and economic operators, secondarily consumers and public health stakeholders. The different typologies of impact assessed in this Study can be gathered in five main categories, as follows:

- i. **Direct charges.** Direct charges include taxes and fees paid by economic operators or consumers. In line with the nature and scope of Directive 2011/64, the focus of this Study is excise duty on manufactured tobacco, and the related excise duty revenues of Member States. This dimension has been examined across all thematic areas considered. Unless differently stated, all references to 'tax rates', 'tax structures', 'tax revenues' etc. in this Report relate to excise duties. However, in some cases, the analysis has encompassed also VAT. In fact, since manufactured tobacco products, as well as new products, are subject to VAT, possible changes in the excise duty treatment of products may have indirect effects also on VAT receipts. The impact on VAT was not assessed systematically but only where relevant for the analysis, e.g. where – as in the case of electronic cigarettes – excise duty gains would seemingly be mitigated by VAT losses.

Importantly, tax revenues are distributional impacts: what is a benefit for tax authorities is a cost for consumers and/or manufacturers. In the assessment and comparison of policy scenarios these impacts were primarily examined from the perspective of tax authorities. In this sense an increase of tax revenues is rated positively and *vice versa*. Impacts on tax revenues can be triggered by variations of: (i) rates applicable to excisable products; and (ii) scope of the tax system, i.e. the inclusion or exclusion of certain products within or from the existing categories. It is also worth mentioning that these variations also trigger other impacts, considered below under market or social effects, such as tax-induced substitution between products, cross-border distortions, health effects (in terms of smoking prevalence), demand for illicit products and crime.

- ii. **Substantive compliance and administrative costs and cost savings.** Substantive compliance and administrative costs for economic operators have been assessed in all instances where the policy revision implies including additional products within the scope of the Directive, namely in the cases of a possible inclusion of new products and raw tobacco among excise goods. In these scenarios, companies previously outside the EU excise system would need to comply with the information and substantive obligations envisaged by Directive 2008/118 and related implementation rules.¹⁶ For example, setting up a tax warehouse generates substantive compliance costs; record-keeping of stocks and flows, registration of consignees and consignors, issuance of guarantees,¹⁷ and the use of the ECMS system for intra-Community flows can instead be considered as 'information obligations', thus generating administrative costs. Administrative and substantive compliance cost savings are also assessed in the course of the Study – e.g. when the revision of a definition reduces legal uncertainty and thus lower burden for operators. However, they are not the most relevant dimension of the analysis, because none of the policy options mainly deals with the simplification of the existing regimes. In the Study, administrative and substantive compliance costs are analysed separately but jointly referred to as 'regulatory costs', in the final comparison of policy options.
- iii. **Enforcement costs and benefits.** As regards enforcement costs and benefits, two main types have been considered:
- (i) enforcement costs and cost savings *stricto sensu*, which are those borne by public authorities to apply the revised Directive provisions; and
 - (ii) judicial costs and cost savings, which are costs borne by public authorities and economic operators related to the need to interpret unclear legal provisions and, in case of judicial disputes, uphold them in court, as well as benefits (cost savings) in case interpretations and judicial disputes are no longer needed after a clarification or legal revision.
- iv. **Market effects:** Market effects concern distortions of the quantity exchanged and of the equilibrium price of the various products. Taxation, by definition, distorts any market from the equilibrium that it would reach based on the free adjustment of demand and supply. For this reason, the Study did not attempt to assess market distortions *per se*, but those that might go beyond the intended objectives of the regulator, in terms of Single Market functioning and tobacco control policy objectives. Four categories of possible market effects and distortions have been considered:
- (i) Tax-induced substitution across products, i.e. when the demand for a certain product is favoured (hampered) by the higher (lower) taxation imposed on one or more substitute products.
 - (ii) Cross-border distortions and illicit markets. This may be the case when consumers stop purchasing a certain product in their home country and buy it across the border, either by means of bootlegging, or via informal distributional channels (e.g. online) outside the duty-paid regime. This may

¹⁶ Compliance with the excise system obligations is not part of the usual business practices of a company. Rather, with these obligations solely complied for tax and monitoring purposes. For instance, no company would set up a tax warehouse or provide an excise guarantee if not required by a regulatory provision and in order to obtain excise duty suspension. For this reason, the business-as-usual factor is estimated at 0% for all the regulatory provisions linked to the excise framework; hence there is no difference between administrative and substantive compliance costs and burden.

¹⁷ In this Report we have considered the issuance of a guarantee primarily as an administrative costs, although it is not explicitly defined in the Better Regulation Toolbox. On one side, it consists of a direct charge for businesses, i.e. the fee paid to the financial institution that release the guarantee. On the other side, the tax warehouse operator has the 'information obligation' to submit proof of the guarantee issued to the public authorities.

- also be the case when consumers stop purchasing licit products and resort to illicit markets, supplied with either domestic or cross-border products.
- (iii) Single Market functioning, and possible distortions induced by diverging legal treatments or uneven application of Directive provisions or other administrative obstacles hampering the circulation of products or affecting fair competition.
 - (iv) SME competitiveness, since certain impact may have a differential effects on small players and on bit tobacco companies.
- v. **Indirect social effects.** This category includes impacts that poorly lend themselves to a quantification in monetary terms, but are nonetheless important since they concern the underlying values and principles of policy action that are linked to social well-being in broad sense. Two areas of social impact that have been considered related to the policy options at stake - although indirectly - namely: (i) public health (through tobacco control policy and measures); and (ii) crime (through anti-smuggling policy and measures).

The final step of the analysis of impacts consisted of the **comparison of the policy options**. The issues at stake in this Study require policy revisions that are relatively independent from one another. Therefore, the comparison of options have been performed for each thematic area separately, rather than in a cumulative way. Given the different nature of the impacts considered, the final comparisons required combining different approaches, and specifically, a partial cost-benefits analysis (CBA) approach for quantifiable (monetary) impacts, such as market effects, tax revenues and – where feasible – regulatory costs, and a multi-criteria analysis (MCA) for non-quantifiable or mixed ones.

2.4 Structure of the Report

The Report is divided in two volumes: **Volume 1 – Main Text**, and **Volume 2 – Annexes**. The rest of Volume 1 includes four Sections structured following a cross-sectoral approach, meaning that every Section is further subdivided into six parts, each one focusing on one of the issues at stake (see **Table 2**). The four Sections include the following:

- **Section 3** deals with the problem analysis and provides an assessment of the current situation in the six areas identified, including an overview of the background and an analysis of the expected developments in the absence of any Commission intervention.
- **Section 4** defines the various policy options identified to address the issues at stake, and outlines the impact areas requiring a more profound analysis.
- **Section 5** provides an assessment of the policy options considered, in both a quantitative and qualitative way, and compares the respective positive and negative aspects of each options to the 'no-change' scenario.
- **Section 6** summarises the key findings of the Study and provides a set of conclusions.

3 ANALYSIS OF THE ISSUES AT STAKE

3.1 New Products

3.1.1 Overview of Products and Markets

3.1.1.1 The Products and the Industry

➤ DEFINITIONS

The new products discussed here include two main categories of products. The first group includes a heterogeneous class of products¹⁸ commercially known as electronic cigarettes (or e-cigarettes). These are also referred to as Electronic Nicotine Delivery Systems (ENDS) or Electronic Non-Nicotine Delivery Systems (ENNDS) in the case of equivalent products not containing nicotine. Based on the WHO definition “ENDS/ENNDS heat a solution (e-liquid¹⁹) to create an aerosol which frequently contains flavourants, usually dissolved into Propylene Glycol or/and Glycerin. All ENDS contain nicotine.”²⁰ The aerosol produced by e-cigarettes and inhaled by the user is essentially a vapour, hence the widespread terminology of ‘vaper’ and ‘vaping’ to denote users and consumption. In EU legislation, the electronic cigarette is defined in the Tobacco Products Directive 2014/40 (TPD2) as “a product that can be used for consumption of nicotine-containing vapour in a mouth piece, or any component of that product, including a cartridge, a tank and the device without cartridge or tank. Electronic cigarettes can be disposable or refillable by means of a refill container and a tank, or rechargeable with single use cartridges”. The TPD2 also defines ‘refill container’ as “a receptacle that contains a nicotine-containing liquid, which can be used to refill an electronic cigarette”.²¹

The second group includes recent alternative nicotine delivery systems that heat but do not burn tobacco, and are therefore referred to as Heat-not-Burn (HnB) or simply Heated Tobacco Products (HTP). There is no ad hoc definition for HTP in the TPD2, but they fall under the more general category of ‘novel tobacco products’, which comprises all tobacco products placed on the market after 19 May 2014 that are not covered by other tobacco categories. Unlike e-cigarettes, HTP do contain tobacco, although typically of reconstituted type. Like e-cigarettes, HTP consist of two components: a heating device and an electronically-heated tobacco element (a stick or a pod). When heated, the tobacco element generates an aerosol that the users inhale. HTP and e-cigarettes have in common the absence of combustion processes, therefore are sometimes jointly categorised as ‘non-combustible’ products as opposed to conventional tobacco products that are ‘combustible’.

With respect to definitions, it is important to underline that at present there are no European standards for these products. In connection with some TPD2 requirements on product safety, the European Committee for Standardization (CEN) has created in 2015 a new Technical Committee - CEN/TC 437 'Electronic cigarettes and e-liquids', with the aim of developing European standards covering terminology and definitions, as well as requirements and test methods for e-liquids, devices, and emissions. This

¹⁸ This class may include products commercially known as e-cigars, e-hookah, vape pens, personal vaporisers, electronic pipes etc.

¹⁹ In the USA, the FDA has adopted the term ‘e-liquid’ in its guidance document: “liquid nicotine and nicotine -containing e-liquids (i.e., liquid nicotine combined with colorings, flavorings, and/or other ingredients) are generally referred to as e-liquids”.

<https://www.fda.gov/downloads/TobaccoProducts/Labeling/RulesRegulationsGuidance/UCM499352.pdf>

²⁰ Conference of the Parties to the WHO Framework Convention on Tobacco Control, “WHO Report, Electronic Nicotine Delivery Systems and Electronic Non-Nicotine Delivery Systems (ENDS/ENNDS)”, August 2016.

²¹ TPD2, Art. 2(16).

work follows earlier standards developed by the French standard setting agency (AFNOR) and the British Standards Institute, and is expected to complete by 2017.²²

Similarly, there is no *ad hoc* category for these products in the World Customs Organization (WCO)'s Harmonised Systems and the corresponding EU Combined Nomenclature (CN). Devices fall under the generic CN 8543.70 (Other machines and apparatus), while e-cigarettes liquids can be classify under CN 3824.90 in the case of cartridges containing a preparation of nicotine but also as CN 2106.90, which refers to other food preparations.²³ So far, the tobacco element of HTP systems has been generally classified in the 'other / other' manufactured tobacco category (CN code 2403.99.90).²⁴ However there are discussions ongoing at WCO on a possible different categorisation of HTP. Reportedly, some countries have proposed to use different categories, i.e. the other smoking tobacco category, the 'homogenised' tobacco category, or the 2402 category (cigars, cheroots, cigarillos and cigarettes). A decision is expected in September 2017

➤ **PRODUCT CHARACTERISTICS**

For the purpose of this Study, two main components of new products should be distinguished: (1) the hardware (i.e. the device); and (2) the consumable (i.e. the e-liquid that is vaporised or the tobacco element that is heated).

The constituents of **e-cigarettes devices** are generally: a battery, a reservoir/tank for holding the solution, a heating element/atomizer, and a mouthpiece. However, there is a substantial heterogeneity between different types of devices available on the market. Conventionally, they are classified in three main groups, based on technical features, and on the degree of control that users have over their utilization (choice of liquid, settings etc.)²⁵:

- (i) First-generation, or so-called 'cig-a-likes', since they often resemble cigarettes (although not necessarily). They can be disposable or rechargeable using pre-filled cartridges.
- (ii) Second-generation, often referred to as 'tank systems'. These are typically shaped like pens, and feature a transparent reservoir that holds larger amounts of e-liquid than cartridge-containing models. Closed-tank systems (largely similar to cartridge systems) also fall into this category.
- (iii) The third (and fourth) generation includes various modular systems, aesthetically departing from the cigarette-like shape. They allow various degrees of customization of component parts, and let users to regulate the power delivery and other settings.

The various types of devices co-exist on the market, although open tanks and modular systems have grown in popularity in the past few years and reportedly account for the majority of the market (between 60% and 90%, depending on the source). Disposable devices and cig-a-likes have conversely declined and represent now only a small share of market (ca. 2-16%).²⁶ The market success of open and customizable systems reflect the high fragmentation of the market, due to the relatively low barriers to entry, and the rapid innovation and product development cycle. However, newly-designed closed systems are increasingly being brought to the market, especially by big companies and their affiliates.

²² <https://www.cen.eu/news/brief-news/Pages/NEWS-2015-002.aspx>

²³ Commission Implementing Regulation (EU) No 1101/2014 of 16 October 2014 amending Annex I to Council Regulation (EEC) No 2658/87 on the tariff and statistical nomenclature and on the Common Customs Tariff.

²⁴ Binding Tariff Informations (BTI) have been issued on HTP by various MS customs authorities.

²⁵ Several and not always coherent classifications of e-cigarettes by generations can be found in the literature.

²⁶ Estimates on market shares of devices are elaborated based on *Euromonitor* and other industry and commercial sources, including the Ernst & Young report, "E-cigarettes an emerging category", May 2016.

Large and modular devices are more expensive than ordinary rechargeable and disposable systems and require a certain degree of familiarity. Typically, users start with a low power, more affordable device (i.e. between € 10-25) and later upgrade to larger systems (from € 100). Large devices also influence the patterns of consumption. On the one hand, they consume e-liquids much faster, on the other hand, they deliver nicotine more effectively, thus allowing to reduce the level of nicotine concentration in the e-liquids consumed. The way technological innovation has modified consumption patterns has direct consequences on market dynamics of consumables and, as discussed further below, on tax policy considerations.

There are very few **HTP devices** on the EU market at the time of writing, namely: (i) *iQos* (commercialised by PMI), (ii) *GLO iFuse* (commercialised by BAT), and (iii) *Ploom* (from JTI, no longer commercialised in the EU). They have similar components as electronic cigarettes devices (battery, heating element etc.).

The **e-cigarettes consumables** consist of so-called e-liquids (or e-juices) contained in the device (in the case of disposable devices) or sold separately as replaceable cartridges or refillable tanks (refill containers). E-liquids contain a solution of propylene glycol and vegetable glycerine (PG / VG) in different proportions, flavourings, water and nicotine in different concentration (from nil to maximum 20mg per ml of liquid). The majority of consumable products are 'ready-to-vape' (i.e. pre-mixed), however it is increasingly common among vapers to buy separately the 'base' (a neutral mix of PG / VG with a specific concentration of nicotine) and concentrated flavours – a practice known as 'do-it-yourself'. In countries where nicotine e-liquids are heavily excised, some users reportedly buy highly concentrated nicotine through illegal / online channels and add it to non-nicotine solution to prepare their own liquid avoiding taxation.²⁷ This is sometimes encouraged by retail outlets performing under-the-counter mixing.

E-liquids are available in a variety of flavours. According to some estimates, 7,700 unique flavours exist. Tobacco²⁸, mint, coffee, and fruit flavours are the most common, but a variety of candy (e.g., bubble gum), unique flavours (e.g. Belgian waffle), and alcoholic drink flavours are also available.²⁹ Each ready-to-vape liquid is normally available at different nicotine concentration levels, which further multiplies the number of different items available on the market (so-called 'stock keeping units' - SKU). Preliminary estimates from notification process envisaged by the TPD2 suggest the total number of SKUs in the EU amounts to several tens of thousands. The first-hand evidence collected indicates that the average consumption of nicotine has been declining overtime.³⁰ Today, the most popular products typically have a nicotine concentration of 6-12mg / ml, i.e. nearly half the concentration of the average product consumed 4-5 years ago. This relates primarily to the abovementioned innovation in the devices, which deliver nicotine more effectively. Additionally, according to some stakeholders, it is also a common process among vapers to reduce overtime and eventually eliminate completely the intake of nicotine.

²⁷ Various online outlets selling 'pure' nicotine have been identified in the course of the Study, operating from both EU (e.g. Poland and UK) and non-EU countries (mainly China). Various operators help customs authority's intelligence services by signalling such vendors, but the characteristic of the product makes a tight control difficult.

²⁸ According to Ernst & Young (2016) tobacco flavour represent some 28-34% of the flavour market in Europe, against 19-26% of botanical flavours, and 14-24% of fruit flavours.

²⁹ U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention and Health Promotion, Office on Smoking and Health, "E-Cigarette Use Among Youth and Young Adults. A Report of the Surgeon General", Atlanta, GA, 2016.

³⁰ This is also corroborated by other studies such as Ernst & Young (2016), which shows that the share of vapers using liquids with a concentration higher than 12 mg/ml has decreased from 77% in 2013 to only 11% in 2015. These figures are based on a survey conducted by *Kantar* which involved a relatively small sample of individuals (2,000 in seven countries) recruited with a self-selection approach (i.e. not through random sampling). Their statistical significance is therefore limited.

The **HTP consumables** are available in a much smaller variety. The *iQos HeatSticks* consist of an outer wrapper of paper containing an aluminium foil³¹, a mouthpiece with a filter and a reconstituted tobacco blend. It is reportedly available in three flavours. *Ploom* used small tobacco pods containing the tobacco mixture. *iFuse Neopod* is actually a 'hybrid' product: the cartridge is formed by a small tobacco receptacle and an e-liquid tank; the device heats the liquids, which passes through the tobacco before it is inhaled.

➤ THE INDUSTRY

The **HTP industry** is exclusively made of big tobacco companies, due to the significant barriers to entry. The **e-cigarettes industry** is instead characterized for being (i) highly fragmented; and (ii) largely domestic. Precise data on the number of existing players are not available but the educated guesses provided by various stakeholders suggest there are some 1,000 – 2,000 distributors and producers in the EU, mainly based in UK, FR, IT, PL and DE.³² This estimate does not include franchises and point-of-sales, whose number is countless. As regards e-liquids, the relative few barriers to entry has fuelled the proliferation of brands and a significant share of market consists of myriads of SMEs. According to some stakeholders, in the UK SMEs would account for 85% of the market. Big Tobacco companies started entering in this market through a series of acquisitions of starts-ups.³³ In the past few years they had mixed success in this segment, however various stakeholders agree that in the future they may acquire larger market shares thanks to newly engineered products and better distribution channels. Traditionally, tobacco companies have invested in closed-tank and cig-a-like systems, while SMEs have focused on open systems, but the distinction is increasingly blurred.

The second main feature of the e-cigarettes industry is that it is still highly domestic. The various stakeholders consulted in the sample MS selected for this Study confirmed that - with the exception of big tobacco companies and very few SMEs - national markets are largely dominated by domestic businesses. This seems connected to the above fragmentation of the industry into a several small and micro players, and possibly to the uncertain and diverse rules applicable in different MS.

E-cigarettes devices and components are mostly produced in China, although some major brands are designed and engineered, and sometimes assembled, in the EU (Germany, UK etc.). The products are then distributed through wholesalers or directly imported by main vendors. E-liquids are to a significant extent manufactured in Europe (e.g. FR, PL, UK, IT, CZ etc.) through ingredients sourced from chemical companies (e.g. nicotine) or food additives and fragrances industry (for flavours). A certain share of finished products are also imported from the USA (premium products) or China (low-cost segment).

➤ THE DISTRIBUTION CHANNELS

E-cigarettes are purchased both online and 'offline', i.e. via various terrestrial channels including specialist shops (so-called 'vape-shops') and other generic or mixed retail outlets. The latter group includes also the traditional tobacco shops. Since the few existing market research covers only terrestrial channels, the estimates on the share of the online sales have to be taken with great caution. The estimates provided in

³¹ The aluminium foil may not be present in the products commercialised in certain non-EU geographical markets.

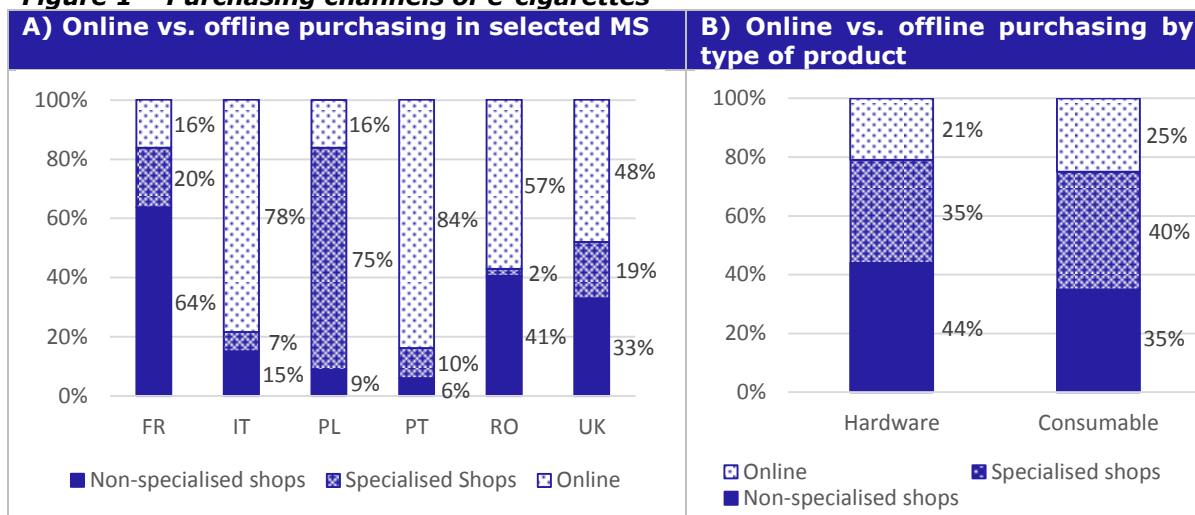
³² According to *Euromonitor* estimates in the two main EU markets, i.e. UK and France, the top 5 brands account for less than 30% of sales.

³³ To name a few: BAT acquisition of CN Creative, Ten Motives, and CHIC; JTI acquisition of E-lites brand; Imperial Tobacco acquisition of Blu (via Fontem Ventures); PMI acquisition of Nicocigs.

Figure 1A shows a great cross-country variability, with online sales ranging from 16% up to 84% - although other sources (**Figure 1B**) provide more conservative estimates. As it will be discussed further below, the online share appears higher in MS where e-cigarettes are subject to excise duty (e.g. IT, PT, and RO). In these MS, this channel has largely replaced vape-shops. The online trade is notoriously difficult to track and the domestic or foreign origin of certain products is often unknown. Some MS have banned cross-border distance selling of e-cigarettes³⁴, but it cannot be excluded that some cross-border transactions take place nonetheless.

Only a minority of consumers purchase e-cigarettes exclusively online³⁵, and online-only vendors are rare. In most of cases, retailers operate online shops as a supplementary channel to terrestrial outlets. Most of stakeholders concur that the direct relation with the customer and the level of service provided is an essential marketing factor, since products are highly interchangeable and customers' loyalty is low. Customers come to vape-shops to receive advice on the products and use the online outlets to replete stocks. Big tobacco companies' products - including HTP - are more often distributed through traditional tobacco point-of-sales, but also a few flagship shops exist. The distribution of e-cigarettes is normally not subject to regulation stricter than that for conventional cigarettes, including in MS where cigarettes retail is subject to State monopoly. An exception is Hungary, where only shops holding a specific license are allowed to sell e-cigarettes.

Figure 1 – Purchasing channels of e-cigarettes



Sources: (A) *Euromonitor International: Passport Tobacco, 2016 Edition*. (B) *Kantor* (cited in *Ernst&Young, 2016*).

3.1.1.2 Market and Consumers

➤ INFORMATION SOURCES

At present, there are no official sources of market data for e-cigarettes and HTP at the EU level and MS level. Industry and commercial intelligence data are the only sources available, but their degree of precision varies, due *inter alia* to the fact that the rapid innovation, the mixed purchasing channels (including online), and the diffusion of 'do-it-yourself' practices add complexity to the assessment. The most comprehensive and systematic source of data seems the *Euromonitor* database, which collates statistics and estimates based on a variety of sources. Stakeholders' have different views on the

³⁴ The MS that allow cross-border distance selling of e-cigarettes are: CZ, DK, FR, DE, IE, MT, NL, SK, SE, and UK (industry sources).

³⁵ According to a study commissioned by HMRC in the UK some 16% of vapers buy only online and other 13% mainly online. IFF Research, "Understanding the online e-cigarettes market", November 2016.

reliability of *Euromonitor* data, therefore in this Study they have been triangulated with other estimates collected from national associations and other industry players and experts (including both SMEs and big companies).

MS that apply excise duties on e-cigarettes may have in principle accurate data on consumption (at least of e-liquids), however none of the MS analysed has adopted an *ad hoc* monitoring of e-cigarettes. Tax receipts are poorly usable to infer the market size since: (i) in most of MS tax schemes have just been introduced and no statistics have been collected yet (as it is also the case with HTP), or data are distorted by the depletion of pre-existing stocks; (ii) in Italy, there is a judicial dispute ongoing on the legitimate tax base of e-liquids and, awaiting for the court's ruling, most players currently pay a reduced tax; (ii) in other countries taxing e-cigarettes, various licit and illicit systems to avoid taxation have developed (cross-border shopping, 'do-it-yourself' etc.). Where available, tax revenues have nonetheless been used to cross-check other sources' data.

Comparatively, survey-based data on vaping prevalence are more abundant. At EU level two Eurobarometer studies (2012, 2014) have addressed this subject.³⁶ These data were also used to carry out a specific study on the prevalence of e-cigarette use commissioned by DG SANTE.³⁷ Various surveys were also carried out in MS, often commissioned by State's authorities to research companies or other organisations (including NGOs). Consumers' survey data can be useful to triangulate industry estimates. However, there remains a high level of uncertainty and variability with per capita consumption and expenditure.

➤ **OVERALL MARKET ESTIMATES**

Most of the sources reviewed concur that in 2015 the EU **e-cigarettes market** exceed € 2.5 bn of turnover, being about one-third of the global market.³⁸ The most developed market in the EU is the United Kingdom, with an estimated 2.6 million vapers.³⁹ The other main markets are France, Italy, Germany and Poland, altogether accounting for some 5.0 million additional vapers. Assuming a similar proportion between market value and vaping prevalence in other MS, the overall number of regular consumers in the EU can be estimates at ca. 9.0 million, in 2015.⁴⁰

Euromonitor estimates a two-digit growth rate over the next 3-4 years (**Figure 2**). This is in line with other analysts' forecast predicting the global market will hit USD 32.0 bn by 2021.⁴¹ However, these estimates may not take into account the slow-down expected in the EU from the entry into force of the TPD2 rules, as well as country-specific issues (e.g. the clarification of tax regime in Italy). On this basis, some national stakeholders provided slightly different and more conservative growth estimates.

³⁶ Special Eurobarometer 429, "Attitudes of Europeans towards Tobacco and Electronic Cigarettes", 2015; and Special Eurobarometer 385, "Attitudes of Europeans towards Tobacco", 2012.

³⁷ Farsalinos K. E. et al., "Electronic cigarette use in the European Union: analysis of a representative sample of 27 460 Europeans from 28 countries", Society for the Study of Addiction, 2016.

³⁸ In 2015 the global e-cigarettes market was estimated at USD 8.0 bn.

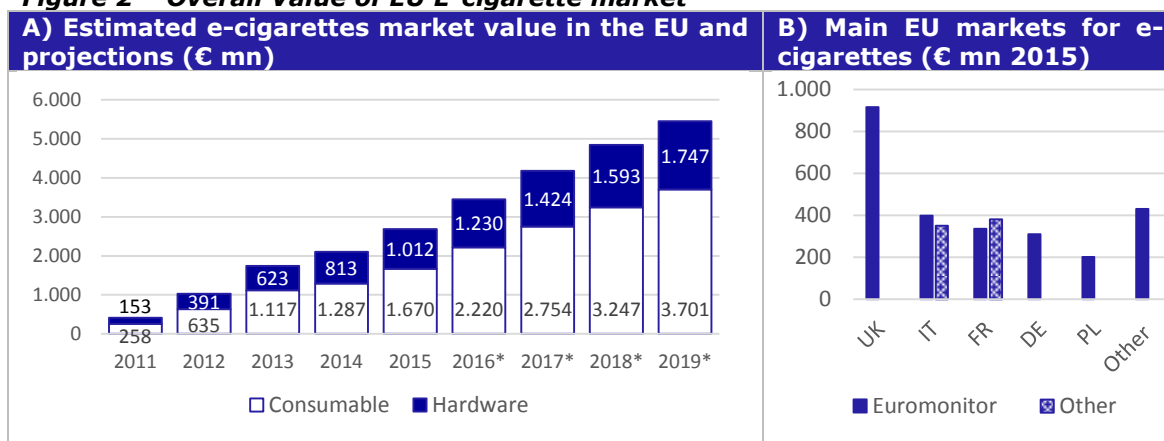
³⁹ ASH, "Use of electronic cigarettes (vapourisers) among adults in Great Britain", ASH fact sheet, May 2016.

<http://ash.org.uk/information-and-resources/fact-sheets/use-of-electronic-cigarettes-vapourisers-among-adults-in-great-britain/>

⁴⁰ The country level estimates on vaping prevalence may differ significantly, based not only on the source but also on the way regular/occasional vapers are counted. For instance, the INPES estimated in France the number of vapers was 2.8 mn in 2014, i.e. more than five times the *Euromonitor* estimate. According to a consumer survey the Italian vapers are nearly 1.0 million, but according to industry they are about half this amount. The figure provided in this report is consistent with Eurobarometer 429 estimate of 2% of population aged +15 in the EU, i.e. some 8.5 million.

⁴¹ Beige Market Intelligence "Global Vapor Market (e-cigarette and vaporizer) Strategic Assessment and Forecast Till 2021", 2017.

Figure 2 – Overall Value of EU E-cigarette market



Sources: (A) Euromonitor International: *Passport Tobacco, 2016 Edition*. (B) Euromonitor International: *Passport Tobacco, 2016 Edition* and industry estimates.

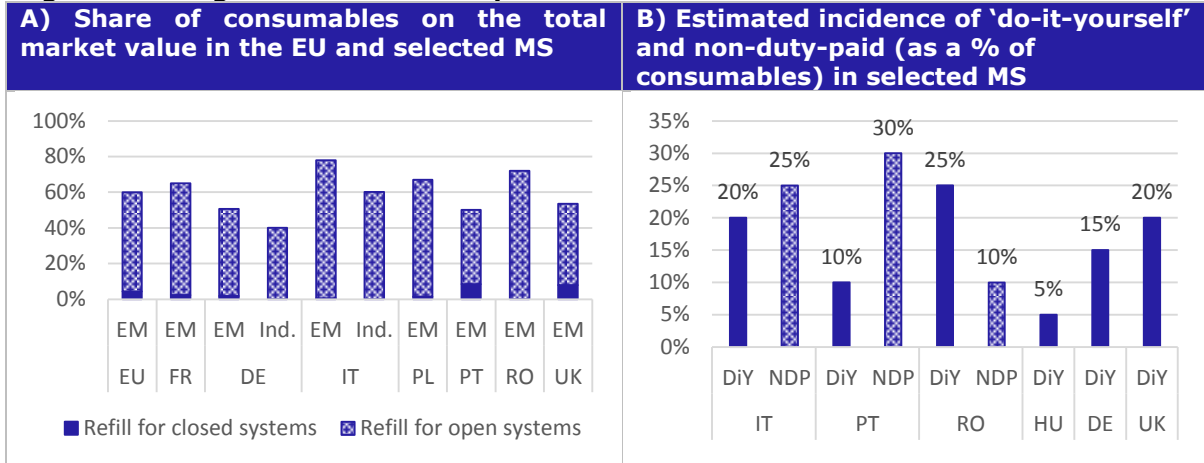
With respect to turnover composition, it is generally accepted that hardware and consumables account for respectively 40% and 60% of industry turnover. As shown in **Figure 3**, this proportion may differ across countries and industry estimates may differ. For instance, in Germany various economic operators concur device sales represent the majority of the market. This seems to reflect the fact that German market is relatively younger as compared to e.g. the UK, France and Italy.⁴² More generally, this proportion may be influenced by a number of factors, in particular: (i) the preference of consumers for premium or cheap devices (in the case of devices, price range from €10 to over €100) and the rapidity of obsolescence; (ii) the expenditure on e-liquids, as determined by both price-related choices and the diffusion of high power devices, which consume liquids more rapidly; (iii) the incidence of 'do-it-yourself', both for devices (less common) and e-liquids. It should be noted that these three variables are somehow connected, since a higher expenditure on large devices may trigger a higher consumption of liquid, which in turn may encourage vapers to save money through 'do-it-yourself' mixing.

Only gross estimates of the incidence of 'do-it-yourself' are possible. **Figure 3B** reports a series of educated guesses on the share of self-mixed products on the total consumed, in a sample of MS. On average, this practice seemingly amounts to some 15-20% of the total volume of e-liquids (i.e. an estimated 5-6% in terms of turnover). The main driver behind 'do-it-yourself' is costs savings, but many vapers also find it enjoyable to customize their own vaping liquids. Overall, self-mixing allows to save an estimated 50% - 70% over the price of ready-to-vape liquids, but this measure varies greatly with the quality of ingredients. 'Do-it-yourself' normally implies using standard solutions containing low-concentration nicotine, but consumers may increase savings purchasing separately the basic components, including nicotine in almost pure concentration. This practice will be *de facto* prohibited by TPD2, but control over extra-EU online outlets may turn out to be problematic.

In countries where e-cigarettes are taxed, there is also a share of informal market that will unlikely be captured by the notification and annual reporting system established under the TPD2. Non-duty-paid e-liquids may be traded across the border from countries where they are not taxed and used for self-consumption or re-sold evading taxes. According to some gross estimates, in some MS non-duty-paid may account for up to 10-30% of the e-liquids market.

⁴² In young markets the value share of device may be influenced by one-off purchasing of products that are soon abandoned.

Figure 3 – E-cigarettes market composition



Legend: DiY: 'Do-it-yourself'; NDP: Non-duty-paid.

Source: (A) EM: *Euromonitor International: Passport Tobacco, 2016 Edition*; Ind: Industry estimates. (B) Author's estimates based on stakeholder interviews.

The **market for HTP** is still a niche and little information is available. Considering that *Ploom* is (reportedly) no longer commercialized and *GLO iFuse* is marketed on a pilot basis only in Romania, the near totality of HTP European market at the moment is represented by *iQos*. After a pilot period in few EU cities, *iQos* was progressively introduced during 2016 in various EU markets that – at the time of writing – include IT, DE, UK, PT, RO, DK, LT, ES, EL and NL. In most of these cases the distribution started in the second half of 2016 and is limited to selected main cities, so in many respects it is too early for any consideration on market results from these products. Based on PMI reports,⁴³ the global turnover from *iQos* (device and consumables) in 2016 amounted to USD 739 mn. The sales of *HeatSticks* amounted to 7.4 bn sticks. The most developed market is Japan, where *HeatSticks* sales amounted to some 5 bn sticks in 2016. The rest of *HeatSticks* are essentially sold on the European markets (including small amounts sold in Switzerland and Russia), which therefore account for about 2.4 bn sticks.⁴⁴

➤ CONSUMERS PROFILE

According to *Eurobarometer 429*, some 12% of Europeans have tried e-cigarettes.⁴⁵ Of them, some 2% are current regular users, 3% are former regular users, and 7% have tried it in the past but have never used it regularly. In terms of geographical penetration, the highest proportion of consumers who tried e-cigarettes at least once is found in France (21%), and the lowest in Portugal, Greece, and Slovenia. These data reflect the situation at the end of 2014. The rapid growth of the market suggests vaping prevalence have increased meanwhile. In the UK, regular vapers have grown to some 5.3% of the population (+15 y.o.) in 2016.⁴⁶ As regards the demographic composition of vapers, the combination of various national survey and databases allows to estimate that⁴⁷:

- Vaping prevalence is likely higher among men (57%) than women (43%).⁴⁸
- The use of e-cigarettes among children and young people seems relatively established in the main markets, but trends seem contradictory (**Table 5**). In

⁴³ <https://www.pmi.com/investor-relations/press-releases-and-events/event-details?EventId=5246224>; <https://www.pmi.com/investor-relations/press-releases-and-events/event-details?EventId=5246131>

⁴⁴ Author's estimates based on PMI reports to the investors.

⁴⁵ Data on HTP are unavailable since these products were not on the market at the time of the survey.

⁴⁶ ASH, "Use of electronic cigarettes (vapourisers) among adults in Great Britain", May 2016. The figure actually refers to Great Britain.

⁴⁷ The different methodologies used in the national surveys do not consent a direct comparison of data.

⁴⁸ Author's elaboration on *Euromonitor* and national surveys estimates from a sample of MS.

particular, figures from the USA suggest consumption among young people is growing at a fast pace, while in the UK survey data indicate a less pervasive and stable diffusion.

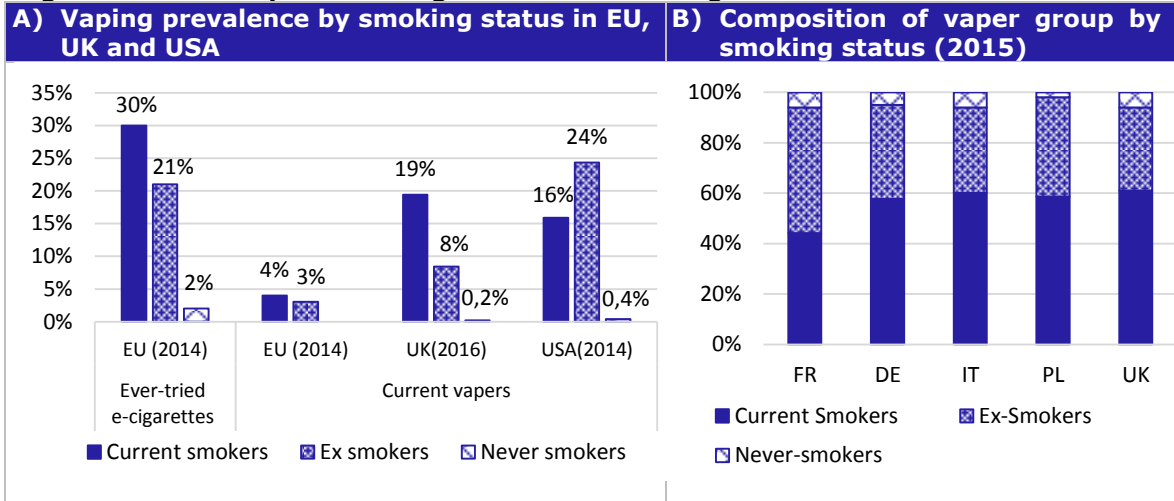
Table 5 – Evidence on the use of e-cigarettes among children and young people

Great Britain	France	Germany	USA
Some 12% of 11-18 y.o. tried e-cigarettes at least once (2016) Regular users: 2% on a monthly basis Prevalence increased since 2013 but stable over 2015	Prevalence among 15-24 y.o. users (2014): • 8.8% (male) • 5.4% (female)	(1)Some 27.6% of 12-17 y.o. tried once (2014). (2)Prevalence among 12-17 y.o. users (2015): • 7.8% (12 months) • 2.4% (last 30 days)	Use in the last 30 days (2015): • Middle school: 5.3% (up from 1.1% in 2013) • High school: 16% (up from 4.5%)

Sources: UK: ASH, "Use of electronic cigarettes among children in Great Britain", October 2016; FR: Inpes, "Baromètre santé", 2014; DE: (1) Die Drogenbeauftragte der Bundesregierung, "Drogen und Suchtbericht", June 2016, (2) Bundeszentrale für gesundheitliche Aufklärung, "Rauchen und E-Zigaretten bei jungen Menschen in Deutschland: Ergebnisse der Drogenaffinitätsstudie 2015; USA: U.S. Department of Health and Human Services. "E-Cigarette Use among Youth and Young Adults". A Report of the Surgeon General, 2016.

Several surveys have investigated the relation between e-cigarettes use and conventional tobacco use. The existing evidence concurs that there is a close relation in consumption patterns, and in particular the vast majority of those who use or have tried an e-cigarette are current or former tobacco smokers. According to Eurobarometer 429, only 2% of never-smokers have tried electronic cigarettes – against 30% of smokers – and a negligible number of them have become regular vapers (**Figure 4A**). National-level surveys confirm this pattern, and also in a most-developed e-cigarettes market like USA only 0.4% of never-smokers currently vape.⁴⁹ From a different perspective, this is confirmed also by various national or cross-country surveys addressing current vapers only (**Figure 4B**): the majority of vapers are also current smokers, about four in ten are former smokers, and only a minority (approx. 5%) have never smoked.

Figure 4 – Consumption of e-cigarettes and smoking status



Sources: (A) EU: Eurobarometer 429; UK: ASH (2016); USA: CDC/NCHS. (B) Kantor (cited in Ernst&Young, 2016).

➤ **SUBSTITUTION WITH CONVENTIONAL TOBACCO**

Electronic cigarettes can be considered to a various extent and depending on individual experience either a substitute of conventional tobacco products or a complement of them. Substitution seems the main driver: two-thirds of 'ever-trying'

⁴⁹ Source: CDC/NCHS, National Health Interview Survey, 2014.

vapers considered reducing tobacco use or quitting smoking as the most important reason to start using e-cigarettes.⁵⁰ As regards complementary uses, some 44% of vapers attribute importance to the possibility of using e-cigarettes in circumstances where conventional smoking is not allowed, and about one-quarter considered e-cigarettes attractive *per se*.⁵¹ There are no surveys or other studies available on HTP demand, but it is reasonable to assume that similar drivers apply. HTP is marketed as a 'reduced risk' product and in this sense it may appeal prevalently current smokers. As compared to e-cigarettes the potential substitution here is enhanced by the presence of tobacco. Own industry panel data show a rate of conversion of smokers to a 'predominant' use of *iQos* between 7% and 15% of participants to trial tests.⁵²

The potential of e-cigarettes – and by extension of all reduced risk products - as a smoking cessation support is a fundamental element of the current debate on e-cigarettes regulation (and taxation). About six in ten smokers have reportedly tried to quit smoking at least once, and some 10% of them have attempted to do so with the help of e-cigarettes or similar vapour devices. In this respect, e-cigarettes are increasingly challenging nicotine replacement tools (like patches, gums, inhalers etc.) as a smoke quitting aid. Although not licensed to this end, in some MS (e.g. UK, FR, PL, and ES) they have become more popular than medical tools.⁵³ One e-cigarette product, developed by a BAT subsidiary, has also obtained in the UK the medicine license. The degree of e-cigarettes effectiveness in this regard is difficult to estimate in a robust way, given the scarcity of randomized clinical trials. According to Eurobarometer 429, some 14% of 'ever-tried' vapers eventually managed to stop smoking completely, and some 21% reduced tobacco consumption. However, the majority of them (58%) did not change their smoking habits (or stopped for a while but then started again). While complete substitution occurred in a minority of consumers, dual use of e-cigarettes and conventional tobacco seems more widespread. Unfortunately, only sparse and unsystematic evidence is available on dual users and their consumption patterns. A survey commissioned by the Italian Public Health Institute estimated some 18% of current dual users did eventually reduce smoking - some 11.5% of them drastically.⁵⁴ In the UK, some 41% of dual users use e-cigarettes *inter alia* to reduce, but not to quit tobacco completely.⁵⁵

➤ PRICE SENSITIVITY OF THE DEMAND

The possible role of e-cigarettes as a smoking cessation tool is emphasized by various experts and institutions engaged in tobacco harm reduction, and it is also backed up by a growing body of literature.⁵⁶ For this reason, there are concerns that too strict regulation, contradictory messages⁵⁷ and taxation may eventually keep smokers away of this opportunity. The price argument is particularly relevant for this Study, since all sources concur the use of e-cigarettes is markedly sensitive to price. According to the Eurobarometer, the price is the second most important factor in consumers' choice of vaping products, much more important than type of product, brand and other factors. This was largely confirmed by the qualitative evidence collected from stakeholders, according to whom the price differential between conventional cigarettes and e-cigarettes is fundamental for attracting regular smokers. A few scholars have

⁵⁰ Eurobarometer 429.

⁵¹ *Ibidem*.

⁵² <https://www.pmi.com/investor-relations/press-releases-and-events/event-details?EventId=5246224>

⁵³ Eurobarometer 429. As regards the UK, specific estimates about trends in using e-cigarettes and other NRT are also available through the Smoking Toolkit Study, www.smokingengland.info

⁵⁴ DOXA, "Il fumo in Italia", March 2016. The results have been recalculated excluding non-smokers from the sample.

⁵⁵ ASH (2016).

⁵⁶ Rahman M.A. et al., "E-Cigarettes and Smoking Cessation: Evidence from a Systematic Review and Meta-Analysis", Bernard Le Foll, 2015.

⁵⁷ In the UK, some 27% of smokers who never tried an e-cigarette are reportedly concerned they are not safe enough. Source: ASH (2016).

researched in a systematic way the dynamics of the demand for e-cigarettes and the relations with the price of cigarettes (see Box 1 below). Their studies represent the state-of-the-art in the analysis of e-cigarettes demand, and have been referenced by various institutions, including the WHO. However, due *inter alia* to the rapid evolution of this market, their results have to be taken with some caution.

Box 1 – Analyses of E-cigarettes Demand in the existing literature

The following papers are the main systematic researches conducted on e-cigarettes demand. While they provide a very helpful indication on the possible dynamics of the demand with respect to price levels, they have to be taken with caution, since: (i) none addresses comprehensively the EU market; (ii) the products covered are in some cases incomplete; (iii) none covers the online sales; (iv) data often refer to the first generation of e-cigarettes, and products have changed significantly since then.

- Huang J. et al. (2014).⁵⁸ The paper investigates own and cross-price elasticity of demand for e-cigarettes and examine the impact of cigarette prices and smoke-free policies on e-cigarette sales. It is based on US retail store scanner data from 2009 and 2012. The paper found that sales of e-cigarettes are very sensitive to price (own price elasticities for disposable e-cigarettes around -1.2 , while for reusable e-cigarettes approximately -1.9). Therefore, policies increasing e-cigarette retail prices, such as imposing a tax could potentially lead to significant reductions in e-cigarette sales. No consistent relationships between cigarette prices and e-cigarette sales was found.
- Zheng Y. et al. (2016).⁵⁹ The study estimated a system of demand for various tobacco products and e-cigarettes, finding price substitute relationships between cigarettes and e-cigarettes. The e-cigarette category includes disposables, starter kits and replacement cartridges, but only offline sales are considered. Own-price elasticity is estimated at -2.1 , cross-price elasticity with respect to conventional cigarette is $+1.9$.
- Stoklosa M. et al. (2016).⁶⁰ The first study analysing the relation between prices and demand for e-cigarette in Europe (actually six EU markets, i.e. Estonia, Ireland, Latvia, Lithuania, Sweden, and the United Kingdom). The analysis is based on e-cigarette sales in 2011-14 but is limited to closed systems. Based on static models the price elasticity is -0.8 , increasing to -1.15 in the long-run dynamic model. Cross price elasticity of e-cigarettes vs. conventional cigarettes is very high: $+3.6$ to $+4.6$ in static model, and $+6.5$ in dynamic model.

The affordability of e-cigarettes for consumers depends on price levels and consumption patterns. There is a high variability in these parameters, in particular:

- Price levels.** Non-disposable devices may cost between €10 and €100 or more, and the repayment time may vary greatly. The price of e-liquids mostly ranges between €4 to €7 per 10ml depending on the quality and the geographical market. Closed-tank refill and cartridges have a lower out-of-pocket cost, but are often much more expensive per volume of liquid. 'Do-it-yourself' products may cost a fraction of ready-to-vape ones.
- Level of consumption.** The amount of e-liquid *per capita* may vary greatly between sole vapers and dual consumers of e-cigarettes and tobacco products. Furthermore, the amount of e-liquids consumed is *ceteris paribus* proportional to the power of the device utilized. Most of regular vapers (including dual users) fall into the category of 1-2ml per day, but according to some surveys one vaper out of ten may consume more than 4ml per day.

⁵⁸ "Estimating cross-price elasticity of e-cigarettes using a simulated demand procedure", Nicotine and Tobacco Research, 592-98; Huang, J., Tauras J., Chaloupka F., "The impact of price and tobacco control policies on the demand for electronic nicotine delivery systems", Tobacco Control, 23(3), 41-7, 2014.

⁵⁹ Zheng, Y., Zhen C., Dench D., Nonnemaker J., "US demand for tobacco products in a system framework", Health Economics, 2016.

⁶⁰ Stoklosa M., Drope J.M., Chaloupka F., "Prices and e-cigarette demand: evidence from the European Union", Nicotine and Tobacco Research, 18(10), 1973-80, 2016.

Comparing the consumers' costs of vaping and smoking is not only constrained by the above uncertainties, but also by the lack of an accepted method to establish an equivalence between the two products. For tax purposes, the Italian customs have conducted specific tests aimed at determining a correspondence between e-liquid and conventional cigarettes based on the duration of the experience.⁶¹ However, this approach has received many criticisms from industry and other stakeholders, in relation to the different patterns of use of e-cigarettes as compared to conventional ones, as well as the major influence that the device employed in the experiment has on the estimated 'vaping time'. The same approach was used by Italian authorities to establish an equivalence for HTP. Some scholars borrowed this approach to compare the costs of smoking and vaping and to conclude "existing prices of e-cigarettes are generally much higher than of combustible cigarette"⁶² – a statement that however contradicts most of stakeholders' perception. Based on this Study's hypotheses on the market value and the number of vapers, the average expenditure per capita of vapers (including dual user) is below €1.0 per day, which may increase to some €2.0 or €3.0 for an average daily vaper who uses some 2ml of ready-to-vape liquid or cartridge. This seems lower than the average smoker's expenditure that, assuming a consumption of 14.2 sticks per day⁶³ may vary between €1.7 in Bulgaria to €7.2 in the UK.⁶⁴ The statement may instead hold true for HTP, which is commercialized at a price per stick comparable to mid-price /premium cigarettes.

3.1.2 Tax and Regulatory Framework

3.1.2.1 Non-harmonised tax regimes across the EU

➤ OVERVIEW

The diffusion of current electronic cigarettes in the EU started after the adoption of Directive 2011/64, which is therefore silent in this respect. In the following years, the possibility of considering them as an excise good was debated at EU level, but there was substantial agreement that these products do not qualify for being taxed under Directive 2011/64. Since 2014, some Member States have started however to adopt *ad hoc* consumption taxes on e-cigarettes. The precursors were Italy (2013) and Portugal (2014), later joined by Romania, Slovenia and Latvia. As of today, some nine MS have adopted an *ad hoc* tax (see **Table 6**), and reportedly a few more are considering to introduce it, or are in favour to do so if a harmonised approach is taken at EU level. After an early experience in Italy with an *ad valorem* tax (soon dropped following a Constitutional Court's ruling in 2014), all national regulators have opted for a specific tax per amount of e-liquid. Romania, Portugal and Slovenia clarified the tax trigger is the content of nicotine, while other countries tax both nicotine-containing and nicotine-free e-liquids indistinctly (in Italy the collection of tax on nicotine-free liquids has been suspended by a second Court's ruling in 2015). Latvia has adopted a slightly different approach that envisages a specific tax per volume of liquid plus a specific amount per nicotine concentration. Croatia has adopted a fiscal regime for e-cigarettes but a zero rate is currently applied.

The debate on heated tobacco was less straightforward. It also appeared on the market when the Directive 2011/64 had already been revised, and MS had different

⁶¹ Based on this experiment Italian Customs have established that 1ml of e-liquids is consumed over a period of time equal to which a typical smoker consumes 5.63 combustible cigarettes.

⁶² Liber A.C., Drope J.M., Stoklosa M., "Combustible cigarettes cost less to use than e-cigarettes: global evidence and tax policy implications", Tobacco Control. Published Online First: 28 March 2016. doi: 10.1136/tobaccocontrol-2015-052874.

⁶³ Eurobarometer 429.

⁶⁴ Based on WAP as of January 2016.

views on whether it could be considered an excisable manufactured tobacco product or not and, in case, which category applied. Different approaches were also initially envisaged depending on the different characteristics of products, i.e. small tobacco 'pods' or short tobacco rolls, containing or not an aluminium foil to prevent they could be smoked as they were. Based on that some regulators were inclined to classify HTP in the 'smoking tobacco' category or as a manufactured cigarette. Various MS were simply of the opinion the legal framework was not in tune with these products and should be revised.

At the moment, HTP are present only in a minority of EU countries, therefore many MS are exempted from deciding the applicable fiscal regime. The variety of approaches eventually adopted for these products is however significant. Italy has adopted a product-specific approach to the only product actually on the market (*iQos Heatsticks*) by establishing an equivalence of time consumption to conventional cigarettes under the same puffing conditions (and applying a 50% reduction); in Portugal there is a mixed approach with an *ad valorem* component, a specific component and a minimum excise; Hungary has a fully specific but per unit tax; the rest of MS (**Table 6**) applies a fully specific per weight tax using the rate applicable to smoking tobacco or to fine-cut tobacco (Slovenia).⁶⁵ Heated Tobacco products are commercialised also in other MS, like Germany, the UK, the Netherlands etc. Reportedly, no specific regulation has been adopted, and the product is traded under temporary administrative arrangements that commonly imply using the 'other smoking tobacco' category. This allows moving it under suspension of duty using the EMCS, but not all national authorities agree with this approach, so the absence of a harmonised framework may *de facto* impede the commercialisation of HTP in those countries.

Table 6 - Overview of non-harmonised taxes for e-cigarettes and heated tobacco

Country	Electronic Cigarettes	Heated Tobacco Products
PT	€0.60/ml nicotine liquid, reduced to €0.30 since 01.01.2017	Ad valorem: 20% of RSP (reduced to 16% in 2017) Specific: € 78 /kg (€80 / kg in 2017) Minimum Excise: €169 /kg (As smoking tobacco)
IT	€0.385/ml on all liquids, but taxation of non-nicotine liquids has been suspended after Constitutional Court's ruling 83/2015	Depending on SKU: From € 63.25 to €63.36 per 1,000 sticks (as 50% of cigarettes excise)
RO	RON 0.5/ml nicotine liquid (ca. €0.11/ml)	RON 384 / kg (ca. € 85) (as smoking tobacco)
SI	€0.18/ml nicotine liquid	€ 88 / kg (as FCT – minimum duty)
LV	€0.01/ml of e-liquid + €0.005/mg of nicotine	€ 62 / kg (as smoking tobacco)
HU	HUF 55/ml (ca. €0.18/ml) since 01.01.2017 (a different legislation may enter into force since April 2017, bringing the tax rate to HUF 65/ml).	HUF 10,000 / per 1,000 sticks (€ 32.46)
FI	€0.30/ml	n.a.
EL	€0.10/ml	€ 156.7 / kg (as smoking tobacco)

⁶⁵ Some information is reported from the Vapor Product Tax database www.vaporproductstax.com and have not been cross-checked with official sources.

HR	HRK 0.00/ml	HRK 600 / kg (ca. € 80.7) (as fine-cut tobacco)
SK	n.a.	€ 73.9 / kg (as smoking tobacco)

Source: Interviews, pieces of national legislation and the Vapour Product Tax database.

➤ TAX RATIONALE

There can be multiple reasons behind the introduction of non-harmonised tax regimes for new products, which may vary across countries. Before discussing the impact of these taxes and the rationale for a possible EU-wide harmonised regime it is useful to briefly recap the main objectives behind national schemes, suspending all considerations on the strength of the underlying arguments.

One of the main purposes of taxing new products is to offset somehow the actual or potential tax revenue losses deriving from declining consumption of conventional products. The underlying argument is that new products are largely substitute of conventional tobacco products, and consumers may be induced to switch across nicotine sources by a more favourable tax treatment, with adverse effects on public budget.⁶⁶ In this sense, excisability would have the twofold effect of: (i) recovering from new products part of the revenue lost from conventional products, and more importantly (ii) slowing down substitution. This last point is evidently controversial in the light of the claimed reduced risk carried by non-combustible products. **Table 7** below provides a very rough estimate of the hypothetical excise revenue loss due to a reduced consumption of conventional cigarette connected to vaping. Every step of this calculation implies a significant level of uncertainty, therefore the final estimate of €1.67 bn excise losses must be taken with extreme caution and purely as a speculative exercise.

The case of heated tobacco products is slightly different, in that these products are subject to consumption taxes in all countries where they are marketed. In this sense, the tax revenue argument relates – if any – to the smaller rate currently applied to HTP as compared to cigarettes (again, regardless of risk reduction considerations). Given the novelty of this market and the absence of detailed sales data in the MS where these products are marketed, the figures provided in **Table 7** below should be considered as highly uncertain.

The substitution of conventional tobacco products with new products may also indirectly affect VAT receipts although at a much more limited extent since both new and old products are subject to VAT. In particular, in the case of HTP the impact on VAT seems negligible, since selling price levels are similar to conventional cigarettes. In the case of e-cigarettes, some minor VAT losses are possible since e-cigarettes are generally cheaper than conventional tobacco (except certain FCT or low-price cigarillos), although not in MS with a high national tax. However, as discussed above, the e-cigarette expenditure includes also hardware (ca. 40% of the total), which is also subject to VAT, and may partly balance VAT losses on consumables.

⁶⁶ Actually, in some MS nicotine-free e-liquids are also taxed but – as the Italian case demonstrates – a national Court may consider it disproportionate or illegitimate.

Table 7 – Hypothetical impact on excise yields from new products

Est. number of vapers with previous tobacco experience	Est. share of those who reduced tobacco consumption through vaping (Eurobarometer)	Corresponding reduction in tobacco consumption (assuming 14.2 sticks per day)	Hypothetical excise revenue 'gap' from reduced cigarette consumption.
9.0 mn total vapers 0.5 mn vapers who never tried tobacco 8.5 mn vapers with previous tobacco experience	14% permanently quit 21% decreased tobacco use	-6.17 bn sticks / year from smoke quitting -4.62 bn sticks / year from reduction (assuming a 50% reduction) -10.79 bn sticks overall / year	-2.22% est. variation in cigarettes consumption ca. € 74,390 mn cigarettes excise revenue in the EU -€ 1.67 bn possible tax gap
Est. HTP (consumable) sold in 2016	Estimated tax revenue from HTP	Corresponding reduction in cigarette excise yield	Hypothetical net revenue gap from HTP
2.4 bn pieces (overall EU)	€ 126 / kg (average OST taxation where marketed) € 0.039 / sticks (est. 0.31g per stick) € 93.6 mn estimated total tax receipts	€ 0.153 average excise yield per cigarette stick (in 2015) -€367 mn / year (excise revenue from cigarettes)	-€ 0.27 bn possible tax gap

Source: Author's elaborations, based *inter alia* on Eurobarometer and Excise Duty Tables (July 2016).⁶⁷

The above argument does not take into account the possible public health benefits of switching from combustible to non-combustible products and the ensuing positive impact on healthcare expenditure and other broader societal benefits (e.g. on labour productivity and growth). There is a growing body of literature on the reduced health risk of new products as compared to conventional tobacco, including from public health authorities and high-level institutions. In the UK, the Royal College of Physicians and Public Health England have published extensive evidence reviews of both the intrinsic safety of e-cigarettes (for vapers and by-standers) and their value as a stop-smoking tool.⁶⁸ On the other hand, other public health stakeholders point out that e-cigarettes aerosol is not harmless, and that e-cigarettes use among youth and young adults may pose a public health concern.⁶⁹ The matter was debated in November 2016 at the 7th FCTC Conference of Parties. The Conference eventually adopted the WHO Report, which underlined the lack of conclusive evidence on the role of these products in tobacco control⁷⁰, and invited Parties to consider regulatory measures for ENDS/ENNDS in line with national laws and public health objectives.⁷¹ In accordance with the WHO Report, MS authorities may therefore apply differently the

⁶⁷ DG TAXUD, "Excise Duty Tables", July 2016. Hereinafter 'EDT'.

⁶⁸ Tobacco Advisory Group of the Royal College of Physicians, "Nicotine without smoke: tobacco harm reduction", Royal College of Physicians, 2016; McNeill et al., "E-cigarettes: an evidence update", Public Health England, 2015.

⁶⁹ U.S. Department of Health and Human Services (2016).

⁷⁰ "If the great majority of tobacco smokers who are unable or unwilling to quit would switch without delay to using an alternative source of nicotine with lower health risks, and eventually stop using it, this would represent a significant contemporary public health achievement. This would only be the case if the recruitment of minors and non-smokers into the nicotine-dependent population is no higher than it is for smoking, and eventually decreases to zero. Whether ENDS/ENNDS can do this job is still a subject of debate between those who want their use to be swiftly encouraged and endorsed on the basis of available evidence, and others who urge caution given the existing scientific uncertainties as well as the performance variability of products and the diversity of user behavior". WHO Report to FCTC COP (2016).

⁷¹ http://www.who.int/fctc/cop/cop7/FCTC_COP7_9_EN.pdf?ua=1

precaution principle and decide to tax these products so as to make them less affordable to minors and deter the use in this age group.⁷²

Finally, some MS may be using the tax system as a monitoring tool over the market, the existing players, the cross-border trade, and the consumption levels. This seems clearly the case with Croatia, which is temporarily applying a zero rate on electronic cigarettes, with a view to collect more detailed information on the market before taking a decision on a possible taxation. Other Member States that have already imposed a positive tax may also have considered monitoring as a complementary objective. In fact, none of the MS analysed in this Study had in-depth information on the e-cigarettes market structure and size before introducing taxation.

3.1.2.2 The Revised Tobacco Products Directive (2014/40)

In May 2016, the Tobacco Products Directive 2014/40 (TPD2) entered into force. The Directive contains various provisions for the regulation of electronic cigarettes (Art. 20) and novel tobacco products e.g. HTP (Art. 19), which are likely to deeply influence the future development in these sectors. A detailed assessment of TPD2 is outside the scope of this Study, but it seems useful to recap some of the salient provisions and how they may shape market trends. In particular, as concerns e-cigarettes:

- (1) **Notification.** Manufacturers and importers of electronic cigarettes and refill containers shall submit a notification to the competent authorities of the Member States of any such product that they intend to place on the market, six months before the intended placing on the market. The data on notifications are not yet available but anecdotal evidence suggests they amount to several thousand items. The process inevitably implies administrative and compliance costs. Most of MS authorities collect notification fees from operators in order to cover their administrative costs. These include one-off fees for new products, modification fees and annual/recurrent fees, as well as other registration fees (e.g. per point-of-sale). The amount charged varies from € 50 in Greece to € 4,000 in Denmark. A few countries do not apply fees and internalise the administrative costs (e.g. Ireland, Lithuania, and Slovakia). In addition to that, economic operators have to prepare the dossiers for the notification and carry out the laboratory tests required at their expenses. As businesses typically have hundreds of items in their portfolio, notification costs may amount to sums that small operators can hardly afford (anecdotally from € 100,000 to € 500,000 for the first year). For costs saving purposes, some operators have partly slimmed down their product portfolio. Most of operators anticipate a price increase of 5-10% to cover these costs. Moreover, there are seemingly disparities in the implementation across MS, with different interpretations of the six-month ahead notice and possible exemptions granted to products already notified by another operator. Considering the rapid innovation cycle of e-cigarettes, unclear or diverse rules affecting time-to-market may distort competition.
- (2) **Monitoring.** In connection with the above, Member States shall monitor the market developments concerning electronic cigarettes and refill containers. These include comprehensive data on sales volumes by brand name and type of the product, information on the preferences of various consumer groups, including young people and non-smokers, and the mode of sale of the products. The information shall be made publicly available, ensuring a duly protection of

⁷² According to WHO Report: "In parallel, combustible tobacco products should be taxed at a higher level than ENDS/ENNDS to deter initiation and reduce regression to smoking".

confidential information and trade secrets. Once implemented, this system may respond effectively to the current information needs.⁷³

- (3) **Limits on container size and nicotine concentration.** Refill containers cannot exceed a volume of 10 ml, in disposable electronic cigarettes or in single use cartridges and refill cartridges or tanks cannot exceed a volume of 2 ml. These provisions have a modest impact on production costs, but may affect consumer experience, penalizing the use of larger, new-generation devices that consume e-liquids much faster. Article 20 also established that nicotine-containing liquids shall not contain nicotine in excess of 20 mg/ml. Since most of vapers already use liquids with a concentration below 20 mg/ml the market effect will be negligible. This provision will affect only the 'do-it-yourself', which typically implies the use of bases with a higher concentration of nicotine. A beneficial effect on curbing the illicit trade of pure nicotine can be expected.
- (4) **Warning and leaflets.** Unit packets of electronic cigarettes and refill containers must include a leaflet with various prescribed information. Since e-liquids are commonly sold in bottles, manufacturers shall add a box specifically to keep leaflets in. Additionally, manufacturers / importers will have to translate the leaflet in all the languages of MS where they intend to sell. This requirement will inevitably increase production costs which will be passed-on to consumers.

The provisions for novel tobacco products are less articulated. As regards notification, the TPD2 establishes similar rules as for e-cigarettes, i.e. the submission of a notification to the competent authority six months before the placing on the market, as well as a variety of studies and background information on the safety, the consumer preference, and a risk/benefit analysis. Novel tobacco products may be subject to various other provisions e.g. health warnings, advertising restrictions etc. depending on whether they are classified as smokeless products or not. Considering that big tobacco companies are the sole manufacturers of HTP, the administrative and compliance costs of TPD2 that may significantly impact on small e-cigarettes businesses are modest in the case of HTP.

3.1.3 Problem Analysis

3.1.3.1 Limited knowledge of new products and their market

The baseline review carried out in the previous Section showed that there is still limited knowledge of new products, their intrinsic features, the value-chain, and the consumption patterns. A growing number of surveys and academic studies have been investigating these markets, but their outcomes are often partial, uneven and obsolescent, given the rapid evolution of products and behaviours. In the framework of the FCTC COP, the WHO has systematized the existing scientific evidence on the health effects of e-cigarettes and exposure to their aerosol, as well as their consumption among youth, and their impact on smoking cessation or reduction.⁷⁴ The WHO Report underlines the uncertainties surrounding the impact of these products, also due to the role of industry interests in research, and the need "to promote a transparent, paused debate of results in order to maximize the contribution of ENDS research to evidence-based policy".⁷⁵

⁷³ See: EUREST Report for DG SANTE, "Study on the development of a EU common reporting format for submission of data on ingredients contained in tobacco and related products and disclosure of the collected data to the public", 2015.

⁷⁴ http://www.who.int/tobacco/industry/product_regulation/electronic-cigarettes-report-cop7-background-papers/en/

⁷⁵ "In a review of 105 studies analysing the composition of liquids and emissions, on which ENDS/ENNDS safety assessments have been mostly based until now, 30% had authors that had

The information gap is addressed in certain MS by specific research commissioned by public health institutions. Public Health England have set up the UK Electronic Cigarette Research Forum, and have commissioned a report on the existing evidence on e-cigarettes. Among other things, the report concluded that e-cigarettes could help people to quit or to reduce smoking, and that using e-cigarettes is around 95% safer than smoking.⁷⁶ Public Health England also affirms that there is no evidence e-cigarettes can undermine the long-term decline in cigarette smoking among youth. This contrasts with the conclusion of the U.S. Department of Health and Human Services and the Centers for Disease Control and Prevention, who consider e-cigarette use among youth and young adults a public health concern. According to a report published in 2016: (i) e-cigarette use has surpassed conventional cigarettes, and is strongly associated with the use of combustible tobacco products; (ii) e-cigarette aerosol is not harmless, and the use of products containing nicotine in any form among youth, including in e-cigarettes, is unsafe.⁷⁷

The above uncertainties and disparities of views are compounded with a general lack of robust information on market penetration, industry structure and growth perspective. Member States that have introduced *ad hoc* taxes on new products did not have an in-depth insight into these markets and admittedly adopted tax frameworks also for monitoring purposes. The monitoring system being set up under the TPD2 may provide in the future a response to these information needs. The system envisages the collection of detailed information on product sales in all MS, including information on consumers' preference (e.g. youth) as well as mode of sales. It is not clear how this information will be aggregated and treated, but it is important that it becomes available to tax authorities for analysis and discussion within the Commission's expert group and other relevant fora. Any EU-level harmonised approach to new products should build upon robust and validated evidence that is currently missing.

3.1.3.2 Non-uniform tax treatment of e-cigarettes across the EU

As discussed above, several MS have introduced national consumption taxes on e-cigarettes refill containers. Since e-cigarettes are not harmonised excise goods, these taxes are not subject to the EU excise systems as laid down in Directive 2008/118 and related measures. The tax regimes and the implementation mechanisms vary across countries, and as more MS opt for national schemes (six MS have introduced that in 2016), the level of fragmentation of the EU market increases, with various possible adverse consequences.

- **Competition and Single Market functioning.** E-cigarettes are not the first product subject to non-harmonised excise duty in the EU, but since they may have a profound impact on the highly regulated tobacco market as well as on public health objectives, they may deserve a closer attention in terms of competition and single market functioning. National tax regimes have in the first place affected cross-border competitiveness. Heavy tax rates, such as in Italy and Portugal, have caused a price shock⁷⁸ that severely hampered the competitiveness of domestic manufacturers *vis-à-vis* foreign players. In principle, foreign operators selling their

received funding from ENDS/ENNDS interests –including the tobacco industry - for the studies analysed or for previous studies (25% declared and 5% undeclared). Another 5% declared interests from the pharmaceutical industry. While this in itself does not necessarily invalidate the results of studies, in the past, studies linked to commercial interests of the tobacco and pharmaceutical industries have been found to be biased." WHO Report to FCTC COP (2016), Appendix 3.

⁷⁶ McNeill A., Brose L.S., Calder R., Hitchman S.C., "E-cigarettes: an evidence update", Public Health England.

⁷⁷ U.S. Department of Health and Human Services (2016).

⁷⁸ In Portugal the industry estimates that taxes led to a retail price increase of nearly 150%; in Italy was about 60%. In Hungary some stakeholders anticipate a 100-150% increase in 2017.

products in these countries should be subject to the same tax regime as domestic ones, however poorly controlled cross-border online sales and cross-border 'bootlegging' allow to easily circumvent national taxes, creating an unfair competitive environment for domestic operators (see next bullet point on tax implementation). In addition to the tax charge, national tax regimes also imposed administrative and compliance costs that especially small businesses found difficult to cope with (e.g. registering, establishing tax warehouses, anticipating the excise at the import stage, buying tax stamps etc.). As a consequence, various markets (e.g. IT, PT, RO) assisted to a fundamental consolidation. Many small players left and few better established ones increased their market share, although eroding their margins. As many consumers turned to cross-border online purchasing to avoid taxes, a high share of physical outlets closed down. Inevitably, the national regulations also raised barriers to the EU market integration. Foreign operators have to register as taxpayers (and undertake the administrative burden) if they want to operate in countries that have adopted an excise on e-cigarettes. Most of the operators have reportedly chosen not to do so, and opted for operating only in tax-free markets.

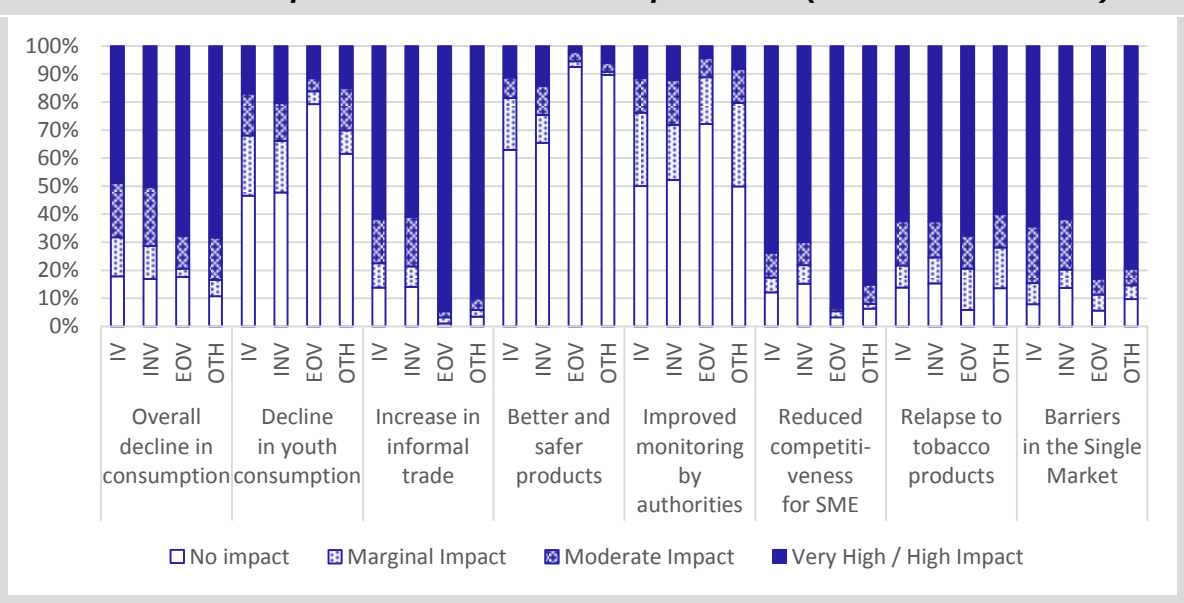
- **Tax Implementation.** Since e-cigarettes fall outside of the harmonised system, MS are deprived of the facilities that are efficiently used to monitor and control conventional tobacco products. For their intrinsic characteristics e-liquids are much easier than tobacco products to move across the borders elusively, and customs authorities have limited technical means to control small shipments effectuated through ordinary courier delivery services and/or to perform tests on anonymous liquids to determine their nature. The investments required to properly enforce national regulation would be significant, and various MS may prefer not to divert resources from the fight against tobacco smuggling to the control of e-liquids. This may create a breeding ground for 'bad players' and illicit practices, for instance:
 - In Italy, soon after the introduction of the tax, a certain number of national players moved their premises to neighbouring Slovenia and continued operating from there through online outlets, or introducing illicitly non-duty-paid products.
 - In Romania, operators are requested to report the amount of liquids produced within a certain amount of days, and pay the corresponding excise. Local manufacturers cannot suspend the payment of the duty, but 'bad players' may easily carry e-liquids from across the border with a simple invoice, and pay the excise only in case they are detected by customs authorities.
 - In Portugal, the majority of terrestrial outlets disappeared in a short time period after the introduction of the tax on nicotine-containing liquids. These were replaced by informal trade across the Spanish border, or 'under-the-counter' mixing of non-nicotine liquids (not excised) with highly concentrated nicotine fluids.
- **Tax Revenue.** The above difficulty of enforcing a tax regime in the absence of a common EU framework, compounded with the obvious reduction of the demand due to increasing prices (and in some cases legal uncertainties), inevitably affected the amount of excise yielded.
 - In Italy, an initial forecast of € 85 mn of tax revenue from non-combustible products was largely unmet: in the year 2015 the tax revenue from e-cigarettes was € 5.17 mn and similar estimates have been made for 2016.⁷⁹ This is the result of multiple interconnected factors: (i) the abovementioned substantial switch of purchasing from vape-shops to non-duty-paid channels i.e. cross-border online and 'bootlegging'; (ii) the booming of 'do-it-yourself'; (iii) the unilateral adoption by the majority of economic

⁷⁹ <https://agivapenews.com/2016/02/25/tassa-e-cig-entrate-per-soli-5-milioni/>

operators of a 'light tax', i.e. instead of paying the excise on the entire volume of the e-liquids, an estimated 80-90% of players pay only for the nicotine fraction (less than 2% of the total volume)⁸⁰; and (iv) the decrease in the demand due to higher prices.

- In Portugal, nearly no tax was collected in 2015 (also due to stock depletion), whereas around € 1.7 mn is estimated for 2016. According to some stakeholders the combined effects of tax avoidance mechanisms may have reduced the tax yield by half.
- **Legal Certainty.** In the light of the international debate on the excisability of e-cigarettes, the absence of a clear orientation and the disparities of treatments across MS may fuel also a fragmented jurisprudence, which may hinder subsequent attempts to harmonise rules across the EU. In Italy, the Constitutional Court has already been called upon twice on this point. The first sentence declared unjustified the application of excise duties on 'non-nicotine products substituting manufactured tobacco' and the related electrical and mechanical devices and parts thereof. The second ruling - still pending at the time of writing - will clarify the regime applicable to e-liquids with respect to the exciseability of zero-nicotine products.⁸¹ This precedent may eventually propel similar disputes between industry and tax regulators in other countries. Eventually, a patchwork of potentially contradictory judicial rulings across MS may become an obstacle for a future EU-wide consensus on a common treatment of e-cigarettes.

Box 2 – Perceived impact of the taxation of e-liquids in MS (results from the OPC)



Legend: IV: Individual vapers; INV: Individual non-vapers; EO: Economic Operator (e-cig industry); OTH: other types of respondent.
Source: OPC.

3.1.3.3 Unclear categorisation of heated tobacco and other non-combustible novel products

⁸⁰ On this matter a ruling of the Constitutional Court is awaited. For a summary of the various judicial disputes of the past three years, see the communication of the Italian custom agency (AAMS) of October 2016:

<https://www.agenziadoganemonopoli.gov.it/portale/documents/20182/1108855/Circolare+prot.+106492+d el+28-10-2016.pdf/02c81d18-33dc-443b-a1b8-43d17b454f49>

⁸¹ The application of excise duty on zero-nicotine liquids has been temporarily suspended following a sentence of an administrative tribunal.

In the absence of an EU harmonised approach to the treatment of HTP, various MS have set up national tax regimes for these products or are considering to do so. In the UK, the matter is the subject of an ongoing public consultation.⁸² As shown in **Table 6** the tax base and the rate applied vary significantly across countries. The lack of a harmonised category for HTP may cause on the one hand legal uncertainties and on the other hand practical difficulties in the circulation and monitoring of commercial flows. The current temporary arrangements adopted by some MS may also unintentionally affect other tobacco products. The expected development and commercialization of other non-combustible novel products containing tobacco or nicotine⁸³ may add complexity and create new loopholes in the current legal framework.

- **Legal and administrative certainty.** The variety of the legal and administrative arrangements adopted individually by MS may only increase in the future, as existing products will seek the authorization for entering other geographical markets, and new HTP products (or new reduced-risk platforms) will be developed. At present, various MS levy non-harmonised taxes, with rates often in line with the rates applied to the 'other smoking tobacco' category. However, other MS do not agree with this approach and may require a different categorization, creating a situation of substantial disparity of treatment. For the moment, no dispute has been reported, but the proliferation of legal approaches can only deepen the current uncertainty.
- **Single Market functioning.** The above issues have practical ramifications on the mechanisms under which the products circulate across the EU. The Commissions initial position was that some HTP could be covered by the Directive (although indirectly) in the category of cigarettes or 'other smoking tobacco' and therefore would be subject to EMCS, but on this point the consensus among MS was not unanimous. Furthermore, some manufacturers modified their products by adding an aluminium layer with the aim to prevent they 'can be smoked as they are' and are therefore excisable as cigarettes., There remain uncertainties and disparities of view among Member States on how HTP products can be classified and how their movements across the EU should be monitored. Some MS agreed to extend the use of EMCS to HTP but this is subject to specific bilateral arrangements. This evidently generates administrative complexity and burden for both manufacturers and national authorities, and may eventually limit the free circulation and access of these products to certain markets.
- **Unintended effects on other products.** Some countries, have not created an *ad hoc* national tax category for HTP and treat them as 'other smoking tobacco'. Reportedly, this is seen as a 'temporary' and not optimal approach that may likely be revised in the near future. Among other problems, this approach may have unintended effects on the other products falling into this category. In other words, any adjustment of the tax regime applied to HTP would apply also to the other products in this category, such as pipe tobacco. To avoid these unintended consequences, public authorities may therefore face limitation in their freedom to pursue their policy objectives.

➤ SUMMARY OF PROBLEM ANALYSIS

⁸² According to the UK Government, a definition of heated tobacco for duty purposes should be based around the following criteria: (i) is not cigarettes, cigars, hand-rolling tobacco, or chewing tobacco; (ii) consists of or includes tobacco; (iii) has been prepared to produce or flavour vapour; (iv) has not been prepared for use in a water pipe. Source: <https://www.gov.uk/government/consultations/tax-treatment-of-heated-tobacco-products/tax-treatment-of-heated-tobacco-products>

⁸³ See for instance PMI's prototype *Platform 3* <https://www.pmiscience.com/platform-development/platform-portfolio/e-vapor-platforms/platform-3>

Problem drivers	Adverse Effects	Expected evolution
Limited knowledge of new products and their market	<ul style="list-style-type: none"> • Difficult monitoring of market trends • Uncertainties on the social and health effects 	<ul style="list-style-type: none"> • The body of knowledge is growing, but controversy persists. • TPD2 monitoring scheme may provide the information needed to understand market and industry.
Non-uniform tax treatment of e-cigarettes across the EU	<ul style="list-style-type: none"> • Adverse effects on single market functioning • Reduced competitiveness of SMEs • Enforcement difficulties and tax losses • Legal uncertainty and risk of disputes 	<ul style="list-style-type: none"> • Distributional effects across country will persist. • As SMEs lose competitiveness a consolidation is expected. • In the absence of a clear orientation more legal disputes can be expected.
Unclear categorisation of Heated Tobacco Products	<ul style="list-style-type: none"> • Legal and administrative uncertainty and burden • Obstacles to free circulation of products • Unintended effects on other products 	<ul style="list-style-type: none"> • As new products come to the market and the penetration increases, fragmentation problems will become more acute. • Disputes may appear • To avoid unintended effects, MS may lose tax revenue.

3.2 Raw Tobacco, Tobacco Refuse, and Reconstituted Tobacco

3.2.1 Raw Tobacco

3.2.1.1 Overview of Product and Markets

➤ THE PRODUCT

In Europe, different varieties of raw tobacco are cultivated, mainly Virginia, Burley, Kentucky, and to a more limited extent some oriental varieties in Bulgaria and Greece. Each variety undergoes a specific curing treatment, i.e. a specific process for the first drying:⁸⁴

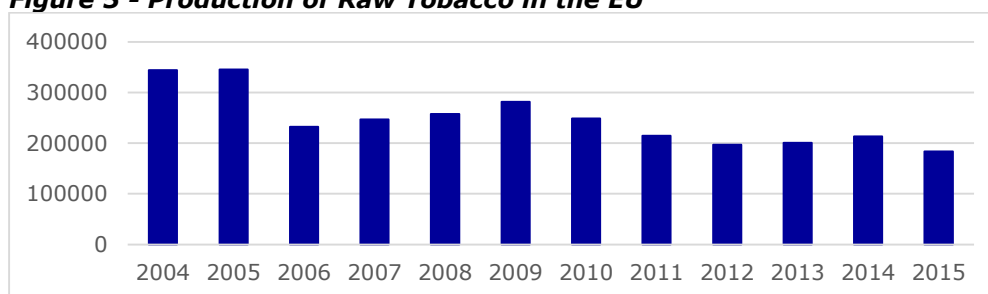
- 1) *Air-curing*, which can be distinguished into light and dark. Light air curing implies drying tobacco in the air under cover without fermentation, like in the case of Burley tobacco. Dark air-curing also includes a fermentation phase before the first processing;
- 2) *Flue-curing*, which is carried out via ovens, and is applied to Virginia tobacco;
- 3) *Fire-curing*, which consists in drying tobacco by means of fires, and is applied to Kentucky tobacco; and
- 4) *Sun-curing*, which consists in drying tobacco in the sun, and is applied to oriental varieties.

In addition, tobacco leaves have different qualities according to their position on the stalk (from basal to top leaves).

➤ TRENDS IN PRODUCTION AND TRADE

In 2015, the EU production of tobacco totalled approximately 184,000 tonnes. The output has been steadily declining since 2000, when the production amounted to about 439,000 tonnes. **Figure 5** below shows the trend in EU tobacco production from 2004 onwards. The decline followed the removal of product specific subsidies, triggered by the reform of the Common Agricultural Policy initiated in the early 2000s.⁸⁵ The weighted average price,⁸⁶ as measured by the European Commission, is estimated at €2.35 per kilogram; hence, the total production value for 2015 amounts to about €430 mn.

Figure 5 - Production of Raw Tobacco in the EU



Source: Eurostat and DG AGRI. **Note:** BG included as of 2007; HR include as of 2014; no data for RO.

At present, nine MS produce more than 1,000 tonnes of tobacco per year:

- Italy is the main producer, with slightly less than 40,000 tonnes;

⁸⁴ Cf. Commission Decision of 20/10/2005 relating to a proceeding under Article 81(1) of the EC Treaty. (Case COMP/C.38.281/B.2) – Raw Tobacco Italy. Hereinafter ‘Commission Decision on the Raw Tobacco Case’.

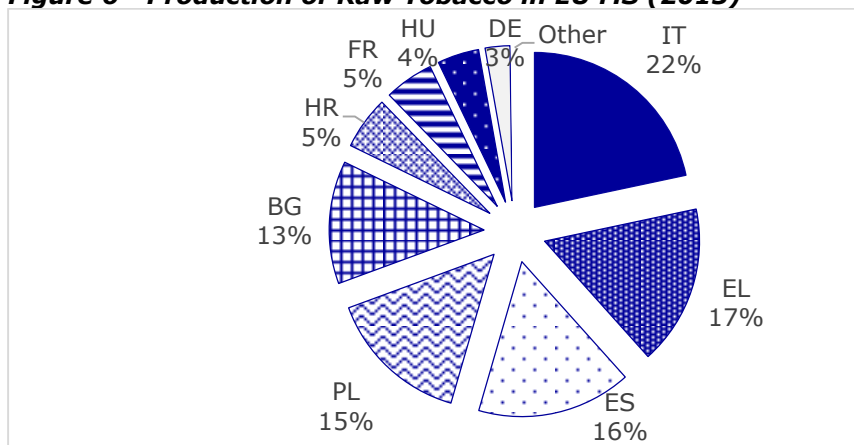
⁸⁵ DG AGRI, “Raw Tobacco – Production statistics – 2003-2014 harvests”, 2015. Available at: http://ec.europa.eu/agriculture/tobacco/statistics/production-statistics_en.pdf (last accessed on March 2017).

⁸⁶ Weighted across product varieties.

- Greece, Spain, Poland and Bulgaria produce between 20,000 and 30,000 tonnes each;
- France, Hungary and Croatia produce between 8,000 and 10,000 tonnes; and
- Germany produces about 5,000 tonnes.

Within each MS, tobacco crops are usually concentrated in certain regions, for instance Umbria and Veneto in Italy, Eastern and Southern regions in Poland, Eastern regions in Hungary, and Extremadura in Spain. The share of production per EU MS is shown below in **Figure 6**.

Figure 6 - Production of Raw Tobacco in EU MS (2015)



Source: European Commission (2015). **Note:** no data for RO.

The EU is a major importer of raw tobacco: in recent years, inward flows amounted to about 600,000 tonnes/year, with the bulk of imports originating from Brazil, Sub-Saharan Africa and India. Imports have declined compared to the early 2000s, when they amounted to 750,000 – 800,000 tonnes/year, reflecting the decline of the market for tobacco products. However, the drop in imports has been less pronounced, in percentage terms, compared to that of EU production.⁸⁷ Exports total typically around 100,000 tonnes/year, mostly to Eastern and South Eastern neighbouring countries. Accordingly, in recent years the EU internal market for raw tobacco can be estimated at about 700,000 tonnes. Considering an average wholesale price of € 2.35/kg,⁸⁸ the total market value can be estimated at about € 1.6 billion.

➤ **INDUSTRY ANALYSIS**

The tobacco value chain, namely the set of operations from the growing of tobacco plants to the production of final products, consists of the following links:

1. crop cultivation and harvesting, including drying, identification of product quality, and packaging of cured leaves into bales. Raw tobacco at this stage of the value chain can be referred to as loose or cured leaves;
2. first processing, including threshing (i.e. separation of tobacco laminas from stems and veins), cutting, stabilisation (including second drying), and sorting of leaves into homogeneous lots. The product at this stage of the value chain can be referred to as processed tobacco;
3. manufacturing of tobacco products – such as cigarettes, cigars and cigarillos, fine-cut tobacco and other smoking and non-smoking products –, which is

⁸⁷ Trade data are from DG AGRI, "Agricultural trade statistics 2005-2014, 2015", which relies on EUROSTAT data.

⁸⁸ No granular information is available to calculate the weighted average price of raw tobacco taking into account not only of EU production, but also of imports and exports. However, this figure is considered representative by the industry and Commission services.

preceded by the blending of the various varieties and qualities, and by the inclusion of other additives and ingredients (e.g. reconstituted tobacco).⁸⁹

The tobacco value chain is relatively 'closed', meaning that almost all raw tobacco is used exclusively for the manufacturing of tobacco products, and, vice versa, tobacco represents by far the main ingredient of tobacco products.

With respect to the production of raw tobacco, in 2014 about 55,000 farmers were active in this sector. The largest number of farmers operated in Bulgaria (about 24,000) and Greece (about 13,000). Italy, despite being the main producer, had less than 3,000 tobacco farmers. In 2015, the surface cultivated with tobacco in the EU amounted to about 89,000 ha. On average, each farmer had a surface of 1.6 ha. However, the average extension is highly variable across MS, ranging from 0.6 ha per farmer in Bulgaria to 6.6 ha in Italy and 16.9 ha in Germany.⁹⁰ In 2015 the average raw tobacco yield amounted to 2.1 tonne/ha, ranging between 1.6 tonne/ha in Greece and Bulgaria – countries where oriental tobacco is cultivated, with a lower yield but a higher price – and 3.3 tonne/ha in Spain.⁹¹ Tobacco growers consist of independent farmers and groups of growers, often organised in cooperatives. In many MS (e.g. Italy, France, and, to a lesser extent, Poland and Hungary) groups of growers represent the standard organisational structure.

Growers sell cured leaves to first processors, who in turn transform them into processed tobacco, usually in the shape of tobacco laminas, or strips. While growers comprise tens of thousands of entities, there are only a few dozen first processors. According to Eurostat data, 100 first processing plants are active in the EU. However, Fetatab – the EU trade association – reports a lower number, i.e. slightly above 50.⁹² The processing facilities are located in the areas where raw tobacco is cultivated, rather than near logistics hotspots (e.g. ports). First processors sell their output to tobacco manufacturing companies, and mostly to the *Big Four*, which purchase about 80% of European tobacco.

The relation between first processors and growers is symbiotic, going beyond the simple seller-buyer relationship. Though differences exist across MS because of the structure of the tobacco sector, first processors usually play an important role also in the upstream phase. A first processor knows about 18 months in advance the quantity and quality of raw tobacco demanded by its customers and, on this basis, enters into a contract with the farmers before the seeding phase, determining the quantity and quality of raw tobacco cultivated in each of the growers' plots. First processors provide growers with the seeds needed – in line with the quality and quantity requested – and grant advance credit if necessary. Then, throughout the cultivation phase, the first processor's agronomic experts cooperate with and visit the growers regularly, that way both providing agronomic support, and checking the production and identifying at an early stage any deviation from the contracted amount of raw tobacco. While the relation is very close, cases of vertical integration, i.e. first processors owning directly land plots for tobacco cultivation, are unknown in the EU (and very rare at global level).

3.2.1.2 Legal and Regulatory Framework

⁸⁹ COGEA, "Evaluation des mesures de la PAC relatives au secteur du tabac brut – Rapport final", DG AGRI, 2004.

⁹⁰ DG AGRI, "Agricultural trade statistics 2005-2014" (2015).

⁹¹ The small surface of tobacco growers is inversely proportional to the high labour intensity, as one ha of tobacco may require up to 1,000 working hours/year, and up to 2,500 in case of oriental varieties, cultivated in Bulgaria and Greece.

⁹² Namely, 57 in 2012. Cf. Nomisma, "The European Tobacco Sector: An Analysis of the Socio-Economic Footprint", PMI, 2012.

Raw tobacco is currently not regulated by Directive 2011/64/EU and MS are free to adopt their own fiscal and legal framework, if deemed necessary. This is the case in five out of the six MS visited in the context of the fieldwork. There, raw tobacco is subject to fiscal or legal requirements and, to a varying extent, to private or co-regulatory tools – the only exception being France, where private regulation alone governs the sector, given that the only first processor is owned by growers' cooperatives. Even though this trend is recent, in no MS among those covered in-depth and those for which information was collected raw tobacco is unregulated or unmonitored.

At EU level, tobacco production was subject to specific rules until 2009. Under the Common Market Organisation (CMO),⁹³ each farmer's output needed to be monitored to receive subsidies.⁹⁴ Furthermore, access to subsidies was conditional upon farmers having a 'cultivation contract' for the sale of raw tobacco, established in advance with a first processor. The aim of the system was to support tobacco growers and to produce tobacco in the EU, and its discontinuation was followed by a steep output decline. However, as a secondary effect, CMO rules also provided both incentives against illicit trade and a monitoring system to control the sector.

In general, all economic operators have an economic incentive to hide part of their output to avoid taxation and/or sell goods on the black market, where it exists. In the case of tobacco products, their price largely consists of taxes (up to 86% for cigarettes).⁹⁵ As a result, illicit products are both cheap for consumers and highly rewarding for unlawful suppliers, including of raw materials. Hence, unlike most of the other agricultural products, a black market for raw tobacco has its own economic rationale. A subsidy scheme counters this economic incentive by increasing the cost of cheating. First of all, the higher the output declared the more the tobacco grower is rewarded, reducing the output which can be diverted to the illicit market. Secondly, by taking part in illicit transactions for part of the harvest, the tobacco grower runs the risk of losing subsidies on the whole production. For such a system to work, the incentive needs to be sufficiently significant. This was most likely the case for tobacco: under the CMO, the overall support, considering both direct subsidies and interventions on price, could reach up to 75% of the grower's income.⁹⁶ Furthermore, monitoring a subsidy system is much easier than monitoring a sanctioning system. While in the former growers have an incentive to over report quantities, and this information can easily be checked at delivery, in the latter growers have an incentive to underreport quantities, and hidden output must then be inferred or found by monitoring authorities. Underreporting is easy for agricultural products, as the yields are aleatory, and they are produced by a large number of growers, rather than in large factory sites limited in number.

The tobacco sector was de-regulated when subsidies were decoupled from production in 2010.⁹⁷ Further to the impact on the income of tobacco operators, which falls outside the scope of the Assignment, de-regulation also affected the control tools and the overall legality of the tobacco market, as both public authorities and economic

⁹³ The EU agricultural policy for the tobacco sector was reformed by Council Regulation (EC) No 864/2004 amending Regulation (EC) No 1782/2003 establishing common rules for direct support schemes under the common agricultural policy and establishing certain support schemes for farmers, and adapting it by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia to the European Union. This regulation phased-out production-linked payments, which have been abolished as of 2010.

⁹⁴ The latest piece of legislation setting the legal framework for raw tobacco was Council Regulation (EC) No 1636/98 of 20 July 1998 amending Regulation (EEC) No 2075/92 on the common organisation of the market in raw tobacco.

⁹⁵ Source: EDT (2016).

⁹⁶ Interview with Commission services.

⁹⁷ Cf. Commission Decision C(2004)4030 relating to a proceeding under Article 81(1) [EC] (Case COMP/C.38.238/B.2 - Raw tobacco - Spain).

operators acknowledge. For this reason, public authorities and economic operators reacted and, immediately after the end of the CMO or in more recent years, re-introduced some forms of public regulation for the tobacco sector, sometimes in conjunction with self- or co-regulatory schemes in which economic operators, also via interbranch organisations, played a significant role.

Though being rather different in terms of specific regulatory requirements and, most notably, with respect to the excisability of raw tobacco, national systems share a similar legal and economic rationale. The aim is to reduce incentives for the illicit trade of raw tobacco, including when sold to final consumers as cut tobacco, and this is done by:

- identifying under what conditions raw tobacco is deemed legal by defining categories of operators which are allowed to trade in raw tobacco (mostly by registration/authorisation systems);
- prohibiting trade and imposing stiff sanctions, usually at least as high as the excise duty on 'other smoking tobacco', or imposing selective excisability. Selective excisability means that when not traded between authorised operators or sold at retail, raw tobacco is subject to an excise tax. Differently, no tax is imposed when raw tobacco moves along the links of the licit value chain. From an economic perspective, the two systems are equivalent.⁹⁸ In none of the MS visited, raw tobacco is subject to full, rather than selective, excisability;
- creating the conditions for an effective monitoring, which includes recordkeeping duties for the operators along the value chain and, in case of tobacco-growing countries, mandatory written (and, possibly, registered) contracts.

Table 8 provides an overview of the various systems, described in greater details in the following paragraphs. In the case of Slovakia and the UK, the analysis is somehow different to reflect that these are not tobacco-growing countries.

Table 8 – National regulation, overview table

	FR	HU	IT	PL	SK	UK
Definition of raw tobacco	No	Yes	No	Yes	Yes	Yes
Excisability	No	No	No	Yes, selective	Yes, selective	No
Registration/ Authorisation	No	All operators (growers included)	All operators (growers included)	Yes for intermediaries but not for growers	Yes if not tax warehouse	All operators trading with raw tobacco
Restrictions to trade	Private exclusivity clauses	Only between authorised operators	Raw tobacco can be sold to first processors or manufacturers	No, but subject to excises when unauthorised operators	No, but subject to excises when unauthorised operators	Only between authorised operators
Written contracts for growers	Commercial practice	Yes, registered	Yes, registered	Yes, as of October 2015	N.a.	N.a.
Record-keeping	Not specific	All operators (transaction-specific for traders)	For groups of growers and first processors	Only for authorised intermediaries	Yes for authorised operators	N.a.
Controls	Not specific	Yes, Police	Yes, Agri Agency (private support)	Yes, customs	Yes, customs	Yes, customs
Retail sale	Not possible	Prohibited	Not possible	Prohibited	Possible (excisable)	Unclear

⁹⁸ Either you cannot trade raw tobacco with non-authorised operators and, if you do, you pay a sanction; or you can trade with non-authorised operators paying a quasi-sanction, i.e. the excise tax.

Source: Authors' own elaboration.

France. The system adopted in France is unique, with no public regulation for the raw tobacco sector, and only self-regulation. Such a system is possible, and remains effective, because the whole upstream part of the value chain, i.e. growers and first processors, are part of the same company structure. In France, there is only one first processing plant, and it is owned by the growers' groups.⁹⁹ As a result, even though after the end of the CMO there was no longer a specific regulatory framework in place, the functioning of the sector remains largely in line with what was required under the subsidy system.

1. *Definition.* No definition of raw tobacco is provided in the Excise Duty Act.
2. *Excisability.* Raw tobacco is not excisable.
3. *Registration/Authorisation.* Operators are not required to register/be authorized.
4. *Restrictions to trade.* No restriction to trade is imposed. However, cultivation contracts include an exclusivity clause: the grower is obliged to sell the whole production to the cooperative to which he/she belongs; the cooperative is obliged to buy the grower's entire production. At the same time, *France Tabac*, the grower-owned first processor, has to buy the cooperative's entire output.
5. *Written contracts.* Written contracts are not mandatory, but *de facto* required. The contract includes information on the cultivated surface and the expected yield.
6. *Recordkeeping.* For fiscal and administrative purposes – but not because of any specific tobacco legislation – growers' groups and the first processor keep record of the quantity and quality of raw tobacco purchased or sold.
7. *Controls.* No specific control is foreseen on top of the usual fiscal and administrative controls to which all economic operators are subject. *France Tabac* carries out private controls to comply with the traceability and integrity requirements imposed by its customers.
8. *Retail sale.* The legislation does not provide for an explicit ban on the retail sale of raw tobacco. However, only authorised tobacco products can be sold in licensed stores, and raw tobacco is not among those.

Hungary. While not excisable, since 2013¹⁰⁰ raw tobacco flows have been monitored by tax authorities and have been allowed between registered operators only. In addition, all operators along the value chain, from growers to manufacturers, are subject to registration duties. Breaches of the legal framework are sanctioned with fines amounting to up to 320 €/kg of raw tobacco (HUF 100,000/kg). The system provides for the following requirements:

1. *Definition.* Raw tobacco is defined as tobacco removed from the stem, and unmanufactured tobacco or tobacco refuse of heading 2401.
2. *Excisability.* Raw tobacco is not excisable.
3. *Registration/Authorisation.* All operators dealing with raw tobacco need to register: groups of growers, first processors, tax warehouse keepers dealing with raw tobacco, importers, traders, as well as other economic operators intending to use raw tobacco. Currently, registered operators total 360.
4. *Restrictions to trade.* No trade is allowed between non-registered operators. In case of violations, sanctions amount to up to 320 €/kg and seizures are possible.

⁹⁹ Currently, there are 6 cooperatives of tobacco growers in France. They represent about 1,000 growers. Only some 5 growers are not part of this system.

¹⁰⁰ Act CXXVII of 2003 on Excise Taxes and Special Regulations on the Distribution of Excise Goods, hereinafter 'Hungarian Excise Act'. The new framework for raw tobacco was introduced by Decree 557/2013. (XII. 31.) *Korm. Rendelet a szàritott dohàny és a fermentàlt dohàny elòàllitàsàròl, tàrolàsàròl és kereskedelméròl.*

5. *Written contracts.* Since it is illegal to grow tobacco without a registered contract, written contracts between farmers and first processors are mandatory. Contracts must include information on surface, volume of production, and quality of raw tobacco.
6. *Recordkeeping.* Growers and first processors must keep records of the deliveries of raw tobacco, as well as of outgoing flows of processed tobacco. Data are communicated to customs authorities at regular intervals or in case of discrepancies with the contract (e.g. losses, destruction). Tobacco importers and intermediaries are imposed full recordkeeping obligations under the Excise Act and need to communicate each raw tobacco shipment before dispatch (8,000 transactions per year).
7. *Controls.* Controls can be carried out at different stages, in the field or during first processing. As raw tobacco is not excisable, controls are managed by the Police, not by customs authorities. Controls were made more frequent and more stringent under the new regime.
8. *Retail sale.* Only authorised tobacco products can be sold in licensed stores, and the sale of raw tobacco to consumers in these stores is prohibited.

Italy. In Italy, raw tobacco is not excisable. However, the upstream part of the sector, i.e. growers, growers' organisations, and first processors, is subject to a registration and monitoring system. The system was set up in 2015 by means of an interprofessional agreement stipulated by the first processors' association and the main growers' association. Since the signatory parties represented most of the tobacco sector, in 2015 the system was extended by means of a Ministerial Decree¹⁰¹ to all domestic growers and first-processors.¹⁰² The system provides for the following requirements:

1. *Definition.* No definition of raw tobacco is provided in the national legislation.
2. *Excisability.* Raw tobacco is not excisable.
3. *Registration/Authorisation.* All economic operators in the value chain must be registered: tobacco growers, growers' organisations and associations of growers' organisations, first processors, tobacco manufacturers, and linked companies.
4. *Restrictions to trade.* Only growers' organisations and associations of growers' organisations can enter into a contract with a first processor for the sale of raw tobacco. Individual growers are not allowed to. When raw tobacco is bought by a tobacco manufacturer or a linked company, a processing site must be indicated.
5. *Written contracts.* Raw tobacco can only be delivered and sold within the national territory based on a written contract between registered sellers and buyers. The mandatory model of the contract between the grower and the purchaser is annexed to the interprofessional agreement and must include the identification of the parties, the surface dedicated to tobacco cultivation, the price and the quantity contracted. The non-respect of the written form is sanctioned with a fine amounting to up to 10% of the value of the contract.
6. *Recordkeeping.* Each contract and each delivery must be registered and communicated to the regional control agency, and then to the national control agency, *AGEA*, in charge of managing agricultural payments.
7. *Controls.* Controls are managed by *AGEA*, and carried out by one of its subsidiary, *Agecontrol*. Sample controls are carried out on growers, in the field, and on first processors, both at delivery and during the year, to verify stocks and flows of raw tobacco. Controls are paid by growers and first processors,

¹⁰¹ Italian Ministry of Agriculture, "Decreto dipartimentale n 2858 del 7.10.2015 come modificata con Decreto dipartimentale 2988 del 3.9.2015".

¹⁰² Cf. Regulation (EU) No 1308/2013 of the European Parliament and of the Council establishing a common organisation of the markets in agricultural products and repealing Council Regulations (EEC) No 922/72, (EEC) No 234/79, (EC) No 1037/2001 and (EC) No 1234/2007.

not by means of public funds, and cost €124,000 (about 3.10 €/tonne of tobacco, based on 2015 production).

8. *Retail sale.* Raw tobacco cannot be sold to final consumers, since only homologated tobacco products can be sold in licensed shops.

Poland. In Poland, raw tobacco was made excisable as a reaction to the increasing illicit traffic of raw tobacco, which was diverted into the production of cigarettes, as well as sold at retail, not only within the MS, but also in neighbouring countries. Raw tobacco is excisable when sold to an operator that is not authorised as a tobacco intermediary. Obviously, such an excisability requires a regulatory framework to identify authorised sellers and buyers of raw tobacco. This regulatory and fiscal framework was introduced in the excise law in 2015,¹⁰³ and made effective as of 2016. The system provides for the following requirements:

1. *Definition.* Raw tobacco is defined as tobacco not part of a living plant and not yet a tobacco product. In practice, the definition of raw tobacco includes all steps between harvesting and incorporation into a manufactured product.
2. *Excisability.* Excise duties are due when raw tobacco is sold to an entity other than a tax warehouse keeper or an authorised intermediary. Purchases and sales of raw tobacco by groups of producers do not trigger excisability, as long as the group only buys raw tobacco from its members under a delivery contract. The excise is set at the level of non-tax stamped 'other smoking tobacco', that is 54.01 €/kg (PLN 229.32) and more than 20 times its commercial value.
3. *Registration/Authorisation.* An economic operator that is not already a tax warehouse keeper intending to purchase raw tobacco without paying the excise duties must apply for an authorisation as 'intermediary tobacco entity' from the customs authorities. The authorisation is subject to the payment of an excise guarantee, which is equal to the payable excises on its monthly sales of raw tobacco, and no less than €471,000 (PLN 2 mn). The authorisation system, and in particular the warranty, led to a reduction in the number of intermediaries in the raw tobacco market from about 300 to 15. Growers and growers' organisations are not subject to the authorisation obligation.
4. *Restrictions to trade.* There is no restriction to trade *stricto sensu*. Trade with 'inappropriate' operators is discouraged by selective excisability.
5. *Written contracts.* Written contracts are mandatory as of October 2015 under the Act on the Agricultural Market Agency. However, no penalty is imposed for failing to meet this obligation.
6. *Recordkeeping.* Authorised intermediaries must keep record of the stocks and flows of raw tobacco purchased or supplied. No recordkeeping duty is imposed to growers.
7. *Controls.* Controls are managed by customs authorities, which can require the payment of the excise in case the consignor or the possessor of raw tobacco is not an authorised intermediary or a tax warehouse keeper.
8. *Retail sale.* The sale of cut tobacco to consumers in Poland was common, and this was one of the reasons prompting the government to introduce selective excisability. The Polish Excise Act does not ban the sale of excised raw tobacco to consumers. However, according to stakeholders, retail sale of raw tobacco was made illegal by means of government resolutions and seizures of both bulk tobacco and the related cutting machines.

Slovakia. Slovakia introduced excise duties on raw tobacco as a reaction to an increase in cut tobacco being imported in the country – where tobacco is not cultivated and tobacco products manufacturing is very limited – and sold to consumers avoiding excise duties. Under the current system, established in 2014, economic operators

¹⁰³ Ustawa o podatku akcyzowym, of 6.12.2008. Hereinafer, 'Polish Excise Act'.

dealing with raw tobacco need to either be authorised warehouse keepers, or be authorised *ex novo* as raw tobacco operators. Raw tobacco is excisable, subject to a tax rate amounting to 71.11 €/kg when not exchanged among tax warehouse keepers or registered operators.¹⁰⁴ Registered operators are also imposed recordkeeping duties concerning the stocks and flows of stored, incoming, or outgoing raw tobacco, in line with what is prescribed for tax warehouse keepers. The legislation applies to a set of activities: cultivation, curing, processing, trading, and retailing tobacco raw materials, which are defined making reference to another legislative act, and include tobacco loose or cured leaves and parts thereof, the results of processing activities, including both processed tobacco and tobacco refuse, as well as reconstituted tobacco.¹⁰⁵

The system was not aimed at raising tax revenues directly, but, rather, at discouraging the sale of raw tobacco for retail, and thus indirectly avoiding tax avoidance on finished products. Accordingly, Slovakia has collected less than €500,000 in tax revenues since March 2014. The number of registered operators is limited to 25.

United Kingdom. A new system for the monitoring of raw tobacco was introduced in the UK as of 1st of January 2017, as a reaction to cases in which raw tobacco was smuggled into the country, with customs authorities having limited power of intervention. Up until then, no legal requirement had been imposed to the trade of raw tobacco, and economic operators, even when not part of the tobacco value chain, did not have to justify its possession. The rationale of the intervention is that once legitimate operators are authorised and identified, non-legitimate players will be easier to catch and anti-smuggling policies to enforce.

The Tobacco Product Duty Act¹⁰⁶ was amended so that any economic entity dealing with raw tobacco – that is any tobacco which is not attached to a living plant or a finished product – needs to be authorised by the HMRC. The authorisation aims at verifying, *i.a.*, whether the operator has a legitimate purpose for operating with raw tobacco and whether it complies with legality requirements. As there is no cultivation of raw tobacco in the UK, activities subject to authorisation include trading (including importing or exporting), storing, transforming or otherwise using raw tobacco. Even though transport activities are not covered, the forwarder may be requested to demonstrate the destination of a shipment. Sanctions are based on the concept of lost revenues, which is the duty that would be charged on an equivalent amount of 'other smoking tobacco' (€/kg 146.41).

➤ THE FCTC PROTOCOL

The obligation to introduce a monitoring system for raw tobacco is also provided for by the FCTC protocol to eliminate illicit trade in tobacco products.¹⁰⁷ Importantly, the Protocol mandatorily covers manufacturers, importers, and exporters of tobacco products and manufacturing equipment. However, parties to the Protocol may extend its obligations also to growers (except for traditional small-scale growers), wholesalers, brokers, warehousepersons, and distributors of tobacco. More specifically, growers may be subject, depending on whether the parties to the Protocol so decide, to: (i) the obligation to keep full records of all tobacco transactions (Art. 9); and (ii) a mandatory license system, if feasible. The Protocol is not yet in force, as only 26 parties (including the EU and 6 MS)¹⁰⁸ ratified it, and will become binding as of

¹⁰⁴ Act 106 of 3 February 2004 on the Excise Duty on Tobacco Products, hereinafter the 'Slovak Tobacco Excise Act', and in particular Art. 19A.

¹⁰⁵ Cf. Art. 2.1 of the Decree of the Ministry of Agriculture and Rural Development of the Slovak Republic no. 212/2002

¹⁰⁶ Tobacco Products Duty Act 1979, hereinafter 'UK Tobacco Excise Act', and in particular amended clause 82.

¹⁰⁷ Protocol to eliminate illicit trade in tobacco products established under the WHO Framework Convention on Tobacco Control.

¹⁰⁸ The protocol falls in an area of mixed competences, thus requiring both EU and MS ratification.

the ninetieth days following the fortieth ratification. The EU already advanced in the implementation of its provisions, with respect to the downstream part of the value chain and with the new tracking and tracing obligations mandated by the TPD2.¹⁰⁹ However, nothing has been foreseen so far for the upstream part.

➤ **PRIVATE CONTROL SYSTEMS**

Finally, the tobacco value chain is also covered by private control systems, in particular in terms of traceability and due diligence requirements. These systems are introduced upon request of the manufacturers of tobacco products, which need to keep control over their value chain for various reasons, including the quality of the products, compliance with legal obligations, and the commercial incentive to make sure they are not involved in illegal or illicit trade. As a result, to sell processed tobacco to manufacturing companies, first processors must set up an internal system ensuring product traceability. The data acquired, processed, and generated by such internal controls are largely sufficient for the monitoring needs of customs or public authorities.

3.2.2 Tobacco Refuse

3.2.2.1 Overview of Product and Markets

➤ **THE PRODUCT**

Tobacco refuse, or tobacco by-products, is any tobacco waste from the drying, curing, and processing of raw tobacco or from the manufacturing of tobacco products. Different types of tobacco refuse exist, depending on the part of the plant from which they originate, the stage of the process in which they are produced, and the dimension of its particles. These types include stems (large or small), which originate from the wooden part of the leaf and its primary and secondary fibres; dust and fines, which are small particles produced during processing and manufacturing activities; and small lamina or scraps, which are larger leaf particles, again produced during processing and manufacturing activities

For the most common varieties (i.e. Burley and Virginia), refuse represents about 20-22% of the gross weight of tobacco leaves. The stems removed by first-processors during the threshing phase are the main source of tobacco refuse. Differently, for oriental varieties, with smaller leaves which are not threshed, the yield of raw tobacco is larger and the share of refuse smaller.

Most of tobacco refuse cannot be smoked without further industrial processing. This applies to stems, both large and small, as well as dust. However, as confirmed by public authorities, customs laboratories, and economic operators, small lamina and scraps can be smoked as they are. These by-products have the right dimension – in other words, they are neither too large nor too small – and may have the right humidity to be smoked in a pipe.¹¹⁰ Smokable tobacco refuse is estimated to represent about 2 to 3% of the output of first processing activities.

Smokability, in this context, is not defined based on the consumer experience – obviously, cigarette blends have a different taste and burning rate compared to tobacco refuse – but on the physical properties of the product. Smokability of tobacco

¹⁰⁹ TPD2, Art. 15.

¹¹⁰ Source: interviews with customs authorities (including forensic experts) and industry operators.

refuse – as well as any other tobacco product – is defined via the so-called smoking test, which has been recently included in the Explanatory Note to the CN Code.¹¹¹

Box 3 - Smoking Test

The smoking test was developed to distinguish tobacco products across the various CN headings, in particular: 2401 unmanufactured tobacco; tobacco refuse; and 2403 other manufactured tobacco and manufactured tobacco substitutes; 'homogenised' or 'reconstituted' tobacco; tobacco extracts and essences. According to the Explanatory Notes to the CN, tobacco refuse should be classified under heading 2401 when it cannot be smoked, or under heading 2403 when it can be smoked: '[w]aste resulting from the manipulation of tobacco leaves or from the manufacture of tobacco products which is capable of being smoked is considered as smoking tobacco if it does not meet the description of cigars, cigarillos or cigarettes.'¹¹² In other words, under customs classification, smokable tobacco refuse belongs to the same group of FCT.

More specifically, the smoking test is used to distinguish unmanufactured and manufactured tobacco and, as a result, can be applied to differentiate between smokable and non-smokable refuse. A 'smokable' product is defined as a product which can be rolled or filled in a cigarette, or filled in a pipe, and burned with several puffs. The test is performed via smoking machines, which simulate the act of smoking. Tobacco refuse is considered not to be smokable when it does not meet any of the three conditions, i.e. it cannot be smoked in the pipe, in the rolled cigarette, or in the machine-filled cigarettes. Differently, smokable tobacco refuse, such as small lamina or scraps, can usually not be smoked in a pipe or in a rolled cigarette, but can pass the test when the cigarette is prepared via a cigarette tube filler.¹¹³

➤ **THE MARKET**

Most of tobacco refuse is recycled within the tobacco industry. Certain by-products can be directly re-inserted into the manufacturing process, some others (e.g. long stems) can be laminated and used to produce expanded tobacco, while the remaining (e.g. short stems or dust) can only be re-used as an input for the production of reconstituted tobacco.¹¹⁴ Small quantities of tobacco refuse are sold to other industries, for example for the extraction of nicotine or tobacco aromas in the cosmetics industry. Normally, tobacco refuse is transported in 200-kg cartons (or, less commonly, 100-kg cartons), as raw tobacco is.

Considering a raw tobacco / waste throughput of about 20%, and an EU production of about 184,000 tonnes in 2015, approximately 37,000 tonnes of tobacco refuse were produced last year by EU first processors.¹¹⁵ The price of tobacco refuse varies depending on its type and quality, plausibly ranging between 0.30 and 0.65 €/kg, and with an average value amounting to 0.50 €/kg. This corresponds to an overall market value of about €18 mn (plausible range between €11 and €24 mn). Therefore, the market for tobacco refuse is marginal, in terms of price and quantities, when compared to raw tobacco or any tobacco product. Though small, however, the market represents a source of revenues for first processors, which are the main source of tobacco refuse and have no chance of reusing it within their own manufacturing process.

¹¹¹ Explanatory notes to the Combined Nomenclature of the European Union, 2016/C 121/05, 'Annex A – Smoking Test for Tobacco and Tobacco Products', 6.4.2016.

¹¹² Explanatory notes to the Combined Nomenclature of the European Union, 2015/C 076/01, at p. 76/108, 4.3.2015.

¹¹³ *Supra* note 111.

¹¹⁴ See below in Section 3.2.3.

¹¹⁵ Tobacco refuse produced by product manufacturers, i.e. after the first processing stage, which is usually not exchanged in the market, is not included. Manufacturers' by-products can be reinserted into the production process, or transformed into reconstituted tobacco.

3.2.2.2 Regulatory Environment

Tobacco refuse is mentioned in Art. 5.1.b of the Directive,¹¹⁶ where it is considered smoking tobacco – and thus excisable – when (i) it can be smoked; (ii) it is put up for retail sale; and (iii) it does not fall under the definition of cigarettes and cigars/cigarillos. This means that tobacco refuse which cannot be smoked or is not put up for retail is not considered an excisable product, while smokable refuse put up for retail sale is excisable under the ‘other smoking tobacco’ category.

The Directive does not include any reference to the CN code, nor to the very recent Smoking Test developed for custom purposes, to determine smokability. However, the same smoking test could also be used also for excise purposes, as it was pointed out by some interviewees during the fieldwork.¹¹⁷ The Directive does not define what ‘put up for retail sale’ means either, and the CN is of no avail in this case, as it only distinguishes between other manufactured tobacco which is sold in immediate packings of a net content not exceeding 500 g (classified under sub-heading 2403.19.10) and larger packings (classified under sub-heading 2403.19.90), without any reference to whether the threshold is intended to differentiate between retail and bulk products.

The definition of tobacco refuse in the national legislations under scrutiny conforms to what is provided for by the Directive. Italy and France have no further mention of tobacco refuse in their legislation other than the *verbatim* transposition of Art. 5.1.b. On the contrary, in Hungary, Poland, United Kingdom and Slovakia tobacco refuse is covered by the regulation schemes for raw tobacco, discussed above in Section 3.2.1.2.¹¹⁸ Hence, in these MS, tobacco refuse is treated as raw tobacco, and its production and trade are subject to the same constrains.

3.2.3 Reconstituted Tobacco

3.2.3.1 Overview of Product and Industry

➤ THE PRODUCT

Reconstituted tobacco, also known as ‘homogenised tobacco’ or ‘recon’, is a brown foil made of tobacco by-products and used in the manufacturing of tobacco products. This intermediate product serves various purposes: (i) recycling tobacco refuse that would otherwise be wasted; (ii) as an ingredient in tobacco blends to obtain certain flavours; (iii) as a vector for additives; and (iv) as a wrapper (e.g. for cigars and cigarillos). The most important use in the tobacco industry is as filler for cigarettes, which usually contain up to 5-10% of reconstituted tobacco (up to 25% in the American market, for blending reasons). Reconstituted tobacco is used for both process and product considerations, as well as for regulatory reasons. First, it optimises the making of tobacco products, as it allows to re-introduce in the manufacturing cycle by-products which could not otherwise be used (e.g. tobacco dust). Secondly, being an artificial material, reconstituted tobacco is more stable than natural tobacco, and allows for a better management of certain product characteristics (such as smokability and burning

¹¹⁶ Where tobacco refuse is defined as “remnants of tobacco leaves and by-products obtained from tobacco processing or the manufacture of tobacco products”.

¹¹⁷ From a legal perspective, it is to be stressed that the smoking test has not been included in any legislation for excise purposes and was only agreed for customs classification.

¹¹⁸ Art. 7 §56 of the Hungarian Excise Act specifies that ‘cured tobacco’ for which players’ registration is necessary, in other words raw tobacco, also includes tobacco waste covered by CN heading 2401. Similarly, in defining raw tobacco, the amended Slovak Tobacco Excise Act makes reference to the Decree of the Ministry of Agriculture and Rural Development of the Slovak Republic no. 212/2002, where tobacco refuse is explicitly included in the scope of the definition. Though not explicitly, the UK Tobacco Excise Act (clause 82, section 8K) and the Polish Excise Act (Art. 99a) define raw tobacco as including waste.

rate). Besides, reconstituted tobacco can be used as a vector for mixing flavours and additives in the product blend. Finally, the use of reconstituted tobacco, which burns faster and comes from the 'poorer' parts of the tobacco leaves, reduces the tar and nicotine content of cigarettes.

Manufacturers of reconstituted tobacco receive tobacco refuse from growers, first processors, and product manufacturers. The main categories of by-products used in its manufacturing include scraps, fines, dust, large stems, and secondary fibres, largely from first processors, as well as dust and small particles from manufacturers, and whole or broken leaves which are damaged or of insufficient quality from growers.

Reconstituted tobacco can have different grades of quality, and is produced in different shapes. The product is usually sold in strips of 5 to 10 cm¹¹⁹ which cannot be smoked and require further processing. Two different processes can be used to produce reconstituted tobacco:

1. Paper-like process. Tobacco refuse is mixed with warm water, and the fibrous portion and the soluble portion are mechanically separated. The fibre portion is then treated as in the paper industry, and a web of fibres is created and then transformed into a tobacco sheet.¹²⁰ Meanwhile, the soluble portion is concentrated, and added back into the fibre web. If the customer so needs, flavours can be added to the concentrated solution.
2. Slurry cast process. Tobacco by-products are ground into a powder, mixed with a binding agent, and then the resulting slurry is cast onto a continuous stainless steel belt to form a sheet.¹²¹ The slurry cast process is used by smaller reconstituted tobacco plants and for in-house facilities, as it is efficient also at smaller outputs. On the contrary, economies of scale are more significant for the paper-like process, which is more efficient with larger outputs.

➤ THE MARKET

All reconstituted tobacco is bought by manufacturers of tobacco products and there is no reported use outside this industry. The global sale of reconstituted tobacco amounts to about 300,000 tonnes, of which 170,000 is produced and consumed in the Chinese market. Compared to natural tobacco, with a global production estimated at about 5 million tonnes, reconstituted tobacco thus represents a much smaller market, about 6% in terms of volume.

The main suppliers of reconstituted tobacco – excluding players operating in the Chinese market – are SWM, an independent player, and the *Big Four* tobacco companies. The European market is served by the SWM plant – located in France – and by the *Big Four* facilities. SWM produced about 50,000 tonnes of reconstituted tobacco in 2015, which was sold worldwide, serving both the *Big Four* and independent manufacturers. In the EU, the market share of SWM is estimated at about 50%. With respect to the big manufacturers, both JTI and PMI have their own reconstituted tobacco factories supplying European manufacturing sites, while BAT produces reconstituted tobacco in-house within its cigarette factories. Industry

¹¹⁹ According to one interviewee, reconstituted tobacco is not shipped in smaller sizes, as it is usually cut by the client, which adapts the cut to its production necessities.

¹²⁰ When tobacco by-products are not rich enough in fibres, e.g. when there is a too small share of stems in the batch, wood pulp can be added.

¹²¹ Cf. Reconstituted tobacco improvers (available at: <http://www.tobaccotech.com/products-services.php?pid=132>, last accessed on March 2017); European Commission, DG SANTE, Tobacco additives (available at: http://ec.europa.eu/health/scientific_committees/opinions_layman/tobacco/en/; last accessed on March 2017).

estimates suggest that the EU market value of reconstituted tobacco amounted to about €90 mn in 2015.

3.2.3.2 Regulatory Environment

Reconstituted tobacco is not explicitly defined in the Directive, and is not considered an excisable product. In particular, as it is not “capable of being smoked without further industrial processing” (Art. 5.1.a), reconstituted tobacco does not fall into the definition of smoking tobacco. With regard to MS, no national definitions or legal frameworks for reconstituted tobacco are in place in the countries visited during the fieldwork.

At the same time, the manufacturing of raw tobacco is subject to traceability requirements imposed for both public and private reasons. As a result, on the one hand, customs authorities need to check reconstituted tobacco plants because they may import, export and store tobacco-related materials, including excisable tobacco products¹²², in excise or customs duty suspension. On the other hand, traceability requirements are imposed on reconstituted tobacco manufacturers by their clients, as in the case of raw tobacco quality and integrity management requires that raw materials and intermediate product batches can be linked to final products.¹²³

3.2.4 Problem Analysis

3.2.4.1 Diversion of Raw Tobacco to Illicit Trade

➤ THE NATURE OF THE PROBLEM

Raw tobacco can be diverted to the production of illicit finished tobacco products that are marketed without paying excise duties. Raw tobacco can be illicitly transformed in factories within the EU, exported towards neighbouring countries, from which finished products can then be re-imported, or sold for retail as cut or bulk tobacco.¹²⁴ Such illicit trade can create negative impacts in terms of tax revenues and tobacco control policy. The problem can be framed as a regulatory failure, and in particular as an unintended negative consequence of two regulatory interventions: (i) the high taxation of tobacco products, which creates the economic incentives for illicit trade; and (ii) the end of the CMO, which deprived the tobacco sector of its monitoring system.

In line with this problem definition, two main drivers can be identified for this problem:

- Economic incentives. The illicit trade of raw tobacco starts when growers sell (part of) their production to illicit operators, i.e. entities not affiliated to the legal value chain. On the black market, growers are offered a premium over market price: while the latter amounts to around €2-3.5 per kg, illegal traders allegedly offer approximately €40-60 per kg. Such a very high price is economically sustainable for the illicit manufacturers because the cost of raw

¹²² Manufacturers of reconstituted tobacco can handle excisable products, i.e. tobacco material which can be smoked as it is. This can happen for example when cigarettes are dismantled for quality reasons, and then their tobacco is recycled into reconstituted tobacco.

¹²³ According to interviews findings, reconstituted tobacco producers also work as third-party service providers, i.e. they receive tobacco by-products from clients and transform it on their behalf. In this case, clients need to be sure that their by-products were not mixed with others. Also, reconstituted tobacco can be used as a vector for additives, which are customer and product-specific, and this is another specific requirement demanding full product traceability.

¹²⁴ Cf. Section 3.2.4.2 below.

tobacco is a very small component of the final industrial price of cigarettes,¹²⁵ let alone the final post-tax price.

- Lack or insufficient monitoring and control tools. Firstly, the EU legal framework does not provide for the monitoring of raw tobacco, as it is neither subject to the excise system, nor covered by a specific regulatory framework. Raw tobacco, however, is regulated and monitored at national level, but with variable effectiveness. That said, countries in which the problem is considered as significant by both internal and external sources (e.g. Poland or Bulgaria), have detailed regulatory frameworks in place. However, interventions are still very recent, and may not have deployed their full effects yet.

The main affected stakeholders, and the related impacts, include:

- tax authorities, because of the loss in tax revenues and the enforcement costs borne;
- economic operators, because of the unfair competition brought about by illicit products;
- health authorities, because cheap illicit products may undermine tobacco control policies.

➤ **THE MAGNITUDE OF THE PROBLEM**

No comprehensive studies or information could be retrieved on the scale of illicit trade of raw tobacco, with the exception of a new set of estimates about bulk tobacco for retail, discussed in Section 3.2.4.2 below. Neither stakeholders nor public authorities were able to provide a quantitative assessment. As a result, to appraise the magnitude of the problem, first qualitative evidence retrieved from interviews is discussed, and then a quantitative analysis is carried out based on data relating to the seizures of raw tobacco.

Stakeholders largely agree that an illicit trade of raw tobacco exists, though smaller compared to the illicit trade in manufactured products. In addition, the magnitude of the problem largely differs within the EU. Comments and evidence provided by public authorities indicate that illicit trade of raw tobacco is a minor problem in Western European countries: for example, based on seizures and raw tobacco control systems, the illicit trade of raw tobacco is considered negligible in France, Italy, and Spain,¹²⁶ which are tobacco growing countries. In the UK, Ireland or Belgium, which are non-growing countries, minor cases, and consequent seizures, concerning raw tobacco, or FCT disguised as raw tobacco, are reported, with annual seizures varying from a few kg to 100 tonnes. The situation is different in Eastern European countries, where the illicit trade of raw tobacco is considered more widespread, especially in Poland and Bulgaria, and, to a lesser extent, and Hungary.¹²⁷

The most reliable data available to assess the scale of the problem are those relating to seizures of raw tobacco by customs authorities. However, seizure data have the following limitations:

- data on seizures represent a fraction of the illicit trade; the relation between the two quantities is unknown;

¹²⁵ A cigarette may contain, roughly speaking, between 0.5 and 1 g of tobacco. 1 g of raw tobacco is worth about €cents 0.3 at current prices.

¹²⁶ According to information provided by stakeholders, a mobile cigarette factory has been dismantled in Spain in 2015, and it used local raw tobacco.

¹²⁷ In the OPC, respondents were asked to provide their assessment on whether the diversion of raw tobacco to illicit trade should be regarded as a significant problem. Companies were almost unanimous in consider that this is not the case, while NGO affirmed that this is a major issue. Views of individuals are split almost evenly.

- seized quantities of raw tobacco depend on both the overall scale of the illicit trade, as well as on the enforcement efforts made by public authorities, which in turn depend on how significant or salient illicit trade is;
- data show a high variance across countries and across years which can be traced back to very different underlying conditions (e.g. different national legislation, tobacco growing vs. not growing country, quality of the enforcement, customers' demand for cheap low-quality tobacco products, salience of the problem for public authorities, etc.). For this reason, any generalisation at EU level should be considered as only indicative;
- data on seizures do not show the origin of raw tobacco, which can be cultivated either in the EU or not. Seizures may partly occur at the border - however it may not always be straightforward to assess its intended illicit use at that point - or at illicit manufacturing sites, in which case it might be complex to reconstruct its origin and trade routes. Public authorities suggest that illicit raw tobacco comes from various origins, including Eastern EU growing countries, neighbouring countries (such as Ukraine or Moldova), and other third countries (e.g. India, Pakistan).

Data on seizures were retrieved from customs authorities in Belgium, France, Hungary, Ireland, Italy, Poland, and the UK. These data are sometimes drawn from official statistics, sometimes based on informed estimates. Large discrepancies in seized quantities are the norm, both across MS and, within the same MS across years.

The average yearly seizures for these 7 MS amount to about 1,000 tonnes per year. These countries represent about 44% of the market for cigarettes and FCT.¹²⁸ Using market size as reference, EU level yearly seizures of raw tobacco can be estimated at about 2,200 tonnes. Assuming seizures represent between one-fifth and one-third of illicit trade flows (see Box 4 below), the illicit trade of raw tobacco could range between 6,700 and 11,200 tonnes, that is between 0.8% and 1.4% of the current EU raw tobacco market (including both production and net imports).

Box 4 – The ratio between seizures and illicit trade

As concerns cigarettes, in 2013, seized products represented about 7% of the estimated illicit trade¹²⁹, which corresponds to a ratio of about 1:15. In the case of raw tobacco, there are no specific estimates on the ratio between seizures and possible illicit trade, and using the above figures from illicit cigarettes seems inappropriate. First of all, raw tobacco has a much lower value-to-weight ratio than cigarettes, which means there is a smaller economic incentives for smuggling raw tobacco as compared to finished products. Secondly, in volumetric terms, raw tobacco is more difficult to conceal than finished products, hence it is fair to assume that customs controls may have a higher success rate. On the other hand, a certain share of seizures of raw tobacco occurs at illicit manufacturing sites, and in this sense the ratio between seizure and overall illicit trade may depend not only on customs border controls but also on value-chain control (including police controls).

If the same seizures/illicit trade ratio of cigarettes is applied to raw tobacco (1:15), the estimated volume of raw tobacco used for illicit manufacturing would amount to about 34,000 tonnes, i.e. some 38 bn sticks (assuming 0.9 g of raw tobacco per cigarette is needed). According to the estimates reported in Box 5 below, this would be tantamount to estimate that some 80% of the illicit cigarettes consumed in the EU are also manufactured in the EU, and only 20% are illegally imported as finished products, which seems however largely excessive. Any estimate in this area has to be taken with great caution given the absence of robust data on smuggling and the related routes, however based on the interviews feedback as well as other

¹²⁸ 2015 data from *Euromonitor International: Passport Tobacco, 2016 Edition*.

¹²⁹ Some 3.36 bn sticks seized in 2014, Source: Commission Staff Working Document, Technical assessment of the experience made with the Anti-Contraband and Anti-Counterfeit Agreement and General Release of 9 July 2004 among Philip Morris International and affiliates, the Union and its Member States, 24.2.2016. SWD(2016)44.

evidence on the foreign origin of the 'cheap whites' – which account for the a large share of illicit cigarettes – it is more reasonable to assume that only a minor share of EU illicit cigarettes are illegally manufactured in the EU.¹³⁰ Assuming the illicit trade of raw tobacco ranges between 6,700 and 11,200 tonnes (i.e. 1:3 to 1:5 seizure / illicit trade ratio), the estimated share of illicit cigarettes manufactured in the EU would amount to some 15-25% of the total illicit cigarettes consumed.

Based on the above assumptions, the estimated illicit trade of raw tobacco would correspond to about 7.4-12.4 bn cigarette sticks that is 1.6-2.7% of the current cigarette consumption, and to excise revenue losses of about € 1.2-2.0 bn. As a benchmark, the overall illicit trade in cigarettes can be estimated at ca. 47 bn sticks, i.e. 10% of the total consumption, as described in more details in Box 5 below. In this sense, the issue of raw tobacco (of EU and non-EU origin) diverted to illicit manufacturing in the EU may represent a minor but not negligible share of the problem (15-25% of illicit cigarettes). As discussed below, the problem is unevenly spread across EU MS.

Box 5 - Estimates of the Illicit Trade of Cigarettes

Studies on the illicit trade of cigarettes have returned different estimates. Such differences can be partly explained by the fact that illicit activities are intrinsically difficult to monitor. In the document assessing the cooperation with PMI to fight contraband and counterfeit activities,¹³¹ the Commission mentioned three main data sources:

1. Euromonitor, which estimated that about 66 bn illicit cigarettes were marketed in 2015, corresponding to 13.6% of the licit market;
2. A report commissioned by the European Executive Agency for Health and Consumers, which estimated that in 2010 the number of illicit cigarettes was approximately 80.5 bn sticks (that is, 13.3% of the licit market in that year);¹³²
3. KPMG Project SUN,¹³³ an annual report funded by the big tobacco companies. It estimated the size of the illegal cigarette market in 2013 at about 58 bn sticks, which is 11.3% of the licit market. In its most recent update, KPMG Project Sun estimated that the market for illicit cigarettes shrunk to 53 bn sticks, which corresponds to about 9.8% of the total consumption, or 10.8% of the licit market.¹³⁴ The methodology of the study is not fully disclosed. The EU reported to the WHO FCT Implementation Database that the illicit trade in cigarettes represented 10.4% of the market in 2013, based on Project Sun data.¹³⁵

Other studies proposed similar or lower estimates:

1. The Impact Assessment for the TPD2 considered that in 2012 the illicit trade in cigarettes in the EU accounted for 8.25% of the market, and that illicit products would increase by 1% per year, based on Euromonitor data.¹³⁶

¹³⁰ According to WHO FCTC Report on Illicit Trade Counterfeit cigarettes represent about 4.4% of total seizures, the rest being 'cheap white' or contrabanded cigarettes. Using the general 1:15 ratio, counterfeited cigarettes consumption may amount to 2.0 – 2.5 bn sticks per year. It can be estimated they account for the majority or a significant share of the illicit manufacturing of cigarettes in the EU, and this would confirm the qualitative perceptions of public authorities and other stakeholders that the majority of illicit cigarettes are introduced in the EU as finished products.

¹³¹ Commission Staff Working Document, Technical assessment of the experience made with the Anti-Contraband and Anti-Counterfeit Agreement and General Release of 9 July 2004 among Philip Morris International and affiliates, the Union and its Member States, 24.2.2016. SWD(2016)44.

¹³² Matrix insight, *Revised Final Report Economic Analysis of the EU market of tobacco, nicotine and related products*, 20 September 2013.

¹³³ Project SUN (2013).

¹³⁴ Project SUN (2015).

¹³⁵ WHO FCTC Implementation Database, 2014 Implementation Report submitted by the EU, available at http://apps.who.int/fctc/implementation/database/sites/implementation/files/documents/reports/eu_2014_report_final.pdf (last accessed in April, 2017).

¹³⁶ Commission Staff Working Document, "Impact Assessment Accompanying the document for a 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

2. The PPACTE project suggested a lower estimate of 6.5%, based on an analysis of 18 European countries or regions.¹³⁷ When comparing results with KPMG Project Sun data, PPACTE estimates are higher in 11 countries, and lower in 5. Differently from Project Sun, the methodology and data are fully disclosed.

In the absence of other systematic and free-access sources, Project SUN data are largely used not only by the big tobacco manufacturers that commissioned it, but also by national public authorities and in the framework of independent studies¹³⁸, despite the fact the report contains an Important Notice that limits the usability of data to the intended beneficiaries: "[...] since we have prepared this Report for the Beneficiaries alone, this Report has not been prepared for the benefit of any other manufacturer of tobacco products nor for any other person or organisation who might have an interest in the matters discussed in this Report, including for example those who work in or monitor the tobacco or public health sectors or those who provide goods or services to those who operate in those sectors". Since details on the methodology and assumptions are not disclosed no firm consideration on its reliability is feasible.¹³⁹

In this Study, a mid-point estimate between the various sources has been used, i.e. 47 bn sticks or approximately 10% of the current cigarette market.¹⁴⁰ Such a parameter falls in the middle of the range of available estimates, which go from the 7.0% estimated by PPACTE (recalculated based on the illicit / licit ratio) to the 13.6% estimated by *Euromonitor*. This estimate is somehow lower than Project SUN's, in this sense potentially correcting for industry-view bias.

➤ THE EU DIMENSION

The magnitude of the problem varies from MS to MS, with some customs authorities considering raw tobacco a top or near-the-top priority, and others considering the associated risks as negligible. Undeniably, the problem has cross-border spill-over effects, as trade flows of illicit raw tobacco cause problems to tobacco growing countries as well as to other EU MS. Also, as signalled, toughening controls in certain countries can create a 'waterbed effect', so that illicit traders or manufacturers move to other EU or non-EU countries where regulation is less strict or enforcement less intense.

➤ DYNAMIC BASELINE SCENARIO

Most stakeholders concurred that the illicit trade of raw tobacco of EU origin became a problem after the end of the CMO, or that, at least, the removal of the subsidies made it more acute. This may have resulted in a surge of the illicit trade of which did not surface when drafting and approving the current Directive. Such increase could also explain the reactions of national legislators, who drafted new regulations for monitoring and controlling raw tobacco in recent years. For this reason, one of the problem drivers, the lacking or insufficient monitoring and control tools, is becoming

tobacco and related products", SWD(2012) 452 of 19.12.2012. Hereinafter: "the Impact Assessment of the TPD2".

¹³⁷ Joossens L, et al., 2014, Illicit cigarettes and hand-rolled tobacco in 18 European countries: a cross-sectional survey, *Journal of Tobacco Control*. Results are discussed in European Parliament, "Workshop Cigarette Smuggling", 2014 and Gilmore AB, Rowell A, Gallus S, et al., Towards a greater understanding of the illicit tobacco trade in Europe: a review of the PMI funded 'Project Star' report, *Tobacco Control*).

¹³⁸ As mentioned above, the European Commission made reference to Project Sun in its submission to the WHO. In addition, cf. the work carried out by the independent Transcrime research centre on the nature, flows, and determinants of the illicit trade of cigarettes at national and sub-national level. Transcrime, "European Outlook on the Illicit Trade in Tobacco Products", 2015 and Transcrime, "The Eastern Balkan Hub for Illicit Tobacco", 2016.

¹³⁹ As reported during the interviews, one customs authority duplicated the KPMG study obtaining similar results.

¹⁴⁰ The overall cigarette market is estimated based on Euromonitor International: *Passport Tobacco*, 2016 Edition.

less pressing, and even more so in the coming years, when the national frameworks will come into force or deploy their full effects. At the same time, however, these frameworks have a national focus and may not fully curb cross-border illicit trade flows. In addition, the economic incentives that make the illicit trade of raw tobacco profitable – the other problem driver identified – is likely to persist. For this reason, the problem is expected to be declining in the near future, though unlikely to be solved.

3.2.4.2 Raw Tobacco put up for Retail Sale

➤ THE NATURE OF THE PROBLEM

Raw tobacco put up for retail sale – also called cut tobacco or bulk tobacco – is a multi-faceted problem, with various roots and drivers. On the one hand, the problem is connected to the illicit trade of raw tobacco, which can be subtracted from the licit value chain and then sold as bulk tobacco, rather than transformed into illicit cigarettes. In this case, the problem analysis and the quantitative estimate of the scale of the problem described above in Section 3.2.4.1 would apply.

On the other hand, raw tobacco put up for retail sale appears to be both a consequence of the illicit trade of raw tobacco, and a 'borderline' product which is marketed to exploit a loophole in the current product definitions. Art. 5.1.a provides that smoking tobacco should be excised as long as it can be smoked 'without further industrial processing', thus creating a possible loophole. Indeed, certain traders are selling bulk tobacco, which is untaxed because it is not sufficiently cut or dried to be smoked without further processing, but that can become smokable after small refinements (e.g. drying in a kitchen oven, or cutting with home-machines). This is indeed the case in several MS, where shops were selling bulk tobacco and also providing 'cutting services'. Actually, bulk tobacco can hardly be defined as requiring further industrial processing; however, the term industrial is not easy to operationalise, and both false positive and false negative errors can arise. For example, a dried leaf of raw tobacco can be smoked without further industrial processing, by means of a simple grinder; however, this should not mean that Art. 5.1.a considers dried tobacco leaves as excisable. From this point of view, the problem could be framed as a regulatory failure linked to the poor design of the definition of smoking tobacco, or to poor implementation/enforcement in certain MS.

The CJEU was called by the Czech State Council to provide an interpretation of art 5.1.a with respect to the excisability of "*dried, flat, irregular, partly stripped leaf tobacco and/or parts thereof which have undergone primary drying and controlled dampening and in which the presence of glycerine is detected [which] are capable of being smoked after simple preparation*".¹⁴¹ The judgment was very recently delivered and the CJEU stated that the Directive should be interpreted as to consider such a product as 'other smoking tobacco', and thus excisable. More in general, at § 24, the Court considered that, given the objectives of the Directive, the notion of 'other smoking tobacco' should be constructed broadly as to cover this and other kind of manufactured tobacco. Furthermore at §32, it is stated that the 'industrial processing' clause for non-excisability cannot be applied to "manufactured tobacco which is ready, or can easily be made ready, by non-industrial means, to be smoked". This judgment thus clarifies the applicable tax regime for some of the borderline retail products consisting of raw tobacco and thus affects the dynamic baseline scenario (see further below in this Section).

¹⁴¹ Cf. Case C-638/15, Request for a preliminary ruling from the Nejvyšší správní soud (Czech Republic) lodged on 30 November 2015 — Eko-Tabak s.r.o. v Generální ředitelství cel.

The main affected stakeholders, and the related impacts, are largely the same as for raw tobacco, and include:

- tax authorities, because of the loss in tax revenues and the enforcement costs borne (including the costs linked to the legal uncertainty of the definition of 'other smoking product');
- economic operators, because of the unfair competition brought about by illicit products;
- health authorities, because cheap illicit products may undermine tobacco control policies.

➤ **THE MAGNITUDE OF THE PROBLEM**

As for the illicit trade of raw tobacco, quantitative evidence, with the exception of the *Crimetech* report,¹⁴² is scant and variance across MS is high. Most of the authorities interviewed in the course of the fieldwork considered raw tobacco for retail sale not an issue in their own MS. This was the case for France and Italy, which expressed limited concern with respect to the overall illicit trade of raw tobacco, but also for countries where the illicit trade of raw tobacco did raise some attention, such as Ireland and Belgium. On the contrary, other countries were more on the alert and already reported cases of online or offline sales of cut tobacco, such as Portugal (which recently adopted a norm to tackle this issue) and Sweden. At the other end of the spectrum, in certain MS, such as Poland and Slovakia, raw tobacco put up for retail sale was a major problem: the opening up of shops where untaxed cut tobacco was sold to consumers, and cutting machines were put at their disposal for the refinement of the product,¹⁴³ was among the main drivers, or possibly the main driver, for introducing an excise tax on raw tobacco.¹⁴⁴

With respect to the magnitude of the problem, the fieldwork suggests that raw tobacco for retail sale is considered less significant compared to the illicit trade of raw tobacco *per se*. The *Crimetech* report, a comprehensive study on the illicit market for bulk tobacco commissioned by the *Big Four* to the commercial spin-off of a University centre, has just been released in 2016. The study covers 9 markets in Central, Eastern, and Southern Europe, including several EU MS (Bulgaria, Croatia, Czech Republic, Greece, Hungary, Poland, Romania, Slovakia, and Slovenia). The methodology consists of estimating the total consumption of FCT based on the smoking prevalence, to then compare the estimated consumption with the quantity of FCT released for consumption. The difference between the two is then allocated to various categories, namely: non-domestic legal, contraband or counterfeit FCT, or bulk tobacco.

In general, *Crimetech* considers that a significant part of the actual FCT consumption can be explained by illicit bulk tobacco. The figures provided for EU MS range between 14% for Hungary (which is, however, a very large FCT market, with the highest prevalence in the EU and more than 6,000 tonnes of official consumption), and as high as 62% in Slovakia, 67% in Poland, 74% in Bulgaria, and 84% in Croatia. These

¹⁴² Crime&tech, "Bulk Tobacco Study 2015 – Assessing the Illicit Trade and Consumption of Cut Tobacco in 14 Markets in Europe", 2016. Hereinafter 'Crimetech'.

¹⁴³ According to art. 15.2 of the Horizontal Directive, the production and processing of the excise goods where the excise duty has not been paid shall be done in a tax warehouse; accordingly, the preparation of raw tobacco to its smokable form would not be in line with such provision if it did not take place therein.

¹⁴⁴ Through the OPC, the general public was surveyed on whether raw tobacco put up for retail sale was perceived as a problem. As for raw tobacco, companies considered this to be a negligible or minor problem, while NGO a moderate or major one. The view of individuals was almost split, with a slight prevalence of those who considered this as a 'no or minor' problem.

percentages would be far higher than the share of illicit consumption of the cigarettes.¹⁴⁵

Most of economic operators, including manufacturers of cigarettes and FCT, did not agree with these results, which appear to be overestimated, and possibly largely so. At the same time, such a high illicit consumption of FCT was never mentioned, even qualitatively, by public authorities. A complete unawareness of an issue of such a large scale tends to be unlikely.

Crimetech remains a useful industry source, but its results could not be validated by the Consultants. While the size of the retail market for raw tobacco remains uncertain, the Consultants' qualitative assessment would put a plausible range at a lower level, between a few percentage points and 10-15% of the FCT market (the latter especially in MS where FCT is a niche product). In terms of lost revenues, those due to bulk tobacco are already accounted in those estimated for the illicit trade of raw tobacco, as discussed in Section 3.2.4.1 above.

➤ **THE EU DIMENSION**

In light of the above, the problem does not affect the whole EU. To the contrary, the emergence of bulk tobacco is concentrated in a handful of countries, though it may potentially emerge in others as well in the future. However, the Slovak example - where raw tobacco is not grown but its retail sale is considered a major threat - proves the existence of cross-border negative spill-overs that could be best managed at the EU level.

➤ **DYNAMIC BASELINE SCENARIO**

As discussed above with respect to the illicit trade of raw tobacco, national frameworks and other enforcement efforts undertaken against the illicit trade of raw tobacco and 'borderline' shops (where existing) are likely to reduce the quantities of raw tobacco put up for retail sale. The phenomenon was already reported in decline in the two most affected MS among those visited, Poland and Slovakia. At the same time, analogously to the experience with other 'borderline' tobacco products, even though certain markets become impracticable, bulk tobacco may begin appearing in other national markets, and growing in the ones in which it is still marginal, as it is probably the case in Sweden. This is due to the fact that not all countries have adopted specific legislative provisions, and the others will probably do so only after the issue becomes more salient. The CJEU judgment C-638/15 provides MS with a legal ground to address the loophole of bulk tobacco.

In conclusion, should no legislative measure be undertaken at EU or national level, bulk tobacco may appear in a higher number of MS, though this may be less likely taking into account the recent interpretation of art 5.1.a adopted by the CJEU. In any case, being a lesser quality product, bulk tobacco is unlikely to win a large market share. This also explains why it is more widespread in countries where tobacco products are less affordable, i.e. where their price is higher compared to *per capita* income, or have become so after the economic and financial crisis.¹⁴⁶

3.2.4.3 Diversion of Tobacco Refuse to Illicit Trade

¹⁴⁵ Illicit cigarettes as a share of the FMC market for the above-mentioned MS are as follows: BG 11.6%, HR 4.3%, HU 7.1%, PL 16.8%, SK 2.3%. Project SUN (2015).

¹⁴⁶ Bulgaria and Poland, where instances of raw tobacco put up for retail sale were reported, are respectively the second- and fifth-highest ranking MS in terms of the ratio between cigarette WAP and GDP per capita. Portugal and Slovakia are also above the median in this respect (respectively, the 7th and 11th MS). This correlation is, however, not perfect, as Czech republic, another country in which retail trade of raw tobacco was reported, falls below the median (18th MS).

As discussed above in Section 3.2.2, the tobacco refuse market is a fraction, both in volume and in value, of the raw tobacco market. In addition, the smokable fraction of refuse, namely small lamina and scraps, and which can then be readily used by consumers, accounts for about 15% of the total volume of tobacco refuse. Furthermore, tobacco refuse is not a necessary ingredient for illicit tobacco products, which can be produced also without it. Finally, most of the tobacco refuse is produced at first processing and manufacturing plants, which are by far less numerous than growers, and by far more controlled by tax or customs authorities in comparison with tobacco plots. For all these reasons, diversion of tobacco refuse to illicit trade was expected to be a minor, if significant at all, issue in the context of the illicit trade of raw tobacco.

This finding was confirmed by the fieldwork and further research. Problems with tobacco refuse were not reported by public authorities in most of the countries visited. Only in the UK and Belgium, 'a couple of cases' concerning tobacco by-products were mentioned, relating to FCT made of refuse. Public authorities largely confirmed that their concern with waste is low, also because 'tobacco refuse can come only from factories, thus creating much more limited problems'.¹⁴⁷ The situation described above is unlikely to change in the near future.

The problem analysis, drivers, and affected stakeholders would be, *mutatis mutandis*, the same discussed above¹⁴⁸ for the illicit trade of raw tobacco. However, the significance of the problem appears to be minor or negligible, based on the assessment of public authorities, as well as from the feedback from economic operators.

3.2.4.4 The Definition of Tobacco Refuse (Art. 5.1.b)

Stakeholders and public authorities largely confirmed that the definition of tobacco refuse provided for in Art. 5.1.b of the Directive is clear, and that the identification of the cases in which excises should be applied to tobacco refuse is appropriate. Hence, from a legal point of view, the provision is properly designed. Differently, concerns were raised concerning its uneven application, in particular with respect to the 'put up for retail sale' clause.

Affected stakeholders include the public authorities in charge of controlling when tobacco refuse is excisable and possibly confronted with revenues losses, as well as economic operators, which may suffer from the lack of legal certainty due to the uneven application of the provision. Public authorities, with the exception of Sweden, do not consider this to be a major issue worth of intervention; on the contrary, economic operators, and in particular first processors, expressed a concern.

The main concern of first processors relates to the possibility that tobacco refuse sold to other companies, within or outside the tobacco industry, for manufacturing purposes is classified as an excisable product. Economic costs, in this case, can be substantial. A container of tobacco refuse contains approximately 20 tonnes, worth about €10,000 at 0.50 €/kg. If that tobacco refuse was considered as other smoking product, the minimum excise level set by the Directive would be €/kg 22 or 20% of the retail selling price. Assuming a fully specific taxation, and disregarding other possible sanctions, excises on that same container would amount at least to €440,000, which is a large multiple of its commercial value. The risk of incurring in

¹⁴⁷ In the OPC, respondents were asked to provide their views on whether the illicit trade of tobacco refuse should be considered a problem. Responses are almost identical to those provided for raw tobacco: companies do not consider it to be a problem, NGO do, though to a more limited extent, while individuals' views are almost equally split.

¹⁴⁸ In Section 3.2.4.1.

such a levy and the costs needed to move by-products under duty suspension would hamper the tobacco refuse market.

The Consultants investigated such cases with both economic operators and public authorities, and were able to find only one case of misclassification, concerning a container of tobacco refuse transported in 200-kg cartons from Bulgaria to France and seized in Romania. Reportedly, the shipment was worth about 4-6,000€, while the case costed €50,000 in legal fees, with both the refuse and the truck eventually confiscated.¹⁴⁹ However, the economic operators concerned acknowledged that the problem was limited to a very specific customs office, and that they never had, prior or after this case, any other problem with tobacco refuse transiting through Romania or any other EU MS. At the same time, they did not feel necessary to change their patterns of cross-border transport of tobacco refuse.

One case of misapplication throughout the entire life of the Directive would suggest a very good track record, rather than a regulatory problem. However, economic operators remain concerned that the situation may evolve negatively in the near future, due to a combination of the additional attention paid to tobacco refuse in certain MS (see box on Sweden below) and the recent codification of the Smoking Test. In particular, economic operators fear that the clause 'put up for retail sale' is not sufficiently clear and operationalised, or that it may be disregarded by customs authorities. Indeed, neither the CN nomenclature, nor the Smoking Test make any reference to the packaging conditions of tobacco refuse, i.e. whether it is sold in bulk or prepared for retail. As confirmed by customs authorities in several of the MS visited, the lack of clarity could result in great attention being given to the smokability of tobacco refuse, while the 'put up for retail clause' could risk not to be taken into due consideration. The problem is considered as particularly serious in Central-Eastern MS, where certain public authorities expressed the need for having a more operationalised definition.

Box 6 - Tobacco refuse for retail sale: the case of Sweden

In Sweden, tobacco refuse for retail sale appeared very recently, most probably in 2016 or 2015, in a number of tobacco shops. This phenomenon is causing growing concern for both public authorities and manufacturers of tobacco products and *snus*. When the Consultants were mystery shopping at a tobacco shop in Sweden, a box of '*råtabaksspill*' (raw tobacco waste) was bought,¹⁵⁰ which is marketed as a 'product for both nose and mouth' and not intended to be smoked. The price amounted to SEK 99 (€10.56) for 300 g, hence SEK 330 (€35.20) per kg, which compares very favourably to the excise duty for smoking tobacco, set at SEK 1,852 (€197.54) per kg. The shop owner reported that the product can be used also for smoking, though possibly after some refinement (e.g., toasting it in the oven). The product is sold by an online wholesale vendor specialised in raw tobacco for snus production. Following an inspection by customs authorities, the vendor was notified a fine amounting to SEK 100 million (about €11 million) for unpaid excise duties on smoking tobacco, after the smoking test showed that the tobacco refuse could be smoked, and because products were put up for retail sale. The fine has been appealed.

3.2.4.5 Issues Concerning Reconstituted Tobacco

¹⁴⁹ Ramboll Evaluation (2014).

¹⁵⁰ In the Swedish law, tobacco refuse is transposed as '*tobaksavfall*'.

Based on fieldwork carried out with economic operators and public authorities and the review of secondary sources, no regulatory or market failure concerning reconstituted tobacco could be identified, with respect to neither illicit trade, nor definition or classification issues. Also, no evidence points to the risk of problems arising in the future. For this reason, no policy option concerning reconstituted tobacco is proposed in the following parts of the Study.

➤ **ILLICIT TRADE**

The fact-finding work found no evidence of any diversion of reconstituted tobacco to the illicit trade, in line with the early findings presented in the Inception Report. This was confirmed by both manufacturers and buyers of reconstituted tobacco, as well as by the tax and customs authorities interviewed, which were not aware of any case of illicit trade of reconstituted tobacco in the recent past.¹⁵¹ This finding can be explained by the following reasons:

- Differently from raw tobacco, reconstituted tobacco is not a necessary input for the production of illicit cigarettes or FCT.
- As discussed in Section 3.2.3.1 above, reconstituted tobacco is an industrial semi-manufactured product which is used by cigarette manufacturers for stabilizing, flavouring and lowering the nicotine and tar content of cigarettes. None of these purposes would be of interest for an illicit manufacturer.
- Finally, and most importantly, while the number of potential sources of illicit raw tobacco, i.e. including growers, is in the tens of thousands, only three plants and few cigarette factories manufacture reconstituted tobacco in the EU, making it much more difficult to obtain. All these plants are subject to traceability systems that allow the identification of losses or misalignment of stocks and flows, and that are accessible to customs authorities.

➤ **DEFINITION AND EXCISE AND CUSTOMS CLASSIFICATION**

Manufacturers and users of reconstituted tobacco reported no instances of misclassification, in particular with respect to the category 'smoking tobacco' (Art. 5.1.a), which could then trigger excisability. This was also confirmed by public authorities. In addition, no problem concerning the customs classification of reconstituted tobacco or the concordance between the latter and the excise classification was identified.

➤ **SUMMARY OF PROBLEM ANALYSIS**

Problem drivers	Adverse Effects	Expected evolution
Diversion of raw tobacco to illicit trade	<ul style="list-style-type: none"> • Fostering of illicit manufacturing of tobacco products • Loss of tax revenues on finished products 	<ul style="list-style-type: none"> • National regulation and enforcement actions likely to partially reduce the problem • Cross-border trade flows could remain outside of national monitoring
Raw Tobacco put up for Retail Sale	<ul style="list-style-type: none"> • Loss of tax revenues 	<ul style="list-style-type: none"> • In MS which had (or introduced) a national legal framework preventing / prohibiting raw tobacco for retail sale, no expected evolution • In other MS, possible appearance of the phenomenon

¹⁵¹ Information was retrieved only on a single case of diversion concerning a road shipment of reconstituted tobacco from Russia to France having disappeared in 2007.

Diversion of Tobacco Refuse to Illicit Trade	<ul style="list-style-type: none"> Negligible to minor impact on illicit manufacturing and loss of tax revenues 	<ul style="list-style-type: none"> No significant changes expected
The Definition of Tobacco Refuse (Art. 5.1.b)	<ul style="list-style-type: none"> Legal uncertainties may create costs for public authorities or economic operators 	<ul style="list-style-type: none"> Current framework may not be sufficient to avoid future disputes (also in relation with the smoking test)
Issues Concerning Reconstituted Tobacco	<ul style="list-style-type: none"> No relevant adverse effects 	<ul style="list-style-type: none"> No significant changes expected

3.3 'Borderline' Cigarillos

3.3.1 Overview of Products

3.3.1.1 Product Definition and Identification

➤ **EVOLVING DEFINITIONS**

The cigars and cigarillos category include a vast range of products of different shapes and sizes, manufactured with different varieties of tobacco and different production processes (e.g. hand-made or machine-made). Cigars and cigarillos can be with or without filter, and with or without a natural tobacco leaf wrapper, provided they respect certain physical characteristics. According to Directive 2007/74 cigarillos are essentially small cigars of a maximum weight of 3 grams each.¹⁵² However, for tax purposes there is no distinction between these two classes. According to Art. 4(1) of Directive 2011/64, the products that can be classified as cigars or cigarillos are: rolls of tobacco with an outer wrapper of natural tobacco or rolls of tobacco with a threshold blend filter and a reconstituted tobacco wrapper of a certain size (i.e. weighing at least 2.3 grams and having a circumference of no less than 34 mm). The current definition was introduced with Council Directive 2010/12/EU of 16 February 2010, and it was the second time the original definition laid down in Directive 95/59 was amended. Initially, the definition did not include a minimum weight for cigarillos wrapped in reconstituted tobacco. A subsequent revision included in this category also rolls of tobacco with a wrapper of reconstituted tobacco where the unit weight not including filter or mouth-piece was not less than 1.2 g.¹⁵³

The previous definitions of cigars and cigarillos *de facto* could encompass products that in many respects had characteristics similar to factory-made cigarettes (FMC), i.e. size (only slightly heavier), shape, neutral wrapper (although of different colour), filter further covered by a filter paper. The similarity was enhanced by other visual elements like the same flip-top box packaging containing the same number of sticks as FMC, whereas most of cigars and cigarillos are sold in a variety of different packaging (cardboard, metal, plastic, wood), containing different numbers of pieces. These products were cheaper to produce than ordinary cigars and cigarillos, since they could be made using FMC machines¹⁵⁴, and they could take advantage of lower excise duties than FMC, resulting in a very competitive retail selling price. For this reason they were dubbed 'eco-cigarillos' (in Germany) or 'price-fighter' cigarillos. The Ramboll Evaluation referred to these products as 'borderline' cigarillos to underline the fact that - although taxed as cigars - they were potential substitutes for FMC.

The amendments introduced in 2010, then confirmed under Directive 2011/64, imposed that cigarillos of shape and size similar to FMC had to have a natural tobacco wrapper and that only larger cigarillos (weighing more than 2.3 g.) could continue to use reconstituted tobacco for the wrapper. The new rules *de facto* implied a revision of production processes and in particular, the impossibility to use FMC machines for products that can be classified as cigarillos.¹⁵⁵ The required use of natural tobacco wrapper not only increased production costs but reportedly influenced taste, making these products less similar to FMC in terms of consumer experience. In this sense, the

¹⁵² "Council Directive 2007/74/EC of 20 December 2007 on the exemption from value added tax and excise duty of goods imported by persons travelling from third countries", Official Journal of the European Union L 346/6, 29.12.2007.

¹⁵³ Directive 95/59/EC as amended by Directive 2002/10/EC

¹⁵⁴ Reportedly, cigars and cigarillos can be produced at a speed between 16 and 160 pieces per minutes (excl. packaging), while FMC machines allow up to 20,000 cigarettes per minute (incl. packaging).

¹⁵⁵ According to a German cigarillos manufacturer the maximum speed allowed by current machines is 100 pieces / minute. In addition, the production implies various other steps requiring a certain amount of manual work. According to another manufacturers under the previous definition it was possible to produce cigarillos at a speed of 2,000 pieces per minute.

'borderline' cigarillos on the market today have different characteristics and price than the 1st generation products that were available prior to 2010. Actually, article 4(2) of Directive 2011/64 extended a derogation to Germany and Hungary permitting the commercialisation under the cigarillos tax category of products compliant with the previous definition. This derogation expired at the end of 2014 therefore all cigarillos currently marketed in the EU must comply with Article 4(1) definition. Evidently, when Ramboll Evaluation was conducted the derogations were still active and this influenced the study's results.

With respect to product definition, it is important to consider also the Combined Nomenclature (CN) classification for customs purposes since – as shown in **Table 9** below – it is not entirely coherent with the excise product definition. The main differences regard:

- (i) the reference to "normal consumer expectations" in the excise product definition, which in CN classification is replaced by a reference to the fact these product "can be smoked". In both cases, these formulations seemingly aim at excluding from this category products like the so called 'party cigars' i.e. cigar-like stick filled with fine-cut tobacco and wrapped in a roll of tobacco, which could not be smoked 'as is'¹⁵⁶;
- (ii) the addition in the CN definition of the absence of a "further layer partially covering the outer wrapper". This is an element characterising 'borderline' cigarillos and making them more similar in appearance to FMC. This distinction has an implication for classification certainty, as it will be discussed further below

Table 9 – Differences in the excise product and CN Definitions of cigars and cigarillos

Excise product definition	CN Classification
<p>Art. 4(1) of Directive 2011/64</p> <p>For the purposes of this Directive the following shall be deemed to be cigars or cigarillos if they can be and, given their properties and normal consumer expectations, are exclusively intended to be smoked as they are:</p> <p>(a) rolls of tobacco with an outer wrapper of natural tobacco;</p> <p>(b) rolls of tobacco with a threshed blend filler and with an outer wrapper of the normal colour of a cigar, of reconstituted tobacco, covering the product in full, including, where appropriate, the filter but not, in the case of tipped cigars, the tip, where the unit weight, not including filter or mouthpiece, is not less than 2,3 g and not more than 10 g, and the circumference over at least one third of the length is not less than 34 mm.</p>	<p>CN code 2402 10 00 - Cigars, cheroots and cigarillos, containing tobacco</p> <p>Cigars, cheroots and cigarillos are rolls of tobacco which can be smoked and, given their properties, are intended exclusively to be smoked as they are, having:</p> <p>(a) an outer wrapper of natural tobacco covering the product in full including, where appropriate, the filter (but without any further layer partially covering the outer wrapper), but not, in the case of tipped cigars, the tip; or</p> <p>(b) a threshed blend filler and an outer wrapper of the normal colour of a cigar, of reconstituted tobacco of subheading 2403 91 00, covering the product in full, including, where appropriate, the filter but not, in the case of tipped cigars, the tip, where the unit weight, not including filter or mouthpiece, is not less than 2,3 g and not more than 10 g, and the circumference over at least one third of the length is not less than 34 mm.</p>

Note: In bold italics the different wording used in the two definitions.

➤ **INDUSTRY AND PRODUCTS**

The cigars and cigarillos manufacturers in the EU comprises and estimated 50 companies, the majority being SMEs and a certain share of family-owned

¹⁵⁶ Ramboll Evaluation (2014), p.227.

businesses.¹⁵⁷ Small operators are generally not involved in the segment of 'borderline' cigarillos, which instead regarded some more established independent companies (also active in the FCT and pipe segments) and to some extent the Big Tobacco companies. Some 'trade brands' of cigarillos are also distributed through supermarket channels, mostly in Germany. A few examples of products is provided in **Table 10** below.

It is important to highlight that under the current legal definition there is no clear-cut criterion to distinguish between a 'borderline' cigarillos and other filter cigarillos. Retail price, packaging and appearance (e.g. a paper partially covering the outer wrapper), and mode of consumption may help identifying products somehow intended at substituting FMC, but it is worth underlining that no clear-cut distinction can be made, since products are distributed over a continuum of price-levels and packaging, and seem often used also to complement and not substitute FMC.

Table 10 – Examples of cigarillos from different types of company

Brand	Company
John Player Special filter cigarillos	Imperial Tobacco
L&M Filtered cigarillos	PMI
Route 66 Filter Cigarillos	Imperial Tobacco
Pall Mall XL Filter Cigarillos	BAT
Chesterfield Filter cigarillos	PMI
Marlboro Leaf / Leaf Beyond	PMI
Break filter cigarillos	Scandinavian Tobacco Group
Burton Original Filter Cigarillos	Joh. Wilh. von Eicken GmbH
Jockey Filter Cigarillos	Mac Baren Tobacco Company
Silverado Filter Cigarillos	Continental Dohanypari
Braniff Full Flavour filter cigarillos	Villiger Söhne

Note: the table includes a limited sample of filter cigarillos sold in a 20 pieces packages which according to the previous Evaluation study might fall in the category of 'borderline' cigarillos. The list is evidently not exhaustive and, as explained in the text, the criteria for the identification of 'borderline' products are far from being clear.

Source: Euromonitor International: *Passport Tobacco, 2016 Edition*, complemented by web and on-site research in tobacco shops.

3.3.1.2 Tax and Regulatory Framework

➤ EVOLUTION OF TAX STRUCTURES AND RATES

Germany was the main market where so-called 'eco-cigarillos' became popular. Between 1995 and 2007, the annual sales of the overall cigars and cigarillos category increased from 1.0 to 6.5 bn pieces. The steep increase can be largely attributed to the appearance of 'eco-cigarillos'. The strong growth between 2003 and 2007 was due to (i) a heavy tax increase on FMC between 2002 and 2005; and (ii) the drop in sales of so-called 'tobacco portions' following stricter taxation between 2005 and 2007. The 'eco-cigarillos' loophole was closed in subsequent steps:

- since the 1st of January 2008, the revised definition of Directive 2002/10 entered into force establishing a minimum weigh of 1.2 g;
- in May 2011, the Government adopted a minimum tax on cigars and cigarillos; the minimum rate was further increased since January 2012;
- since 1st of January 2015, with the end of the derogation (Art. 4(2) of Directive 2022/64), the definition changed again and only natural tobacco wrapper are now permitted.

The outcome of this regulatory process has been a steady decline in the market of cigarillos, which reportedly dropped from some 5.3 bn pieces in 2007, to 3.3 bn the

¹⁵⁷ Source: ECMA.

following year, to less than 2.0 bn in 2016.¹⁵⁸ Similar regulatory processes took place in other MS where 'borderline' products were marketed, but in different periods, which explains some disparities in national level trends across the EU. Further to Germany, also Hungary could derogate on the application of the new definition of cigarillos until the end of 2014. In this country, the overall cigars and cigarillos market has grown nearly four-fold between 2010 and 2014. In 2015 it collapsed back to 2010 levels due to the entry into force of the new definition. In all other markets, the new definition was already valid since 2011 (except for transposition time).

Directive 2011/64 established that cigars and cigarillos may be taxed either through an *ad valorem* excise duty or through a specific duty (by number of items or kg¹⁵⁹) or a mix of both. The minimum overall duty applied is set at 5% of the retail selling price inclusive of all taxes or € 12 per kg or 1,000 pieces. In addition, Article 14(1) allows MS to set a minimum excise duty (MED). Within this framework, MS approaches to these products have been different. In some cases, a full *ad valorem* excise duty may have incentivised 'borderline' products (e.g. ES, PT, AT, HU, EL, and SI). In other circumstances a MED fixed early on has seemingly prevented such developments (e.g. FR, BE, IT). A high specific excise might have had the same effects in other countries (e.g. SE, PL, and RO). Various countries have changed their tax structures and rates over the years either to tackle the diffusion of 'borderline' products or to prevent it. For instance:

- Germany introduced in 2012 a 'dynamic' total tax of 5,760 Cent per piece (minus the VAT of the taxed cigar/cigarillo).
- Spain introduced a MED of € 41.5 per 1,000 units in 2013.
- Austria increased the MED to € 100 per 1,000 pieces in 2013.
- Denmark more than doubled its fully specific rate between 2014 and 2016 (from € 26.5 to € 67.0 per 1,000 pieces).
- Portugal introduced a MED of € 60 per 1,000 pieces in 2015¹⁶⁰, and progressively raised the *ad valorem* duty from 12% to 25%.
- Hungary introduced a MED of € 12.89 in 2015, and simultaneously reduced the *ad valorem* rate from 29% to 14%.
- Italy introduced a MED in 2011, and increased it progressively until € 25 per conventional kg (equal to 400 pieces) in 2014.
- France switched to a mix structure in 2013, establishing a specific rate of € 17.5 per 1,000 pieces in addition to the pre-existing MED.
- Various MS, including EE, LV, LT, IE, UK, and PL increased their fully-specific rates over the period, in one or multiple steps, resulting in an increase of the tax rate ranging between 20% (IE) and 170% (LV).

These measures were largely effective in closing the regulatory loopholes that had incentivised the development of 'borderline' cigarillos but given the blurred boundaries of this class of product in some MS they inevitably affected also the tax burden of 'ordinary' cigars and cigarillos.

➤ THE TOBACCO PRODUCTS DIRECTIVE

Directive 2014/40 (TPD2) has strengthened the rules on how tobacco products are manufactured, produced and presented in the EU, including cigars and cigarillos. However, as compared to FMC, some of the TPD2 rules for cigars and cigarillos are less stringent, namely:

¹⁵⁸ Source: interviews with national stakeholders.

¹⁵⁹ In some countries, like Italy, a 'conventional' weight is used instead of the actual weight.

¹⁶⁰ For cigars weighing less than 3g.

- Member States have some discretion when it comes to labelling rules for products not currently used in significant quantities such as cigars and cigarillos. In particular, they may choose to exempt these products from stringent labelling rules e.g. combined picture and text health warnings, while they must ensure that these products carry a general warning and an additional text warning.
- TPD2 requires that flavourings in cigarettes and RYO tobacco must not be used in quantities that give the product a distinguishable ('characterising') flavour other than tobacco. Other tobacco products, such as cigars and cigarillos, are exempted from the ban on characterising flavours. This exemption will be removed if there is a substantial change in circumstances (in terms of sales volumes or prevalence levels among young people).¹⁶¹
- To reduce affordability, the TPD2 establishes that a unit packet of cigarettes must include at least 20 cigarettes and a unit packet of FCT contain no less than 30g. Instead, no minimum content has been established for cigars and cigarillos. In the case of 'borderline' cigarillos this entails that 10 pieces packet will continue to be available, while this is no longer possible for FMC.

Based on the above considerations, some stakeholders believe 'borderline' cigarillos are not destined to disappear following the change of definition, but they may increase their attractiveness vis-à-vis FMC, thanks to the TPD2 unintended effects.

3.3.2 Estimated Market and Consumption

3.3.2.1 Market and Consumers

Cigars and cigarillos represent an estimated 1.6% of the total tobacco market in EU. In 2015, sales amounted to some 9,300 - 9,500 units and in excess of € 5.0 bn¹⁶² and the overall tax receipts amounted to approximately €664 mn.¹⁶³ For the reasons reported above, disaggregating the share of 'borderline' cigarillos from ordinary products is inevitably arbitrary since there is no objective criterion. Moreover, these products have not been commercialised in all EU markets, therefore their diffusion has to be assessed on a case-by-case basis. In this Study this has been done combining different indicators collected from different sources, namely:

- (i) Overall trend of the overall cigar and cigarillos consumption. According to all stakeholders, the consumption of ordinary products is stable or has been slowly declining for many years in all MS. Therefore, a steep increase/decrease in sales may be due to an exogenous event, such as the commercialisation (or drop) of products whose demand is unrelated to ordinary cigars and cigarillos dynamics.
- (ii) Unfavourable tax regimes. As seen, various MS used to have relatively high fully-specific tax rates and/or MED de facto eliminating tax advantages for 'borderline' products.
- (iii) *Euromonitor's* estimates of 'price-fighter' segment of cigarillos. However, these data have to be taken with some caution.¹⁶⁴
- (iv) Economic operators' feedback, based on interviews with cigarillos manufacturers.

¹⁶¹ On this point see for instance the report of the American Campaign for Tobacco-Free Kids "Not Your Grandfather's Cigar", 2013. https://www.tobaccofreekids.org/what_we_do/industry_watch/cigar_report/

¹⁶² Sources: ECMA and *Euromonitor International: Passport Tobacco, 2016 Edition*.

¹⁶³ EDT (July 2016). Note: the figure does not include data from EL, BG, HR, MT, AT and PL, which were not available in disaggregated form. Data for NL and LV refer to 2014.

¹⁶⁴ When divided by overall sales value the unit price of this class sometimes resulted higher than the unit price of the class of ordinary filter cigarillos, which suggests that the boundaries between these two classes are not always consistent.

The results of the above analyses allowed to consider the share of 'borderline' products in the majority of EU countries (in particular SE, FI, UK, IE, FR, NL, RO, BG, MT, and PL) as very small. In few MS there has been a certain diffusion of these products, often earlier than the introduction of Directive 2011/64, but in many cases these have been tackled with the adoption of tax measures. A brief overview of the likely situation in selected MS is provided in **Table 11** below.

Table 11 – 'Borderline' cigarillos estimated market trends in MS

MS	Evidence of commercialisation of 'borderline' cigarillos	Trends and current situation
DE	<ul style="list-style-type: none"> Widespread diffusion of eco-cigarillos prior to 2007 (up to 6.5 bn pieces) Between 2.0 and 3.0 bn pieces per year (2010-2015) 	<ul style="list-style-type: none"> Regulatory changes led to a collapse between 2007 and 2009, and a constant decline afterwards Industry estimates new 'eco-cigarillos' sales at less than 2.0 bn pieces in 2015 (i.e. some 67% of the overall cigars / cigarillos)
DK	<ul style="list-style-type: none"> Between 2011 and 2014 the overall market of cigars and cigarillos doubled. The 'extra' amount exceeded 75 mn pieces. 	<ul style="list-style-type: none"> Following a tax increase the cigarillos market fell from nearly 140 mn pieces in 2014 to less than 60 mn pieces in 2016.
ES	<ul style="list-style-type: none"> Per capita consumption more than 5 times greater than EU median value. Diffusion started early, thanks to a full ad valorem excise duty. 	<ul style="list-style-type: none"> The market kept increasing until the introduction of a MED in 2014. Cigarillos (of any kind) in 2015 amounted to nearly 2.0 bn pieces
HU	<ul style="list-style-type: none"> Fast growth b/w 2010 and 2014 thanks to the Directive derogation: from 145 mn to 560 mn (all kind of cigarillos) 	<ul style="list-style-type: none"> End of derogation, plus the introduction of MED led this segment to collapse in 2015 (to the same level of 2010). The MED will further increase.
PT	<ul style="list-style-type: none"> A fully ad valorem structure combined with recent tax increases in FMC caused a rapid growth in 2013-2014 (i.e. some 240% in two years) 	<ul style="list-style-type: none"> The introduction of a MED on cigars and cigarillos produced a decline in 2015
LV, LT, EE	<ul style="list-style-type: none"> In 2010 LV had the highest per capita consumption of cigarillos in the EU (268 pieces / year). In both LV and LT the estimated share of price-fighter on the total exceed 80%, in EE it was close to 70% (much smaller in absolute terms) 	<ul style="list-style-type: none"> The fully specific tax rate has increased four times in LV between 2010 and 2015, more than halving sales level (from 133 mn to 57 mn pieces) Similar tax increases in EE and LT
SI, SK, CZ	<ul style="list-style-type: none"> In all these MS the market of cigarillos was very small in 2010 but increase fast until 2015. 	<ul style="list-style-type: none"> SK and CZ increased moderately their specific rates SI introduced a MED in 2013, which slowed down but did not stop growth.
IT, BE, AT, EL	<ul style="list-style-type: none"> In all these countries the market of cigarillos was relatively developed in 2010 and the tax regime was conducive to 'borderline' products (possible minority share). 	<ul style="list-style-type: none"> The market has declined constantly until 2015, also thanks to the increase of MED (IT, BE and AT)

Source: Stakeholder estimates, EDT (July 2016), Author's elaboration of Euromonitor data (*Euromonitor International: Passport Tobacco, 2016 Edition*).

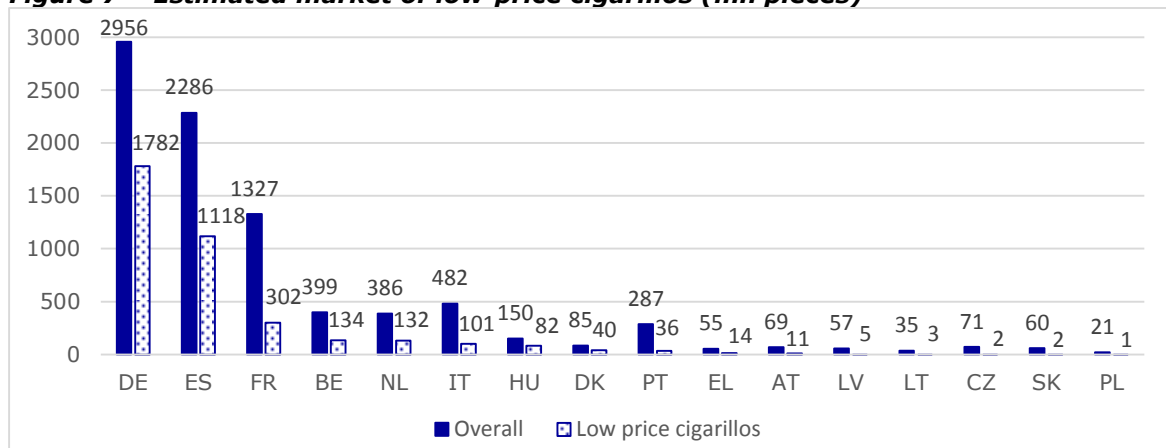
Deducting cigars and non-filter cigarillos from the total¹⁶⁵, the overall filter cigarillos market in the EU varied from some 6.6 bn pieces in 2010 to some 6.3 bn pieces in

¹⁶⁵ Based on *Euromonitor International: Passport Tobacco, 2016 Edition*.

2015. With approximately 7.3 bn pieces, the peak year was 2012, before the introduction of MED and other tax measures in many MS. The share of sales attributable to 'borderline' products is difficult to estimate, and depends on the criteria adopted. Under the current definition, the 'borderline' character seems to relate more to its affordability as compared to other products than to physical or visual features. In other words, the same product – be it a 'borderline' or an ordinary cigarillo – may or may not generate substitution effects in different markets, depending on the tax differential with FMC. In this sense, some tax authorities tend to consider the issue of 'borderline' cigarillos no longer as a matter of product definitions, but in purely market price terms, i.e. all products falling under a certain price level may be considered as possible substitutes of FMC, regardless of their size and packaging. This approach is certainly sensible as regards the policy objectives that competent authorities may pursue, but it makes it even harder to determine what share of the cigarillos market actually consists of 'borderline' products, since the same product may require to be treated differently across different countries.

Based on these considerations, the estimates provided below do not concern the specific brands of 'borderline' cigarillos as intended in the Ramboll Evaluation, but extend the scope to any filtered cigarillos that may represent an attractive low-cost alternative to FMC. The estimates provided in **Figure 7** are based on a combination of different sources and a few strong assumptions, therefore have to be taken with caution. The histograms compare the total sales of cigars and cigarillos¹⁶⁶ with the possible amounts of low price products. These have been estimated based on (i) actual figures, where available (e.g. DE); (ii) a comparison between the cigarette WAP and a theoretical cigarillos WAP (based on current taxation); (iii) industry stakeholders' estimates. The final outcome is that the sales of cigarillos with a retail price potentially inducing substitution in their geographical markets may amount in the EU to an overall 3.70 bn pieces (2015). This figure is somehow greater than the industry overall estimate of some 3.0 bn pieces (in 2016), since it may include also cheap cigarillos that do not necessarily have all the characteristics of 'borderline' cigarillos.

Figure 7 – Estimated market of low-price cigarillos (mn pieces)



Source: Stakeholders' estimates; Author's elaboration of *Euromonitor International: Passport Tobacco, 2016 Edition*.

The Eurobarometer 429 has introduced cigarillos among the product categories subject to a separate analysis. In previous editions, cigarillos were not addressed and were supposedly covered in the broader 'cigar' category. The survey outcomes indicate that 1% of EU smokers (i.e. about 1.1 million people) are regular (daily) consumers of cigarillos, while another 17% smoke them monthly or only occasionally.

¹⁶⁶ *Euromonitor International: Passport Tobacco, 2016 Edition*.

Based on the above estimates on the consumption of 'borderline' cigarillos and assuming they are perfect substitutes of cigarettes (i.e. that the level of daily consumption is equal to cigarettes), the number of regular consumers of these product can be estimated below 0.5 million people.

With respect to consumer profiles, the Eurobarometer 429 reports that cigarillos are almost exclusively smoked by men, mostly aged +55 y.o. Only 2% of 15-24 y.o reported to smoke cigarillos regularly (at least once a month). According to the report, cigarillos are never the first tobacco product used for smoking initiation, probably because of their strong taste. In this sense, cigarillos represent a minor threat for the tobacco control policies among youth, although the development of sweet flavoured products (as in the USA, and to some extent in Spain) requires a close monitoring in the near future.¹⁶⁷

3.3.3 Problem Analysis

3.3.3.1 Tax-induced Substitution

➤ SUBSTITUTION BETWEEN CIGARETTES AND CIGARILLOS

The minimum excise rate established in the Directive 2011/64 is equal to 5% of the retail selling price inclusive of all taxes or € 12 per 1,000 items or per kilogram. When compared to other tobacco products, and in particular cigarettes, this rate is significantly lower. This relates to various historical and economic reasons, including the higher production costs for these products, the high incidence of SMEs in this segment of the tobacco industry, the overall limited and largely occasional consumption pattern. The actual rates applied by MS are generally higher than the EU minimum, but still much lower than the rate applied to cigarettes. In some MS the advantageous tax treatment has encouraged the commercialisation of products that fulfil the cigarillos definition but are in many respect potential cheaper substitutes of cigarettes. From a commercial perspective these products therefore do not compete with traditional cigars but with cigarettes and may therefore have distortive effects of the market and adverse implications for both tax revenues and tobacco control policies.

The price-related substitution between cigarillos and cigarettes has been observed in various circumstances, but especially with the previous generation of cigarillos, for which the legislation allowed more similarities with cigarettes. In Germany, Spain and Latvia, a decline in cigarettes sales (connected to tax increases) were accompanied by a steep growth in the consumption of low-price cigarillos. The opposite trends were also observed: in Denmark, Portugal and Hungary the introduction of heavier taxes on cigarillos between 2014 and 2015 (and the end of the derogation period for HU), caused a rapid decrease in sales, whereas the historical decline in cigarettes consumption temporarily slowed down or reversed its trend. In general, 'borderline' cigarillos appeared where the tax regime was favourable, i.e. a pure or mostly ad valorem structure and the absence or a low MED.

While huge price differentials (related to disparities in tax regimes) may have encouraged some consumers to switch from cigarettes to low-price cigarillos, it is important to underline that these products taste differently, thus limiting substitutability. Furthermore, the volume of 'borderline' cigarillos consumption represent some 0.5% of the consumption of cigarettes, therefore the extent of the possible competitive threat is marginal.

¹⁶⁷ https://www.tobaccofreekids.org/what_we_do/industry_watch/ciqar_report/

At the same time, 'borderline' cigarillos are also different from ordinary cigarillos in terms of smoking experience and may therefore not appeal to typical cigarillos smokers. Their share of the overall cigars and cigarillos market is substantial (about one-third), but manufacturers of ordinary cigar and cigarillos do not consider 'borderline' products as real competitors. The main concern of manufacturers is that the presence of 'borderline' cigarillos, especially when branded by big tobacco companies, may prompt tax authorities to increase the tax rate over the entire category to close the loophole, as it indeed happened in a number of MS in the past few years. Since not all cheap cigarillos are 'borderline' cigarillos this inevitably caused an increase in the tax burden for most of economic operators, including smaller ones.

Tax authorities do not seem to consider 'borderline' cigarillos as a threat to fiscal revenues and tend to consider substitution as a marginal phenomenon that does not really affect tax budget stability and predictability. In many instances, this was the result of a revision of the tax structure and rate applied to these products, using the instruments already envisaged in the Directive. Given the opportunistic nature of 'borderline' products these measures seem generally very effective in mitigating, sometimes significantly, their diffusion. As of 2015, assuming a 100% substitutability between the products, the 'excise gap' due to low-price cigarillos can be estimated at some € 391 mn.

Table 12 – Estimated excise gap due to 'borderline' cigarillos

Est. number of low-price cigarillos	Est. excise revenue from 'borderline' cigarillos, and losses from cigarette substitution	Est. overall excise gap due to substitution
3.7 bn pieces 0.76% of cigarettes	€ 187 mn from 'borderline' cigarillos € -578 mn from cigarettes substitution	€ -391 mn

Source: Author's estimate based on EDT (July 2016), industry data on sales, model-based estimation of 'borderline' cigarillos share. The tax yield from 'borderline' cigarillos is conservative, since it is assumed that the excise burden is equal for all cigarillos, although in practice it is generally higher on 'borderline' cigarillos.

'Borderline' cigarillos are also not (or no longer) viewed as a threat to tobacco control policies, due to the currently limited incidence of substitution and the overall marginality of these products. As already underlined, there is however the need to keep these products monitored, for two main reasons: (i) the rules of the TPD2 are comparatively lighter for cigars and cigarillos, thus potentially encouraging a future development of this market segment with newly designed 'borderline' products; (ii) flavoured products potentially appealing young consumers may grow in popularity.

➤ **OTHER 'BORDERLINE' PRODUCTS**

Other product conceived to exploit regulatory loopholes, such as the so-called 'party cigars', were addressed and eradicated in the current Directive by (i) allowing Member States to tax cigars by weight, instead of (or in addition to) by piece (e.g. this option was chosen by PL, LT, CY, IE and UK); and (ii) stipulating that cigar and cigarillos must be intended to be smoked as they are. All stakeholders interviewed including both public authorities and economic operators concur this problem no longer exists.

3.3.3.2 Disparities between excise product definition and CN classification

As shown in **Table 9**, the definition of cigars and cigarillos laid down in the CN classification differs slightly from the excise product definition. The use of subjective criteria like "normal consumers expectations" in the excise product definition or "that can be smoked" in CN classification does not create any inconvenience, since all stakeholders interpret these provisions as referred to 'borderline' products that could

not be smoked 'as is' which were previously available in some countries but are no longer commercialised.

Instead, the reference in the CN definition to the absence of a "further layer partially covering the outer wrapper" may create some administrative uncertainties and related burden in the case of certain products that have an additional paper covering the tobacco wrapper over the filter. These products are consistently classified as cigarettes for customs purposes, whereas fit into the definition of cigarillos for tax purposes. These inconsistencies have created in the past some classification uncertainties to customs authorities and requests for clarifications. There have been also a few disputes but in all instances it was eventually confirmed that the tax regime applicable to these products is that of cigarillos.¹⁶⁸ To prevent further uncertainties, economic operators have also made frequently recourse to BTIs. In this respect, various stakeholders would be in favour of aligning the two definitions.

The EMCS system does not allow incongruences in the coding of products for CN and excise purposes, therefore these products are commonly coded as cigarillos also under CN, although according to customs classification they should be considered as cigarettes and actually do pay custom duties as cigarettes. Evidently, this system constraint may further fuel uncertainties, confusion and the risk of abuse. In this sense, even in the absence of an alignment of definition a technical intervention on the EMCS system seems necessary to ensure the flexibility required by this dual coding.

➤ **SUMMARY OF PROBLEM ANALYSIS**

Problem drivers	Adverse Effects	Expected evolution
Tax-induced substitution between cigarillos and cigarettes	<ul style="list-style-type: none"> Limited distortion of competition Limited tax revenue loss 	<ul style="list-style-type: none"> New low-cost products may possibly appear on the market also due to TPD2 'incentives' Relevance for competition and tax revenues is expected to remain limited, but monitoring is required Flavoured products appealing to youth may develop
Disparities between excise product definition and CN classification	<ul style="list-style-type: none"> Possible administrative uncertainties and disputes Poor functioning of EMCS 	<ul style="list-style-type: none"> The issue may persist with no significant change in magnitude expected.

¹⁶⁸ At present, as reported by a major manufacturer of low-price cigarillos, there is only one on-going dispute related to these products, in Lithuania.

3.4 Fine-Cut Tobacco, including Roll-Your-Own and Make-Your Own

3.4.1 Baseline Assessment

3.4.1.1 Products, consumers, and markets

➤ THE PRODUCT

Fine-Cut Tobacco (FCT) is a category of tobacco that can be used for making cigarettes.¹⁶⁹ In art. 5 of the Directive, FCT is defined as smoking tobacco¹⁷⁰ 'in which more than 25% by weight of the tobacco particles have a cut width of less than 1.5 mm'.¹⁷¹ From a commercial perspective, FCT includes two sub-categories:

1. Roll-Your-Own (RYO) tobacco, which is intended for the hand-rolling of cigarettes. RYO is rolled by consumers in a cigarette paper and, possibly, adding a filter.
2. Make-Your-Own (MYO) tobacco, which is intended for the machine-rolling of cigarettes. MYO is filled by means of a handheld device into an empty cigarette tube.

From a legislative perspective, neither EU and national acts nor sectoral standards differentiate between MYO and RYO. However, differences exist between the two products:

- In terms of physical characteristics, RYO usually has a thinner cut (around 0.3-0.4 mm) and a higher humidity, while MYO usually has a wider cut (around 0.5-1 mm) and a lower humidity. However, MYO products with a cut in line with that of RYO exist on the market.
- With respect to the blend, the two products may also contain expanded tobacco – defined below in Box 7 – to a varying degree: MYO can include a higher share of it, while RYO usually does not include it, or does to a more limited extent¹⁷². Based on the higher or lower share of expanded tobacco, MYO products can be distinguished between MYO-volume (also known as expanded MYO) and non-expanded MYO.
- As far as commercial differences are concerned, RYO is usually sold in pouches of small size¹⁷³ and the market is populated by brands different from those in the cigarette market; the market share of SME is higher compared to the FCT and the MYO segment.¹⁷⁴ MYO is usually sold in tins and boxes up to several hundred grams and usually includes a claim about the number of cigarettes that can be rolled; the market largely consists of cigarette brands.

Box 7 - Expanded tobacco

'Expanded tobacco' is cut tobacco that undergoes industrial processing to expand its volume. To become expanded, cut tobacco is impregnated with liquid gases (such as carbon dioxide, freon, or ammonia) under pressure and/or at low temperature; then, sublimation of gases is triggered. When sublimating, the gas expands, and the resulting internal pressure enlarges tobacco leaf cells, causing a growth in the volume of the tobacco lamina. Different methods of expansion exist, which lead to a different expansion rate, resulting in an increase of volume of twice to

¹⁶⁹ Cf. the definition included in art. 2.3 of the TPD: "'roll-your-own tobacco' means tobacco which can be used for making cigarettes by consumers or retail outlets".

¹⁷⁰ Hence 'tobacco which has been cut or otherwise split, twisted or pressed into blocks and is capable of being smoked without further industrial processing' (Art. 5.1.a)

¹⁷¹ MS are free to consider smoking tobacco in which more than 25% by weight of the tobacco particles have a cut width of 1.5 mm or more and which is sold for the rolling of cigarettes as FCT. Cf. Art. 5.2, second paragraph.

¹⁷² For reasons of quality, taste and ease-of-rolling.

¹⁷³ The minimum size set by the TPD amounts to 30 grams (cf. Art. 14.1).

¹⁷⁴ Cigarette brands have also entered into the market in the recent years.

more than twice.¹⁷⁵ As an ingredient, expanded tobacco is added to various products, in particular manufactured cigarettes (especially certain 'light' blends) and FCT, especially MYO.

An official method exists in the EU *acquis* to distinguish expanded tobacco from non-expanded tobacco, and to measure the share of expanded tobacco in a blend, based on the different densities of tobacco particles. The method, which is used to classify expanded tobacco under the appropriate CN Code, is described in Commission Regulation (EEC) No 3311/86 of 29 October 1986 on the tariff classification of goods falling within subheading 24.02 E ("Other, including agglomerated tobacco in the form of sheets or strip") of the Common Customs Tariff. Customs officials interviewed during fieldwork had not been recently asked to perform this test, but they considered that its application would not create any particular problem.

➤ CONSUMERS

Statistical differences exist between consumers of FMC and FCT. Rolled cigarettes are more widespread among men, and among people living in a rural area or a small town. With respect to occupational groups and income, FCT is more largely used by unemployed people and by people self-describing as 'in financial difficulties'.¹⁷⁶ Hence, on average, FCT consumers have a lower income and can be considered more price-sensitive.

At more granular level, based on market research and information collected from interviews with economic operators, consumers of FCT include two categories:

- those who have a preference for tobacco for rolling over FMC because of e.g. taste, appearance, social habits. These consumers are more likely to smoke RYO over MYO, and to buy RYO-specific brands rather than cigarette brands.
- those who buy FCT over FMC because of its higher affordability. The MYO market segments is mostly populated by these price-sensitive consumers.

The differentiation of consumers in the RYO and MYO segments is not clear-cut, due to a large share of dual users. For example, in France, about 40% of RYO smokers and 55% of MYO smokers also consume FMC and/or the other FCT product.¹⁷⁷ Also not all consumers use RYO and MYO as it they are intended (i.e. RYO for hand-rolling and MYO for machine-rolling); however, there is no estimate available on how large this different usage is.

➤ CONVERSION RATE

Preliminary to the problem definition and the market analysis, it is necessary to discuss what the appropriate conversion rate between FCT and FMC is. Statements such as 'MYO represents 30% of the tobacco market' or 'the tax rate on FCT is 50% that on FMC' presuppose an implicit or explicit conversion rate between FCT, the quantity of which is measured in kg, and FMC, the quantity of which is measured in pieces (or sticks). In this area, there is no accepted product standard, also because the weight of rolled cigarettes varies among consumers. However, official, industry and academic sources provide a plausible range of estimates for the conversion rate:

¹⁷⁵ Cf. Airco, "DIET, Dry Ice Expanded Tobacco", available at: http://www.aircodiet.com/images/AIRCO_DIET_Process_Description.pdf (last accessed on March 2017); Airco - "DIET brochure", available at http://aircodiet.com/images/AircoDiet - Brochure_15526.pdf; PBD, "Anatomy of a Cigarette", available at: http://www.pbs.org/wgbh/nova/cigarette/anat_text.html. Last accessed on March 2017.

¹⁷⁶ Eurobarometer 429. Cf. also London Economics, "Study on Fine-Cut Tobacco excise structure in the EU", European Tobacco Smoking Association, 2015.

¹⁷⁷ I.e. a share of RYO smokers also consume MYO and vice versa. Data provided by the industry, based on market surveys and *Institut national de la statistique et des études économiques*.

- EU sources. No conversion rate between FCT and FMC is mentioned in the Directive. However, a 1 g of FCT = 1 FMC (in short, '1') conversion rate was taken into account when establishing the appropriate approximation rate to cigarettes, in order to prevent or limit product substitution. In the Impact Assessment, this is made explicit: 1 kg of smoking tobacco corresponds to 1,000 industrial cigarettes.¹⁷⁸ There is another reference in a non-binding EU document, that is DG SANTE practical guide on the reporting of tobacco product ingredients, where it is stated that 'one unit of product' corresponds to one cigarette or 0.75 g of FCT (in short, '0.75' conversion rate).¹⁷⁹
- National sources. Most of the tax authorities interviewed adopted, implicitly or explicitly, the 1 conversion rate. However, this is not always the case: Ireland considers a conversion rate of 0.75 g per FMC, and Sweden of 0.75-0.81 g per FMC.
- Industry sources. Several industry players provided a conversion rate, sometimes as confidential data not for further disclosure.¹⁸⁰ Respondents were split among those who considered the 1 conversion rate as appropriate, and those deeming a lower conversion rates as close as more in line with the real market situation. The latter estimates fall into a range of 0.7 to 0.8 grams of tobacco per rolled cigarette. Finally, it is worth mentioning that MYO boxes sometimes provide a claim on the number of cigarettes that can be rolled, based on a conversion rate as low as 0.4 g per cigarette, but – being a purely marketing claim – such very low values are not considered further in the analysis.
- Academic sources. The PPACTE project¹⁸¹ provides the results of a survey of FCT smokers with respect to the average weight of a rolled cigarette. Out of a sample of 185 smokers, the median weight is 0.79g per cigarette (interquartile values of 0.56g and 1.22g), and the mean 0.94g.

Taking into account the available evidence, when measuring impacts of any change to the taxation of FCT, as done in Section 5.4 below, results will be provided for two conversion rates: 1, which is the one implicit in the current EU framework, and 0.75, which is a plausible value according to national tax authorities, industry and academic sources.

➤ THE FCT MARKET

At EU level, the market for FCT has seen a considerable growth in the period 2006-2012, which was then followed by stability. In 2006, the quantities of FCT released for consumption in the EU amounted to about 65 mn tonnes, which increased to 87.5 mn tonnes in 2012 (+35%, or +5.2% year-on-year). FCT growth then flattened in absolute terms, and market volume has been fluctuating at about 87-88 mn tonnes in the period 2013-2016.¹⁸² Data are shown in **Figure 8** below (left scale). FMC were, to

¹⁷⁸ "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", Impact Assessment, COM(2008)459, 16.7.2008, at p. 43 and ff. Hereinafter 'IA Dir 2011/64'.

¹⁷⁹ European Commission, DG Health and Consumer Protection, "Reporting on tobacco products ingredients, Practical Guide", undated.

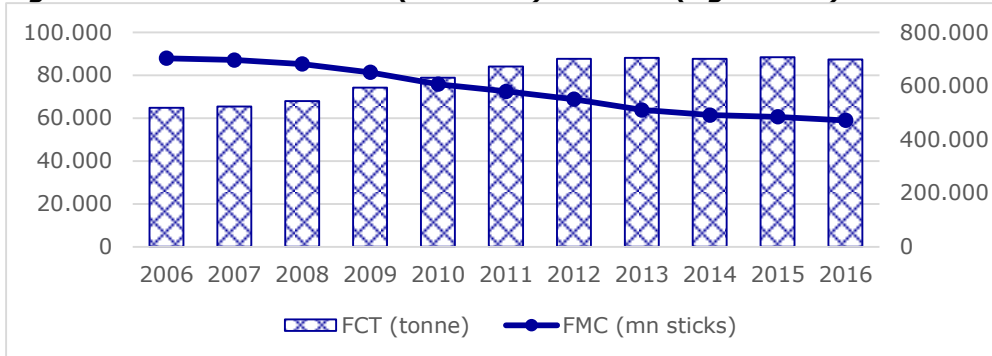
¹⁸⁰ Further than a commercial secret, the conversion rate has an impact on taxation: the lower the conversion rate, the higher the taxation of FMC, keeping a constant approximation rate with the taxation of FMC. This affects operators' incentives to disclose and discuss the subject matter.

¹⁸¹ PPACTE (Pricing policies and control of tobacco in Europe) is a research project funded by the European Commission under the 7th Framework Programme. Cf. Gallus S., *et al.*, "Roll-your-own cigarettes in Europe: use, weight and implications for fiscal policies", *European Journal of Cancer Prevention*, Vol. 23, pp. 186–192, 2014.

¹⁸² Source: *Euromonitor International: Passport Tobacco, 2016 Edition*.

the contrary, in steady decline, and the cigarettes released for consumption in the EU fell from about 700 bn sticks in 2006 to 470 bn in 2016 (-32%, or -3.9% year-on-year). As a consequence of these trends, the relative market share of FCT over total tobacco consumption kept increasing. In stick equivalents, it represented 11% of the market in 2006, 17% in 2012, and 20% in 2016.¹⁸³

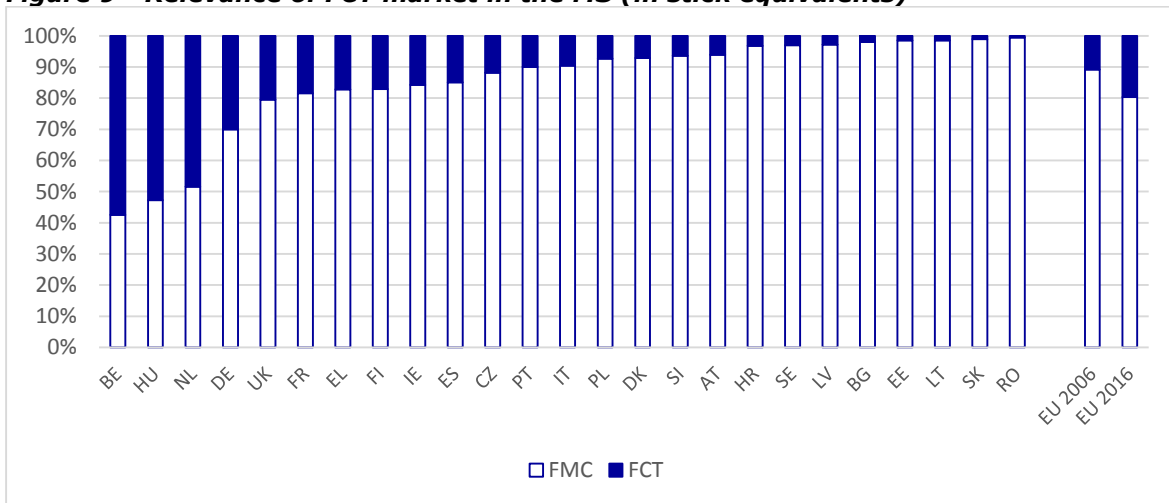
Figure 8 - EU market for FCT (left scale) and FMC (right scale)



Note: Data for the EU 25. **Source:** Euromonitor International: *Passport Tobacco, 2016 Edition*.

At the EU level, the FCT market is still modest as compared to FMC; but penetration rates differ significantly from MS to MS. **Figure 9** below presents the market share of FCT in 2016 for the EU MS.¹⁸⁴ FCT represents more than 20% of the market only in 5 MS, mostly concentrated in North-Western Europe: Belgium, Hungary, the Netherlands, Germany, and the UK. To the contrary, in most countries the market for FCT is less than 10% of the total market (13 MS), or even less than 5% (8 MS).

Figure 9 - Relevance of FCT market in the MS (in stick equivalents)



Note: Conversion rate for stick equivalence: 0.75 g. **Source:** Euromonitor International: *Passport Tobacco, 2016 Edition*.

Given the national character, a more detailed analysis of market trends for FCT and the impact of tax policies was carried out for the 7 MS covered in-depth. While each MS presents its own specifics, the following main points emerge:

1. Steep and sudden increases in FMC taxation triggers increases in FCT consumption; this was the case e.g. in France, Ireland, Italy, and Hungary;

¹⁸³ Figures refer to a conversion rate of 0.75 g per stick. With a conversion rate of 1 g per stick, FCT represented 8% of the market in 2006, 14% in 2012, and 16% in 2016. The market is measured as the sum of FMC and FCT sticks.

¹⁸⁴ Missing data for CY, MT, and LU.

2. Taxing FCT significantly less than FMC is a factor in supporting a large FCT market: the two largest markets in the sampled MS are those where the total tax burden on FCT is less than 50% compared to cigarettes;
3. Conversely, when FCT and FMC are taxed at about the same level, as in Sweden, the FCT market tends to disappear, since only consumers with a strong preference remain in it;
4. The economic crisis and the decline of the available income may trigger downtrading from FMC to FCT (as in Ireland and Italy, and, to a lower extent, in Germany), but this is not easy to prove in isolation, because the crisis was usually accompanied by tax increases;
5. Local factors are important, in particular consumer preferences and cultural habits (or lack thereof) play an important role in explaining market trends;
6. Growth of MYO-Volume is uneven. In Hungary, the FCT market largely consists of MYO-Volume, and to a more limited extent of MYO. In France and Germany, two countries with a large and 'old' consumption of fine-cut tobacco, the share of MYO-Volume reached about 20-30% of the FCT market; in Italy, the FCT market is relatively young, and the presence of MYO-Volume has remained marginal so far. It appears that MYO-Volume has a higher penetration in MS where affordability is a more pressing issue, as well as in more mature FCT markets, but it is difficult to draw a clear trend. Most probably, consumer preferences, consumption habits, and *Big Four* marketing decisions are the most important drivers.
7. There is non-conclusive evidence on whether the existing tax levers, i.e. the relative weight of the specific and *ad valorem* components and the use of MED, have a significant impact on the penetration of MYO-volume. Markets where MYO presence is significant, i.e. Hungary, Germany, and France, feature a different and sometimes changing tax structure. Hungary, as of 2015, introduced a purely specific taxation, replacing the previous system which encompassed a purely *ad valorem* tax coupled with MED. The change had apparently no effects on the size and growth of the MYO-volume segment, according to both market data and the judgment of economic operators and the tax authority. With respect to France and Germany, the former has a high *ad-valorem* component, while the latter opted for a mixed structure, to which a MED was added in 2016. Concerning countries in which the penetration of MYO-volume is negligible, both Sweden and Ireland have a purely specific taxation of FCT; on the other side, Italy has a purely *ad valorem* structure with MED.

➤ COUNTRY BY COUNTRY DESCRIPTIVE ANALYSIS

In the remaining part of this Section, data retrieved from public sources, interviews, or estimates based on databases are presented. Sources and methodological notes are as follows:

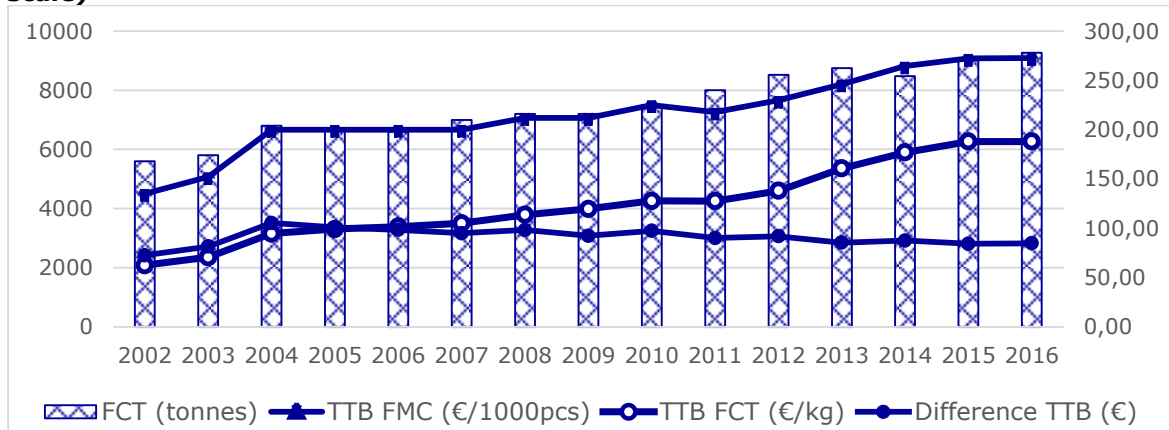
1. Data on FCT market. Whenever available, data published by the national tax authorities are presented. These data were triangulated with data from industry sources. Only for Poland, data from the tax authorities were not available at a sufficiently disaggregated level, and it was only possible to rely on an industry data series (which, for confidentiality reasons, is not disclosed).
2. Data on RYO, MYO and MYO-Volume segments are not available from public sources (with the exception of France and Germany) and are not included in the *Euromonitor* database. Hence, industry estimates were used; however, data series were provided on a confidential basis, and the description is limited to the main facts and to the qualitative considerations expressed during the interviews. The Consultants triangulated the various quantitative and qualitative information for validation purposes.
3. The Total Tax Burden on FCT is calculated at the Weighted Average Price (WAP) and is based on either: (i) WAP and tax components as reported in the Excise Duty Tables; or (ii) WAP calculated on *Euromonitor* data and tax components as

reported in the Excise Duty Tables. The former method is preferred whenever possible.

4. Total Tax Burden (TTB) on FMC is calculated at the WAP and is based the Excise Duty Tables.
5. 'Difference TTB' represents the difference between TTB on FMC and on FCT (at WAP).
6. TTB ratio is calculated as the ratio between TTB on 1000 FMC at WAP and TTB on 1kg of FCT at WAP; a conversion factor of 1 is assumed, in line with the approach on which the current Directive is based.
7. Data are presented in local currencies, to capture impacts on consumers. When necessary, annual average exchange rates were retrieved from the ECB warehouse.

➤ **France**

Figure 10 - France: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above.

As shown in **Figure 10** above, France provides a neat representation of the relation between consumption of FCT and taxation of FMC: when the latter grows, the former grows as well. This can be seen in the period 2002-2004, when an increase of 48% of the TTB on FMC triggered an increase in FCT consumption by 21%; and in the period 2011-13, when an increase in FMC taxation by 13% corresponded to an increase in FCT consumption by 9%. All this happened in a situation in which the tax differential slowly lowered, thus singling out the effect of price shocks in the cigarette market on consumers' decision to downtrade.

France is a moderate consumer of FCT, a habit especially rooted in the Northern and Eastern regions. In 2010, FCT represented already 16% of the market, a share which slightly increased to 18% in 2016.¹⁸⁵ Hence, the growth described above did not start from a small consumer basis, which makes it even more remarkable. The market for FCT has then stabilised from 2013 onwards, as a consequence of a steep increase in FCT taxation (+36% between 2012 and 2016, and a new price increase of 15% expected as of 2017, because of higher excises, other taxes, and trade margins).

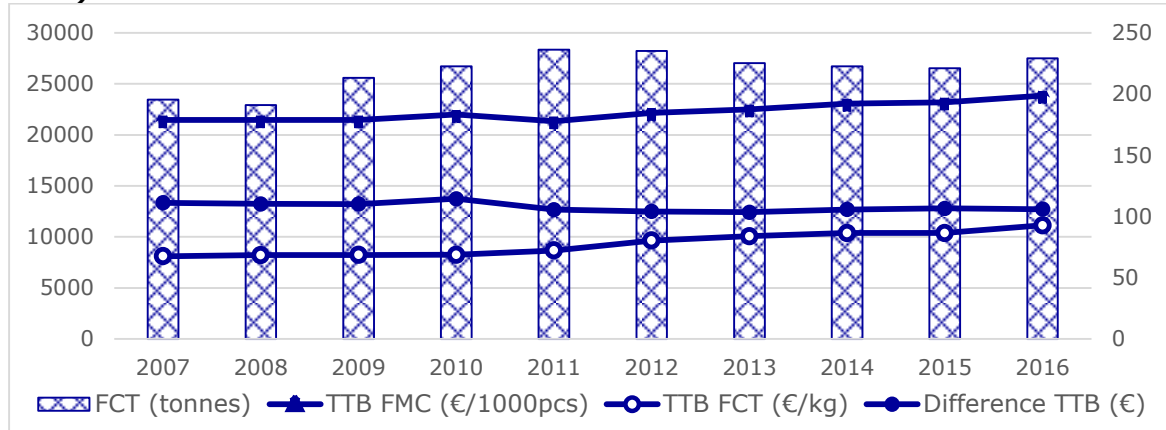
MYO appeared in the French market already in 2003, and grew up to 40-50% of the FCT market (in volume) in the recent years. Most of the growth in the FCT market in the 2010's was absorbed by MYO, while RYO remained stable. MYO-Volume was introduced in 2011 and now represents approximately two thirds of MYO products, that is about 20-30% of the FCT market, being the segment with the fastest growth.

¹⁸⁵ Values measured with a 0.75 conversion rate; 12% and 15% respectively with a conversion rate of 1.

The tax regime was changed in 2013 from a purely *ad valorem* to a mixed structure, but this had no effects on the FCT market overall, or on the trends of the various segments. None of the interventions in the tax structure was considered, by either the tax authorities or market operators, as targeting specifically MYO and MYO-Volume.

➤ **Germany**

Figure 11 - Germany: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above.

With its 25,000 tonnes and a 30% share,¹⁸⁶ the German FCT market is by far the largest in Europe: based on *Euromonitor's* data, it is more than three times larger than the next one, which is Belgium. The market is also mature, and hence stable, with limited yearly variations; the only year in which there was a double-digit increase was 2009 (+12%).

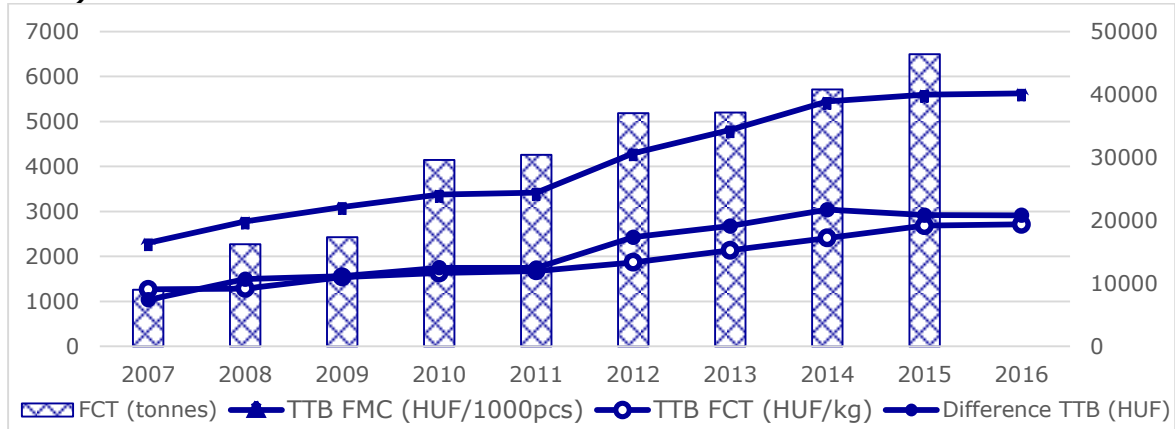
According to industry sources, the growth in the FCT market started in the early 2000's, following three step tax increases on FMC. Subsequently, the German government opted for milder increases: from 2007 to 2016, TTB on FMC increased by only 11%. The lack of price shocks for FMC is thus reflected in a lack of consumption shocks in the FCT market. To the contrary, TTB on FCT increased more rapidly (+37% over the same period), but without sudden increases. At the same time, in Germany FCT enjoys a low taxation compared to FMC, the TTB ratio being lower than 50% (and it was lower than 40% until 2010). The combination of low and increasing taxation on FCT probably contributed to keep the market of large, but stable.

The FCT market is divided in almost even segments between RYO, MYO and MYO-Volume. RYO products represent about 30-40% of the FCT Market, according to industry sources, the rest being MYO and MYO-Volume. According to tax authorities' data, volume products represent about a third of the FCT market, a share which is almost stable since 2012. MYO-Volume products are mostly produced and marketed by the *Big Four*, while the RYO and MYO segments are still largely populated by SME.

¹⁸⁶ Values measured with a 0.75 conversion rate; 23% with a conversion rate of 1.

➤ Hungary

Figure 12 - Hungary: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Note: missing data for the FCT market for 2016. **Source:** See Box 8 above.

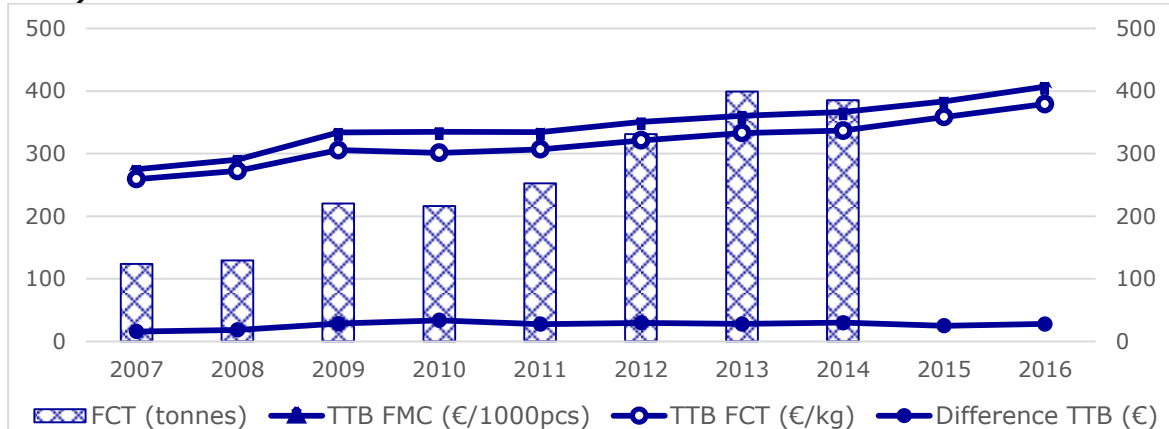
The Hungarian FCT market is very large in relative terms: according to both *Euromonitor* data and public information, FCT consumption is almost on par with cigarettes.¹⁸⁷ This is a recent trend, as in 2007 FMC represented 85% of the consumption, and still 81% in 2010; it results from a steep decline in cigarette consumption and a steep increase in FCT. The growth of the FCT is due to the increase in FMC taxation and the consequent decrease of the affordability of cigarettes. TTB on FMC increased by 47% between 2007 and 2010, and again by 65% between 2011 and 2016, due to the need to align rates with what required under the EU *acquis*. Furthermore, most of the increase was achieved by intervening on the specific component (the *ad valorem* component was even reduced in 2015), which affected low-cost cigarettes more than the rest of the market. At the same time, FCT taxation was also increased, but to a lower extent, so that only in 2015 the TTB differential started to shrink. Importantly, in Hungary FCT is taxed significantly less than FMC, the TTB ratio being lower than 50%. According to government sources, this was made on purpose to prevent consumers from downtrading to illicit products.

From 2014 to 2016, the FCT market has stabilised around 6,000 tonnes. Unlike most of other MS, nearly all the market consists of volume tobacco. MYO-Volume was introduced in 2010-11, and quickly gained importance, so much that it now represents about 85% of the FCT market. The taxation structure was changed, in 2015, from purely *ad valorem* with MED to purely specific but this did not alter the trend with respect to the growth of MYO-volume, and the tax authorities confirmed that this was not the aim of such intervention.

¹⁸⁷ FCT represents 53% of the FCT and FMC markets combined with a conversion rate of 0.75; and 46% with a conversion rate of 1.

➤ Ireland

Figure 13- Ireland: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above. **Note:** for the FCT market size: inconsistent data for 2015 and confidential data for 2016.

In Ireland, consumption of FCT grew in recent years. In relative terms, it passed from 8% of the market in 2010, to 16% in 2016.¹⁸⁸ In absolute terms, the market more than quadrupled between 2007 and 2012. Market growth has been uneven, with +71% in 2009 (albeit from a small base) followed by -2% in 2010, or by +21% in 2013, followed by -4% in 2014. As already highlighted for France, a causal link appears between increases of FMC taxation, which grew the most indeed in 2009 (+13%) and 2013 (+5%), and the downtrading to FCT. As it will be highlighted for Italy, this has also to do with the economic crisis, with FCT skyrocketing right in 2009, the year of the strongest GDP decline in Ireland.¹⁸⁹

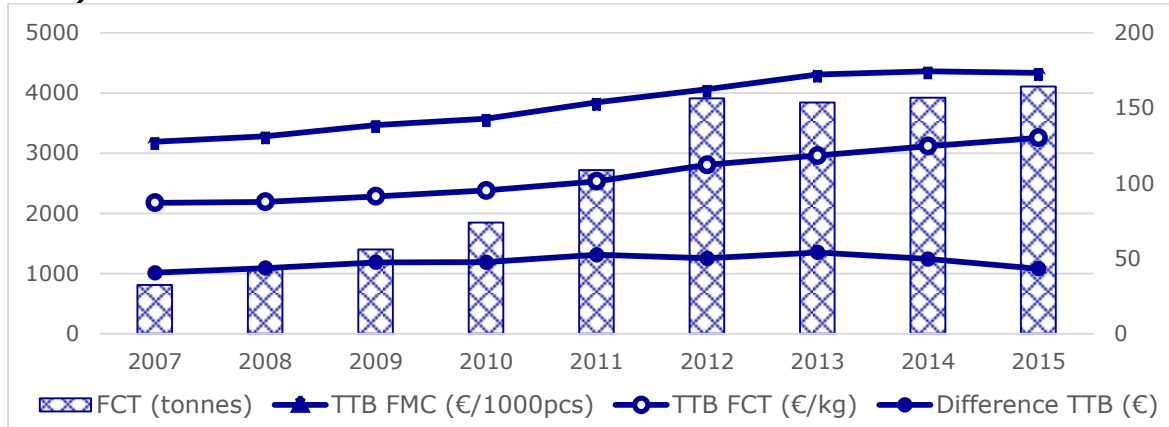
In Ireland, the tax differential between FCT and FMC is limited, with a TTB ratio of about 93% with a conversion rate of 1, and of 70% with a conversion rate of 0.75. Indeed, the Irish tax authorities explicitly pursue a close-to-two-thirds ratio based on a 0.75 conversion rate. The low price differentials could probably explain why the FCT market grew in reaction to price shocks, and then stagnated when the price of FMC did not move. Finally, and notably, while in several MS MYO products are responsible for most of the growth in the FCT market, in Ireland its importance is negligible, at less than 5% (it only appeared in 2014).

¹⁸⁸ Values measured with a 0.75 conversion rate; 6% and 12% respectively with a conversion rate of 1.

¹⁸⁹ For an analysis of the impact of income decline on consumption of FCT, cf. Cornelsen, L. and Normand C., "Is roll-your-own tobacco substitute for manufactured cigarettes: evidence from Ireland?", Journal of public health, Vol. 36, No. 1, pp. 65-71, 2013.

➤ Italy

Figure 14 - Italy: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above. **Note:** missing data for 2016.

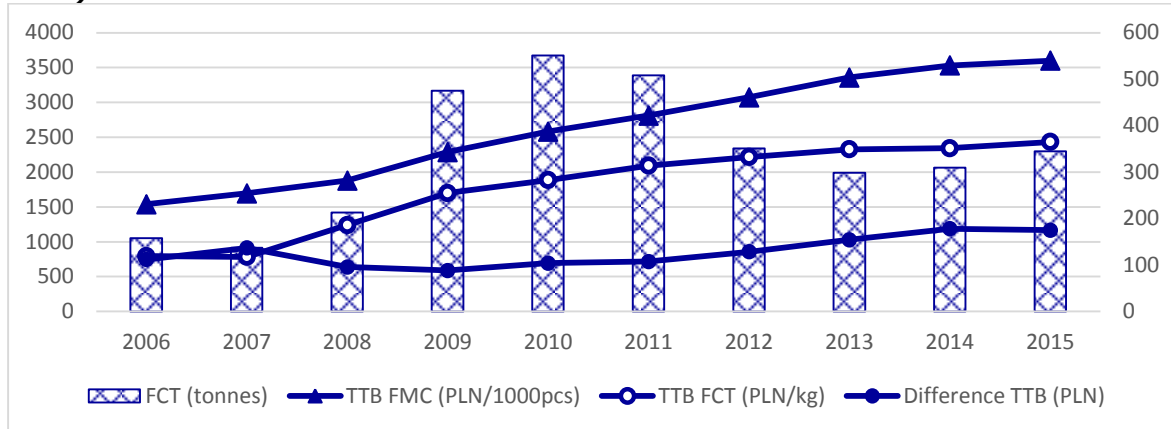
In Italy, the market for FCT remains a minor one, representing less than 10% of the market; while it has been a niche product for a long time, representing only 3% of the market in 2010, FCT gained popularity in recent years.¹⁹⁰ The market for FCT more than quadrupled, albeit from a small base, between 2007 and 2013, with yearly increases of 30% or more for several years in a row. Two main drivers can be identified for the growth: the increase in the taxation of cigarettes, and the effects of the economic crisis. On one side, TTb on FMC increased by 35% between 2007 and 2013; furthermore, the increase was pulled by higher specific rates which have affected the low-cost end of the market. On the other side, the economic crisis hit Italian consumers hard: GDP per capita (in PPP) was down by 7% between 2007 and 2009, and, in 2015, it was still lower than 2007. The market for FCT did stabilise once its taxation was on the rise; as a consequence, the differential TTb decreased, and the TTb ratio approached 75% in 2015. In particular, the MED and the TTb on FCT were increased by 20% between 2012 and 2015. The industry expects the FCT market to remain stable, due to (i) the limited popularity of FCT among consumers other than for price reasons; (ii) the increase in the size of pouches due to the TPD, which will increase the entry price; (iii) the reduced and declining tax differential with FMC.

The Italian market is almost evenly split between RYO and MYO: in 2016, the former represented 55% of the FCT market, in volume. MYO share increased from 23% and it is eroding RYO consumers. MYO-Volume appeared in 2014 and remained a small share of the FCT market, at about 8%, despite the tax structure being 100% ad valorem, which in principle could be an advantage for value-for-money tobacco products.

¹⁹⁰ Values measured with a 0.75 conversion rate; 7% and 2% respectively with a conversion rate of 1.

➤ **Poland**

Figure 15 - Poland: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above.

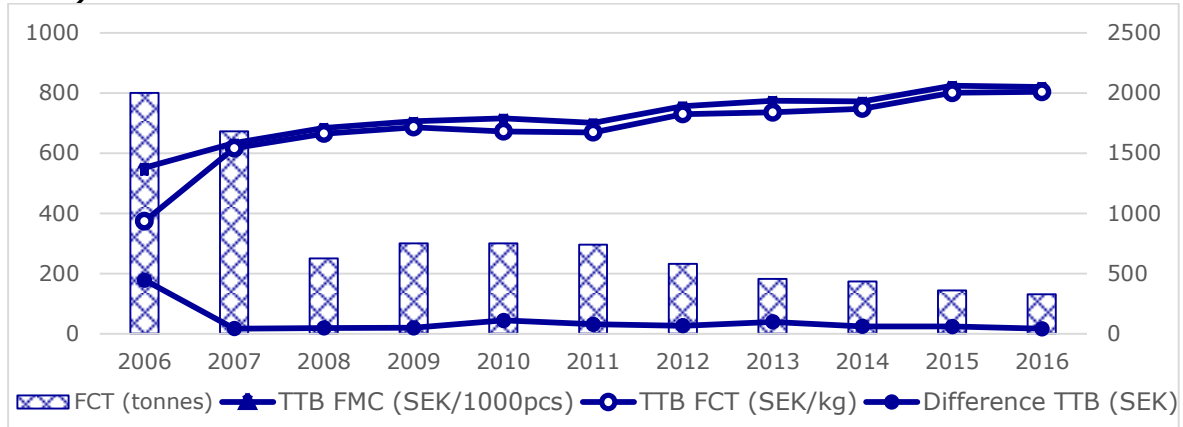
Poland, as most of Central-European MS except for Hungary, is not among the main consumers of FCT, which represents about 7% of the market. This value did not change much from 2010 onwards, where it was about 8%. Market data for FCT are not provided by public authorities and Euromonitor estimates are resorted to. In general terms, the FCT market is has an erratic trend, and the size of the market in the 2012-2015 period was around or above 2,000 tonnes.

The trends in FMC taxation between 2007 and 2010 are similar to Hungary: TTB on FMC increased by 49%, acting mostly, but not only, on the specific component. This resulted in a +37% increase in FCT consumption over four years. However, the market trends of Poland and Hungary diverged in the period 2011-2016, when TTB on FMC was increased by 39% in the former, and 65% in the latter. However, the market for FCT in Poland stagnated or declined, whereas a FMC tax shock would be expected to trigger a growth of FCT. The higher taxation may partly explain the difference: in Poland, FCT taxation was increased more than or in parallel with FMC, and the TTB ratio is at about two-thirds today, whereas in Hungary it is lower than 50%. Finally, the stagnation of the Polish FCT market also coincided with the appearance of the bulk tobacco phenomenon. This has been tackled by Polish authorities,¹⁹¹ and the crackdown on bulk tobacco could partly explain the double-digit market growth in 2015 and 2016.

¹⁹¹ Cf. Section 3.2.4.2 above.

➤ **Sweden**

Figure 16 - Sweden: FCT market size (left scale) and taxation of FCT and FMC (right scale)



Source: See Box 8 above.

FCT is a small part of the Swedish market, consumed especially in certain social circles, or 'subcultures', whose behaviour is usually not price driven. In 2016 FCT represented about 3% of the FCT and FMC markets combined, and less than 2% if snus is added to the picture. This was not always the case, as the FCT market declined by two-thirds between 2006 and 2008, following a steep tax increase on FCT in 2007, when the specific tax was raised from 560 SEK/kg to 1,120 SEK/kg, and the TTB passed from 50% to 73% of the retail price. Basically, since then, TTB on 1000 FMC and on 1 kg of FCT have been almost on par, and this has led to FCT becoming a niche product, targeted at non-price-sensitive consumers. According to interviewees, MYO products are not marketed at all, and the FCT market consists of RYO only.

3.4.2 Problem Analysis

3.4.2.1 Tax-Induced Substitution between FCT and Cigarettes

➤ **THE NATURE AND MAGNITUDE OF THE PROBLEM**

Based on academic literature,¹⁹² the fieldwork, and the analysis presented in the Section above, these facts appear clear:

1. FCT and FMC are substitute products, so that an increase in the price of FMC corresponds to an increase of FCT consumption;
2. absolute and relative taxation of FCT and FMC impacts on the amount of FCT consumed. Indeed, larger FCT markets are associated with higher tax differentials, while increases in FMC taxation (or reduction in the affordability of FMC) are associated with the growth of the FCT market.

While a substitution which is partly tax-induced is undisputed, the key question is whether this amounts to a regulatory failure, or whether such an unavoidable market distortion (unavoidable because any tax regime is itself distortive) corresponds to the intention of the legislators. Such regulatory failure would be a combination of (i) unintended consequences of the increase in the minimum excise level of FMC

¹⁹² The following sources estimate a negative cross-price elasticities between FMC and FCT: Laffer A.B., "Handbook of Tobacco Taxation: Theory and Practice", 2014; Nguyen L. *et al.*, "Demand for Tobacco in Europe: An Econometric Analysis of 11 Countries for the PPACTE Project, Report 6/2012 for the PPACTE Project", 2012; Gwarnicki C.T., *et al.*, "A Comprehensive Examination of Price Elasticities of Tobacco Products: Evidence from Commercial Store Scanner Data", Tobacconomics, 2014.

mandated by the Directive, especially in Central-Eastern MS; (ii) design of the Directive, as it allows for a lower tax rate on FCT; and (iii) implementation of the Directive, as MS are free to raise the taxation on FCT, up to the level of FMC or even further, if they consider the current rates as distortive.

A regulatory problem could be identified if the overall objective of the Directive was not met. According to Recital 18, taxation of FCT should be 'closer' to that of cigarettes, to better take into account the competition between the two products and their equally harmful character. For this reason, a progressive increase of the minimum excise level was staged in the Directive, aiming at a two-thirds ratio in 2020. In most MS, tax rates of FMC and FCT are getting closer to this ratio: as reported in **Table 13** below, the ratio between the TTB on FCT and FMC decreased in only 1 MS among those visited, that is Poland (where it nevertheless remains over the two-thirds threshold); conversely, the ratio is higher than 90% in Sweden and Ireland. It could be argued that certain MS are still too far from the two-thirds ratio envisaged by the Directive for the minima – so, in a way, are not meeting its spirit – but the current legal provisions do leave MS free to pursue their own taxation policy, provided that the minimum excise levels are met. Again, a regulatory problem would be there if the Directive had the objective to equalise taxation on all tobacco products – something which has been advocated by NGO, also in the OPC. However, this is not currently the case.

Table 13 - TTB ratio between FCT and FMC in selected MS

TTB Ratio	2010	2016
DE	38%	47%
FR	57%	69%
HU	48%	48%
IE	90%	93%
IT	67%	76%
PL	74%	68%
SE	94%	98%

Source: EDT (July 2016). **Note:** Conversion rate: 1.

The FCT market experienced significant changes since the adoption of the Directive, and even more since the legislative proposal was drafted in 2008. The growth of FCT (+29% between 2008 and 2012) has taken place for various reasons: (i) the increase in the taxation of cigarettes decided by MS; (ii) the catch-up by Central-Eastern countries with the Directive minimum excise levels for FMC; (iii) the economic crisis; and (iv) the introduction of MYO and MYO-Volume products, which created cheaper alternatives to cigarettes. Such a growth and product diversification may have resulted in undermining tobacco control policy goals. At the same time, it may have affected public budgets, because FCT products enjoy lower tax rates – though MS retain the power to act on the tax rates. In a nutshell, the new product and market conditions may have rendered the minimum excise level on FCT imposed by the current Directive as no longer appropriate.

In conclusion, the case for a tax-induced substitution between FMC and FCT seems strong, but that of a regulatory failure due to the current minimum levels of taxation prescribed results thinner, given the current objectives of the Directive. Taken into account all these aspects, an impact analysis is provided in Section 5.4 below to measure whether a reduction of the tax differential between FMC and FMC could better achieve the objectives of the Directive, including the tobacco control policy goals – proxied by tobacco consumption – and budgetary objectives – proxied by changes in

tax revenues.¹⁹³ The stakeholders affected by this problem would be: (i) public authorities, from both a tax and tobacco control perspective; (ii) economic operators, because of tax levels and the effects on the level-playing field; and (iii) consumers, because of the effects on prices.

➤ **THE EU DIMENSION**

The EU dimension of the problem is limited to the impact of minimum levels established at EU-level. Further and beyond minimum levels, national tax policies vary widely, from quasi-alignment to large differentials, and this depends on sovereign national decisions that are related to specific country's needs. As discussed above, the Directive aims at bringing the taxation of FCT closer to that of FMC (as per Recital 19) and this is indeed occurring in most of MS visited during the fieldwork (see **Table 13** above), Different national policies are reflected on different market conditions, both in terms of size and growth trends. Also, the diffusion of the various FCT products change from MS to MS independently from the EU norms.

➤ **DYNAMIC BASELINE SCENARIO**

The minimum excise level set in the Directive will increase to 48% of the WAP or €60 per kg in 2018, and to 50% of the WAP or €60 per kg in 2020. With respect to national excise levels:

- Some MS, such as Ireland and Sweden, are already aligning the taxation of FMC and FCT. For these countries, no changes in tax differential are expected in the near future.
- Other MS have increased taxation on FCT in the recent years (for example, France and Italy) and are likely to continue in the future, albeit with varying speed, so that the tax differential will continue to shrink. France has already acted in this direction, increasing taxation on FCT as of 1st of January 2017.
- In Germany, plans are for the tax ratio to reach 55% in 2022, hence below the two-thirds ratio. In Hungary, there is no plan for increasing taxation on FCT in the near future.

In conclusion, tax differentials between FMC and FCT have been declining EU-wide since the adoption of the current Directive, and this trend is likely to continue. It is unlikely that the two-thirds ratio will be reached in all MS and it remains uncertain whether the tax increase will be effective in preventing tax-induced substitution.

3.4.2.2 Tax advantage of MYO-Volume products

➤ **THE NATURE AND MAGNITUDE OF THE PROBLEM**

In some MS, volume tobacco has grown as to absorb the whole FCT market (e.g. Hungary); in some others, they reached 20-30% of the FCT market over few years (Germany and France), while in other instances they remained marginal (Italy, Ireland, and Sweden). A mix of affordability, consumer preferences and marketing strategies seem to be the main driver to explain the growth of MYO-Volume.

The emergence of a new product within an established category is not a regulatory failure, inasmuch it does not exploit loopholes in the tax system. Since the tax basis for FCT is weight, MYO-Volume allows consumers to roll lighter cigarettes and, thus, to enjoy a possible tax advantage. Based on industry estimates of conversion rates for FCT and MYO-Volume, the latter would be currently taxed 20% to 33% less on a stick

¹⁹³ IA Dir 2011/64 (2008), p. 15.

equivalent basis.¹⁹⁴ This advantage would inflate demand for MYO-Volume and lower the tax base, since consumers would reduce the quantity of tobacco bought, but not the sticks consumed. The 'lost revenue' due to the lower weight is not negligible in countries with a large MYO-Volume market, such as Germany (an estimated €126 mn), France (€52mn), and Hungary (€73 mn).¹⁹⁵

➤ **THE EU DIMENSION**

The European dimension is disputed, mainly because the penetration rate of MYO-Volume is far from being homogeneous, ranging from 0% to 100% of the FCT market. Also, growth trends are very diverse. Local factors (e.g. consumer habits) seem to play a major role. However, there is a European dimension, inasmuch the current Directive does not provide MS with policy levers for a more fine-tuned intervention on the various FCT segments. Indeed, the current tools appear unfit to tackle MYO-Volume, because (i) there is no separate tax sub-category within the FCT segment and (ii) because there is inconclusive evidence on whether MYO-Volume trends are affected by the tax structure adopted or the level of MED.¹⁹⁶

➤ **DYNAMIC BASELINE SCENARIO**

It is likely that current trends, namely MYO-Volume growing in absolute terms and as a share of the FCT market, will persist in the future, though at a declining pace since FCT markets have reached maturity and MYO-Volume products have already exploited part of their room for expansion.

➤ **SUMMARY OF PROBLEM ANALYSIS**

Problem drivers	Adverse Effects	Expected evolution
Tax-Induced Substitution between FCT and Cigarettes	<ul style="list-style-type: none"> • Failure to meet tobacco control policy goals (insufficient reduction of consumption). • Failure to protect MS budgetary objectives (possible contraction of tax revenues). 	<ul style="list-style-type: none"> • Reduction of tax differential. • Unlike to reach the two-thirds ratio evenly across MS.
Tax advantage of MYO-Volume-based product	<ul style="list-style-type: none"> • Reduction in the tax base. 	<ul style="list-style-type: none"> • Tax advantage likely to remain constant. • Growth of MYO-Volume expected to continue.

¹⁹⁴ Considering an FCT conversion rate of 0.75 and a MYO-Volume conversion rate of 0.5/0.6.

¹⁹⁵ Calculations take into account (i) a conversion rate of 0.6 for MYO-Volume and 0.75 for FCT, which would create a 20% tax advantage; (ii) an own-price elasticity of -1.4. Cross-market effects – i.e. the share of consumers which would switch back to RYO or MYO – is not accounted for.

¹⁹⁶ Cf. section 3.4.1.1 above.

3.5 Water-pipe Tobacco

3.5.1 Overview of Products and Markets

3.5.1.1 The Products and the Industry

➤ DEFINITIONS AND PRODUCT CHARACTERISTICS

Water-pipe tobacco (WPT) consists of tobacco – blended with other substances such as glycerol to form a moist and pliable mixture – that can be smoked in a water-pipe. Depending on the geographical location, water-pipes – defined by the WHO as “*a head or tobacco bowl (in which tobacco is placed), a body, a water bowl, a hose and a mouthpiece*”¹⁹⁷ – are commonly referred to also as ‘narghileh’, ‘shisha’, ‘hookah’, and other names. Water-pipes employ an indirect heat source (such as lit charcoal) to slowly burn tobacco while users draw smoke down through a water chamber and into their mouths through hoses. The most common type of tobacco used in the water-pipe is called Maassel, which is sweetened and flavoured (for example, apple, mint, vanilla, and other fruit or candy tastes).

The WCO’s Harmonised System and the corresponding EU Combined Nomenclature have a dedicated category for water-pipe tobacco (2403.11.00) and the relative Subheading Note defining it as “*tobacco intended for smoking in a water pipe and which consists of a mixture of tobacco and glycerol, whether or not containing aromatic oils and extracts, molasses or sugar, and whether or not flavoured with fruit*”.¹⁹⁸ In addition to this, the residual category 2403.99.90 (Other) includes *inter alia* “*products for smoking consisting wholly of tobacco substitutes and substances other than tobacco*”,¹⁹⁹ including for instance ‘water pipe tobacco’.²⁰⁰ WPT may therefore, somewhat counterintuitively, refer also to products that do not actually contain tobacco but have the same mode of consumption. These products are also referred to as herbal shisha.

➤ THE INDUSTRY

WPT manufacturing is almost entirely foreign. The main manufacturers are located in the Middle East, North Africa and – more recently – in the USA, where the products is growing in popularity especially among young people.²⁰¹ In the EU, limited manufacturing has been reported in Germany and Poland, but the overwhelming majority of WPT is of imported origin. Three main companies reportedly dominate the market, namely *Al Fakher* (based in UAE), *Al Waha* (Jordan), and *Nakhla* (Egypt). *Nakhla* has been acquired in 2013 by JTI, and is apparently the only brand currently owned by a big tobacco company.²⁰²

WPT is typically smoked in ‘shisha lounges’. There are an estimated 8,000 lounges in Germany, a similar number in France, and some 3,000 in the UK. Some 80% of the overall WPT is consumed in these places, while only 20% is bought for private consumption either from retailers or online outlets. The WPT distribution may follow

¹⁹⁷ WHO, “Advisory note: waterpipe tobacco smoking: health effects, research needs and recommended actions by regulators”, 2015. Hereinafter ‘WPT Advisory Note’.

¹⁹⁸ Commission Implementing Regulation 1101/2014.

¹⁹⁹ Explanatory notes 2015/C 076/01.

²⁰⁰ Tobacco-free WPT was previously not included in Chapter 24 (Tobacco and Manufactured Tobacco Substitutes) of the Combined Nomenclature. As reported in the Ramboll Evaluation, this could result in customs officials overlooking the fact that – in certain countries – tobacco-free WPT is excisable, and therefore not subjecting it to scrutiny and control. With the amendment to the explanatory notes C 241/11 of 19 August 2011, tobacco-free WPT was included in Chapter 24 and the issue was solved.

²⁰¹ <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3215592/>

²⁰² <http://www.jti.com/media/news-releases/jti-completes-acquisition-leading-water-pipe-tobacco-company/#>

different channels, involving in different steps importers, wholesalers, distributors, retailers and 'shisha lounges' (sometimes selling also on retail level). According to some rough estimates, the import price of 1kg of WPT before taxes is lower than € 10. At this point, national excise duty levels can make a big difference in determining the final retail selling price (RSP). For instance, in Germany, the MS with the lowest tax rates, the final RSP would be around € 75 per kg, while in Ireland, the MS with the highest rates, the final priced may reach € 316 per kg. When consumed in shisha lounges, at an average price of 12-20€ per 15g, the total income from 1kg of WPT may hit some 800 – 1300€.

In addition to 'ready-to-smoke' WPT, some operators have started commercialising WPT products where the tobacco component is separated from the molasses. This practice allows to pay the excise duty only on the tobacco fraction and is reported in MS with high tax levels (such as SE and UK). It was also introduced in Germany as a way to circumvent a national regulation that used to set a 5% maximum threshold for moisturising agents in tobacco products. This rule is reportedly no longer applied since mid-2016.

3.5.1.2 Market and Consumers

➤ PATTERNS OF CONSUMPTION

While WPT is quite popular – sometimes even more than cigarettes²⁰³ – in other parts of the world (e.g. Middle East and North Africa), it is still a niche product in the EU. According to the latest Eurobarometer, in 2014 only 1% of European citizens were regular consumers of WPT, 4% were occasional users, and 11% had tried it once or twice.²⁰⁴ Compared with the previous Eurobarometer, consumption seems stable²⁰⁵, although according to a recent WHO report in the framework of the FCTC COP the prevalence of daily water-pipe use in Europe is increasing in line with global trends.²⁰⁶

Eurobarometer data suggests consumption levels vary across the EU. For instance, regular or occasional consumption seems more widespread in countries like CY, FR, LV, DK, SE and CZ. However, given the limited prevalence, the margins of error in Eurobarometer data can be significant. Indeed, other industry sources suggest Germany and Spain are, along with France, the main markets, and consumption is also non negligible *inter alia* in Austria, the UK, Belgium, and Poland.

Factors such as the introduction of flavoured WPT and the strong social dimension of WPT smoking may explain why – according to Eurobarometer – regular, occasional and one-off uses are higher among young people (aged 15-24).²⁰⁷ Additionally, 5% of smokers and ex-smokers stated that WPT was the first tobacco product they used, behind cigarettes (83%) and hand-rolled cigarettes (6%).

These figures are confirmed by a number of national surveys carried out in the past few years, in particular:

- Germany: A study conducted by the Ministry of Health in 2016 shows that over a quarter of youths aged 12-17 and 68% of young adults aged 18-25 have tried water-pipes at least once. In comparison, e-cigarettes – reportedly another popular product among young generations – have been tried at least

²⁰³ WHO, WPT Advisory Note (2015).

²⁰⁴ Eurobarometer 429 (2015).

²⁰⁵ Eurobarometer 385 (2012).

²⁰⁶ WHO Report to FCTC COP (2016).

²⁰⁷ WHO, WPT Advisory Note (2015).

once by only 11% of youths (12-17 y.o.) and 19% of young adults (18-25 y.o.).²⁰⁸

- United Kingdom: A quite sizeable body of studies and surveys²⁰⁹ points to the fact that water-pipe use is more popular among young people, albeit with lower numbers in comparison with Germany: approximately 10% of pupils aged 11-15 have ever tried smoking WPT. However, regular consumption is negligible for girls and just above 1% for 15 y.o. boys.
- France: In line with the trends highlighted in other countries, WPT seems to be particularly appealing to French adolescents. A recent study commissioned by the Ministry of Health shows that 17% of middle school students (11-14 years-old) have tried water-pipes at least once, with the figure increasing with age.²¹⁰ This trend was confirmed by a 2001 survey showing that over 50% of 16 years-old have tried WPT at least once.²¹¹
- USA: For comparison purposes, the U.S. Food and Drug Administration reports that in 2015 7.2% of high school students (and 2% of middle school students) declared having smoked WPT in the previous 30 days. The figure, albeit lower in comparison with the previous year, confirms a wider trend of increasing WPT consumption among the youth since 2011.

➤ **OVERALL MARKET ESTIMATES**

Unlike survey data on consumption, there is a notable paucity of market data on WPT (i.e. type and size of players, sales values and quantities, etc.). This is likely due to the very limited size of the EU WPT market and its marginal importance in terms of revenues generated. Moreover, since WPT falls within the 'other smoking tobacco' excise category, figures on tax receipts are usually not available in disaggregated form.²¹² Even commercial databases, such as *Euromonitor*, do not distinguish between pipe and water-pipe tobacco.

According to the EU Market Access Database,²¹³ in 2015 the EU imported 1,441 tonnes of WPT and exported just 81 tonnes (**Figure 17B**). The net import can be assumed as largely corresponding to the estimated legal consumption of WPT due to the fact that manufacturing within the EU is modest. For instance in Germany – one of the few manufacturing MS – the difference between the imported quantity and the quantity subject to excise duties averages 200 tonnes per year. Import statistics also confirm the market has grown rapidly in recent years, i.e. by 75% between 2012 and 2015.

According to stakeholders and industry sources, the overall consumption of WPT in the EU would be much higher and approximately 5,000 tonnes in 2016. Germany is the country with the highest consumption, namely an estimated 2,400 tonnes/year, followed by France and Spain, with possibly 1,000 and 500 tonnes/year respectively.

²⁰⁸ Drogen- und Suchtbericht (2016).

²⁰⁹ Grant A., Morrison R., Dockrell M., "The prevalence of shisha (narghille, hookah, waterpipe) use among adults in Great Britain, and factors associated with shisha use: data from cross sectional online surveys in 2012 and 2013", *Nicotine & Tobacco Research Advance Access*, 2014; Ipsos MORI, "Health and Wellbeing of 15 year olds in England: Smoking Prevalence – Findings from the What About YOUth? Survey 2014", HSCIC, 2015; HSCIC, "Smoking, drinking and drug use among young people in England in 2014", 2015.

²¹⁰ Ehlinger V., Spilka S., Richard J.B., Godeau E., "La santé des collégiens en France. Données françaises de l'enquête internationale Health Behaviour in School-aged Children (HBSC)", INPES, 2016 (2014 data).

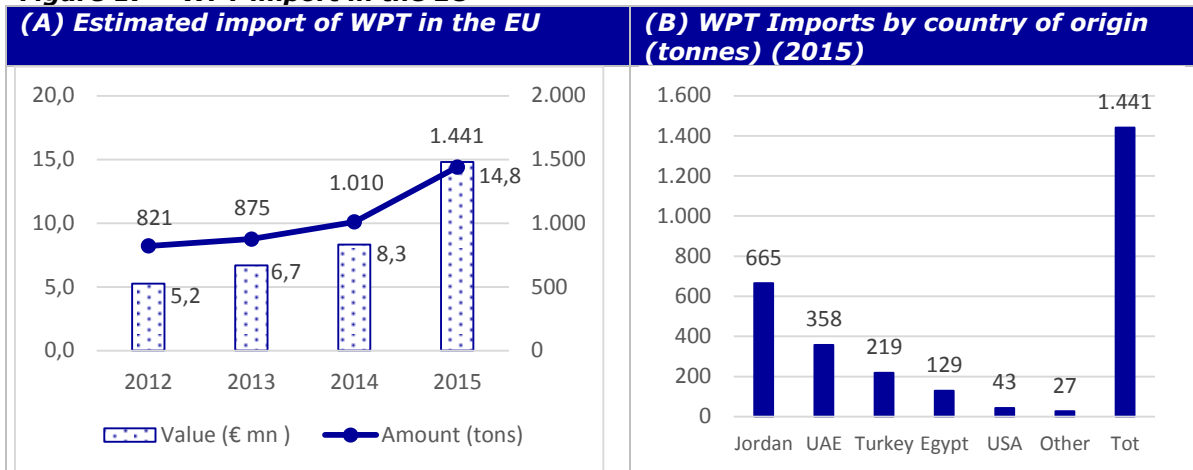
²¹¹ Spilka S., Le Nézet O., "Alcool, tabac et cannabis durant les 'années lycée'", OFDT, 2013 (2011 data).

²¹² For instance, in the excise duty tables published by the Commission, Ireland is the only MS providing separate figures for the 'other smoking tobacco' excise category, meaning that WPT data is always aggregated with pipe tobacco and most of the times with other categories too (FCT, cigars & cigarillos or even cigarettes).

²¹³ DG TRADE, Market Access Database, based on Eurostat Comext.

Consumption in all other MS is considerably lower, if not negligible. For instance, markets in UK, SE and possibly AT are believed to amount to 100-200 tonnes/year each,²¹⁴ while in the case of Italy consumptions seem well below 100 tonnes per year. The huge discrepancy between the two sources can be essentially attributed to the widespread illicit trade that characterises WPT market, as further discussed in the following paragraphs.

Figure 17 – WPT import in the EU



Source: Market Access Database.

➤ **ILLICIT TRADE**

Based on the above discrepancy and on interviews with stakeholders, a significant share (i.e. up to 75%) of the WPT consumption is estimated to be non-duty paid. The extent and characteristics of the illicit WPT market vary across MS:

- **Germany.** The official estimates of the illicit share of WPT market have fluctuated from 63% in 2013, down to 21% in 2014, and slightly up to 26% in 2015. Industry stakeholders estimate the black market amounting to about 1,400 tonnes per year. In the past, this related to a national ban on tobacco with more than 5% of moisturising agents²¹⁵, pushing WPT consumers to: (i) either buy tobacco and moisturising agents separately and then mix them together (a process considered quite burdensome and time-consuming since tobacco needs to be soaked for many days), (ii) or purchase WPT with the desired level of moisture illegally. This provision was however replaced with the implementation of the TPD2²¹⁶, which prohibits the placing on the market of tobacco products containing a number of additives (e.g. vitamins, caffeine, colourants, additives with CMR properties²¹⁷ in unburnt form, etc.) but does not mention moisturising agents. The incentive for illicit trade in Germany is therefore expected to decline in the coming years.
- **Sweden.** The WPT consumed in Sweden is imported from Jordan and the UAE, or comes from Germany and Poland. Due to the high tax rate applied the majority of consumers (estimated in excess of 90%) have reportedly resorted to the illicit/informal trade, including purchasing WPT online from MS with lower

²¹⁴ Incidentally, according to other sources the UK WPT market has been reported to be the second biggest in the EU. Due to the illicit nature of the market, it is difficult to provide a conclusive estimate.

²¹⁵ German Tobacco Ordinance of 20 December 1977 (Verordnung über Tabakerzeugnisse (Tabakverordnung) Vom 20 Dezember 1977), Art. 2.a. The Ordinance sets a maximum limit of 5% of the dry mass of the product (extendable to 8% under specific circumstances) for a number of moisturising agents, namely: glycerol, hydrogenated glucose syrup, butylene glycol, diethylene glycol, propylene glycol, triethylene glycol, orthophosphoric acid, glycerolphosphoric acid and its sodium, potassium, and magnesium compounds.

²¹⁶ By the German Tobacco Ordinance of 27 April 2016.

²¹⁷ Carcinogenic, mutagenic or reprotoxic properties.

excise duties. A minor share of consumers instead buy dry tobacco separately from moisturising agents.

- **France.** According to economic operators the share of black market in France is small – due to tighter mechanisms controlling the distribution chain, and in particular the need for shisha bar owners to purchase the products only from authorised tobacconists.
- **United Kingdom.** According to various operators, between 100 and 200 tonnes are consumed every year in the UK, of which 80-90% is supplied by the black market, in order to avoid the heavy excise duty applied to it.
- **Ireland.** Both the authorities and the industry estimate the Irish WPT market to be negligible. It is nonetheless possible for Ireland to be an entry-point for illegal WPT destined to other EU MS, as suggested e.g. by an exceptional seizure, carried out in 2014.²¹⁸
- **Italy.** The latest figures available on legal distribution of WPT in Italy reported approximately 10 tonnes. As of today, no WPT is distributed through the major distribution channel (i.e. *Logista*), and the WPT market, albeit small, is reported to be completely illicit. In terms of size, some stakeholders suggest it could amount to maximum 100 tons per year.

Overall, it is estimated that three-quarters of the non-duty paid WPT in the EU is supplied by organised smuggling, while the remaining is likely 'bootlegged' in suitcases by private individuals travelling to the EU. Smuggled WPT usually enters the EU via the ports of Rotterdam (NL), Antwerp (BE) and Hamburg (DE).²¹⁹ According to seizure data, other frequent countries of entry include Spain (due to the relatively easy access point of the Strait of Gibraltar), Slovenia (especially before the accession of Croatia to the EU in 2013), and the UK. The typical *modus operandi* adopted by smugglers has been reported to be the creation of letter-box entities through which illicit WPT is shipped to the EU. If the shipment is successful, the company is usually dissolved immediately afterwards and a new one is created for the following shipment. If the cargo is seized by the authorities, the letter-box entity ensures smugglers untraceability. Illicit WPT is usually packaged in anonymous boxes or packages and can also be classified as other similar products, such as for instance incense.

3.5.1.3 Regulatory Framework

➤ TAXATION REGULATION

For excise purposes, water-pipe tobacco falls within the residual category of 'other smoking tobacco' of Article 2.1(c) (ii) of the Directive. The minimum rate is set – according to Article 14.2(c) – at 20% of the retail selling price inclusive of all taxes, or at €22 per kilogram.

MS have adopted different taxation structures: purely specific (BG, CY, CZ, DK, EE, EL, HR, HU, IE, LT, LV, MT, RO, SE, SI, SK, UK), purely ad valorem (AT, ES, IT), and mixed (BE, DE, FI, FR, LU, NL, PL, PT). With the exceptions of DE and ES, all Member States greatly exceed the tax floor set in the Directive. 7 MS have also introduced a minimum excise duty, including however DE and ES who set it at €/kg 22, i.e. the minimum rate already envisaged in the Directive. The other MS with an MED (BE, FR, LU, NL, PT) apply rates ranging from 2 to almost 8 times the €/kg 22 floor. **Table 14** below provides an overview of the WPT taxation approaches in a sample of MS.

Table 14 – Tax structures and rates applied o WPT in a selection of MS

Member State	WPT taxation
DE	Germany applies a mixed taxation structure for WPT, consisting of a €/kg 15.66 specific tax a 13.3% ad valorem tax. In addition, an MED set at €/kg

²¹⁸ <http://www.revenue.ie/en/press/archive/2014/pr-240614-cigarettes.html>

²¹⁹ Based on data from OLAF's *CigInfo* database.

Member State	WPT taxation
	22 applies.
ES	Spain has a purely ad valorem tax (28.40%), complemented by an MED set at the minimum floor of €22 per kilogram.
FR	Similarly to Germany, France has also introduced a mixed structure complemented by an MED, although with higher rates. The specific tax is set at €17 per kilogram and the ad valorem component is 45% of the retail selling price. MED is at €/kg 77, namely 3.5 times the tax floor established in the Directive.
HU	Hungary has a purely specific tax, with a rate of 14,000 florins per kilogram, which is approximately equivalent to €45 per kilogram.
IE	Ireland, with €/kg 219 rate, has the highest specific tax among all MS. It is almost 10 times the minimum rate established by the Directive.
IT	As done for other tobacco products categories (i.e. cigars & cigarillos and FCT) Italy has adopted a purely ad valorem tax, set at 56% of the retail selling price.
PL	Poland applies the same mixed structure as for FCT, namely a €/kg 33.28 specific excise and a 31.41% ad valorem excise. Tobacco-free WPT is also taxed.
SE	Sweden applies the same purely specific structure as for FCT, with a SEK 1,852 per kilogram (approximately equivalent to €/kg 200). Tobacco-free WPT is also taxed.
UK	The UK has adopted a purely specific taxation of £107.71 per kilogram, equivalent to approximately €150 per kilogram (in 2015), namely almost 7 times the Directive's minimum.

Source: EDT (July 2016).

➤ PRODUCT REGULATION

Article 2.13 of the TPD2 defines WPT as “a tobacco product that can be consumed via a waterpipe”. It also includes additional lines aimed at preventing circumventions of the law, stating that “if a product can be used both via water-pipes and as roll-your-own tobacco, it shall be deemed to be roll-your-own tobacco”. It is also stated that the periodical reports to be submitted by the Commission on the implementation and status of the TPD2 shall include a specific section on the “market development and consumer preferences as regards WPT, with a particular focus on its flavours”.²²⁰ While it is envisaged that certain niche tobacco products may be granted an exemption from certain labelling requirements (e.g. cigars & cigarillos), the TPD2 requires that the full regime be applied to WPT in order to fight misconceptions of it being less harmful than other tobacco products.

The latest session of the FCTC COP highlighted that the global WPT market is on the rise. In addition to cultural and commercial factors – such as the social acceptability of the shisha lounge culture or the introduction of flavoured tobacco blends – the lack of WPT-specific policies and regulations is considered one of the main drivers behind the WPT recent growth. For this reason, the COP recommended to enact and implement policies and regulations specifically targeting water-pipes and WPT.²²¹

3.5.2 Problem Analysis

3.5.2.1 Limited knowledge of the WPT market

The baseline review carried out in the previous Sections highlights that the knowledge of the WPT market in the EU is still very limited. This is mainly due to its significant illicit share – which is particularly difficult to investigate and monitor – and to the

²²⁰ TPD2, Art. 28.2(h).

²²¹ WHO Report to FCTC COP (2016).

inclusion of WPT in the residual fiscal category of 'other smoking tobacco'. In most MS, the lack of information regarding the WPT market is unlikely to be addressed in the near future, due to the very small size of the market and its low importance for public authorities in comparison to other tobacco products, and despite the fact there is growing evidence WPT is becoming popular, especially among young people.

With the creation of a specific CN code for WPT (2403.11.00) and the inclusion of tobacco-free WPT within the same chapter of the CN classification (2403.99.90), the monitoring of imports and exports has improved. Moreover, as mentioned in Section 3.5.1.3, the TPD2 requires MS to assist the Commission and provide all available information to prepare a periodical report on the Directive's application and implementation, including a specific section on market developments of and consumer preferences towards WPT, with particular focus on its flavours. While it is unclear how the information will be utilised, it is important to detect at an early stage any market trends – such a disproportionate increase in WPT popularity among the youth – that may require an intervention.

3.5.2.2 Tax evasion

Tobacco products falling in the 'other smoking tobacco' category are typically taxed based on their weight. This mode of taxation was initially designed for pipe tobacco, which does not come in sticks, and cannot be measured in terms of stick equivalents due to a completely different mode of consumption in comparison with cigarettes. Having been included in the same category, WPT is necessarily subject to the same rates as pipe tobacco. However, WPT is considerably heavier due the substances other than tobacco included in it (the actual tobacco content of WPT is approximately 25-30% of the total weight). Given that excise duties do not take the peculiar nature of the product into account and apply indiscriminately to the weight of the entire product, the tobacco content in WPT is taxed relatively more heavily than the other tobacco products in the same category (e.g. pipe tobacco), and in other categories with the same excise rates (e.g. in PL and SE fine-cut tobacco has the same excise rate as 'other smoking tobacco'). This creates strong incentive to tax evasion and illicit trade. Most of the tax evasion reportedly happens at the level of shisha lounges. A common illicit practice in various country consists of buying a small portion of duty-paid WPT and keeping it in store in the event of tax authorities' inspections, and sourcing the rest illicitly. The proportion of 'legal' WTP purchased on the total is an estimated 10%.

The retail price of 1kg of WPT can considerably vary across MS due to the different tax rates applied. For instance, 1kg of WPT with an assumed import price of €10 can be sold to consumers for a price ranging from €75.66 in Germany (lowest rates) to €315.78 in Ireland (highest rates). By contrast, 1kg of illicit WPT can be reportedly purchased in the black market for €40-50. This means that 'black' WPT can range from being 34% cheaper than 'white' WPT in countries with low excise duties, to 84% cheaper in countries with high excise duties.

For illustrative purpose, **Table 15** provide a rough estimate of the volume of tax evasion (including both excise duty and VAT) in some MS and at the EU level. Given the paucity of information and the poor reliability of market data, these estimates have to be taken with great caution.

Table 15 – Estimated Tax Evasion from WPT

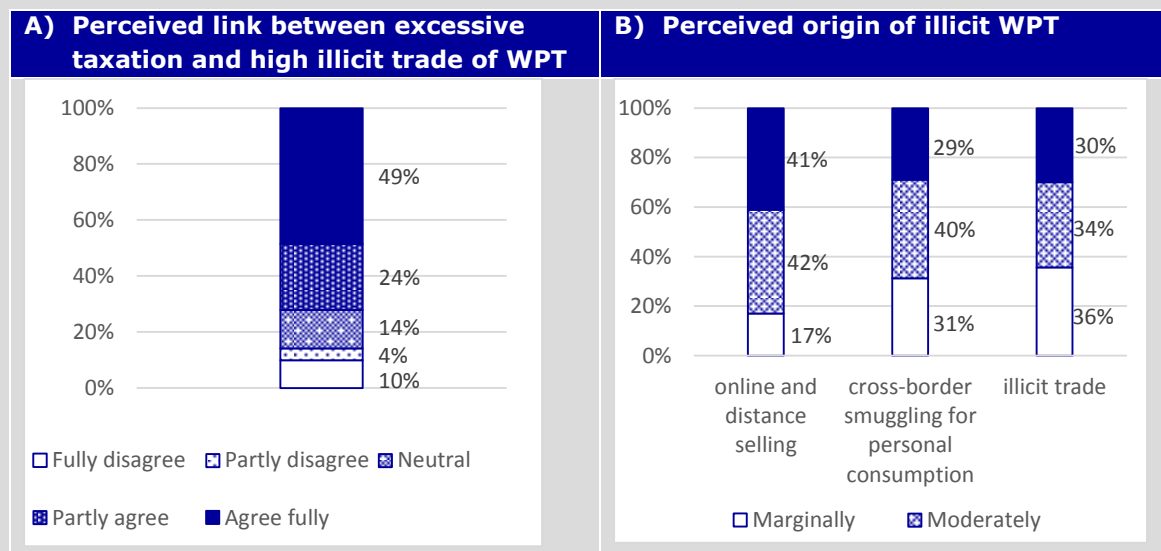
	Estimated total market (tonnes per year)	Estimated illicit market (tonnes per year)	Average WPT retail price (€/kg)	Tax component (€/kg)	Estimated volume of evaded tax (€ mn)
DE	2,400	600 - 1,400	75.66	37.66	20 - 50
UK	200	160 -180	221.25	183.25	30
IT	100	90	146.32	108.32	10
SE	200	160	291.89	253.89	40
EU	5,000	Ca. 2,500			200

Source: Industry estimates and author’s calculations. It is assumed a pre-tax price of WPT of € 38 per Kg.

Box 9 – The perceived illicit WPT market (results from the OPC)

OPC respondents were asked whether in their opinion excessive tax charges on WPT may result in a high rate of informal/illicit trade. Nearly half of respondents fully agreed, and almost one quarter partly agreed, as shown in **Figure 18A** below. In addition to this, over 40% of respondents consider online and distance selling as a significant channel through which illicit WPT is purchased (see **Figure 18B** below).

Figure 18 – Illicit WPT trade



Source: OPC.

➤ **SUMMARY OF PROBLEM ANALYSIS**

Problem drivers	Adverse Effects	Expected evolution
Limited monitoring of the WPT market	<ul style="list-style-type: none"> Difficult monitoring of market trends. Uncertainties on the social and health effects, especially among youth. 	<ul style="list-style-type: none"> TPD2 monitoring scheme may provide information on consumption and market trends. The share of illicit market will remain difficult to monitor.
Incentives to tax evasion	<ul style="list-style-type: none"> Revenue loss. Competitive disadvantage for 'good players'. 	<ul style="list-style-type: none"> As the demand grows market distortions and tax losses may only increase.

3.6 Minimum Excise Duty on Cigarettes

3.6.1 Baseline Assessment

3.6.1.1 The legal and economic rationale

➤ THE LEGAL FRAMEWORK

Article 8.6 of Directive 2011/64 grants MS the option to introduce a Minimum Excise Duty (MED) on cigarettes, that is a minimum floor for the excise yield. As of 01/01/2016, a MED was adopted by 25 MS: all except for DK, SE, and the UK. The MED levels range from less than € 90 per 1000 cigarettes (e.g. BG, HR, HU, LT,)²²² to more than € 300 in Ireland²²³.

The current version of the Directive imposes no limits on the MED. However, it remains subject to Art. 7.4, establishing that it should respect the rules on the mixed structure of taxation and the share of the specific and *ad valorem* components on the total tax burden. These rules currently require MS to impose a specific component on cigarettes which is comprised between 7.5% and 76.5% of the Total Tax Burden (TTB);²²⁴ this condition needs to be measured at the WAP. While the minimum share of the specific component is set at 7.5%, that of the *ad valorem* component depends on the VAT rate. Considering the maximum VAT rate applied in the EU (27%), the minimum *ad valorem* component over the TTB should amount to 2.2%.²²⁵

The current framework for the MED results from a series of legislative revisions which took place over the last 20 years, concerning both its upper limit and the relation with the mixed structure; the changes are summarised in **Table 16** below. Focusing on the most recent changes, before the approval of Directive 2010/12/EU²²⁶ the MED was capped at 100% of the excise yield on the Most Popular Price Category (MPPC). Directive 2010/12/EU removed the limit and Directive 2011/64 had the MED subject to the requirements on the mixed structure of taxation.

Table 16 – Changes to the MED framework

Act	Main provision
Directive 95/59/EC ²²⁷	MED can be introduced on cigarettes MED should not be more than 90% of the total tax on MPPC
Directive 2002/10/EC ²²⁸	Limit for MED raised at 100% of the excise duty on MPPC
Directive 2010/12/EU	No limit for MED Explicit reference to the respect of the mixed structure requirements
Directive 2011/64/EU	No limit for MED Explicit reference to the respect of the mixed structure requirements

➤ THE ECONOMIC RATIONALE

As detailed in Art. 7.1, the Directive requires MS to impose both a specific and an *ad valorem* excise duty on cigarettes: the former is based on quantity (€ per 1000

²²² Ex Art. 10.2 of the Directive, several countries are allowed a transitional period until 31.12.2017 to reach the current minimum excise level, set at €90 per 1,000 cigarettes and 60% of WAP.

²²³ Cf. EDT (July 2016).

²²⁴ That is the sum of the excise duty and the VAT.

²²⁵ The minimum value of the *ad valorem* component is given by the following formula: $\frac{1}{1+VAT} - 0.765$.

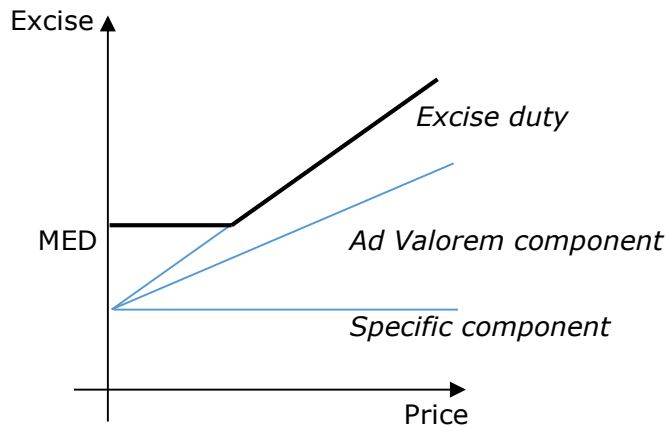
²²⁶ Council Directive 2010/12/EU amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC on the structure and rates of excise duty applied on manufactured tobacco and Directive 2008/118/EC.

²²⁷ Council Directive 95/59/EC of 27 November 1995 on taxes other than turnover taxes which affect the consumption of manufactured tobacco.

²²⁸ Council Directive 2002/10/EC of 12 February 2002 amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC as regards the structure and rates of excise duty applied on manufactured tobacco.

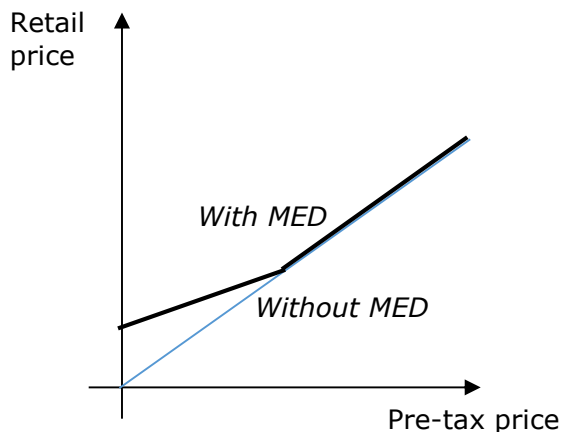
pieces), and the latter as a percentage of the retail selling price. It means that the excise yield on cigarettes (represented in blue in **Figure 19** below) grows linearly as a function of the retail price, with an intercept equal to the value of the specific component. The MED, acting as a minimum floor, prevents the full linearity of the excise duty on cigarettes. Precisely, it increases the excise yield on cheaper products.

Figure 19 - The economic rationale of the MED



By creating a floor, the MED increases the tax burden on all cigarettes below a certain price. It means that when the MED kicks in, a decrease in the pre-tax price will be reflected less than proportionately on the retail selling price. As a consequence, the profitability of cigarettes below the MED is reduced. In this way, manufacturers have limited incentives to market low-cost cigarettes and to reduce the price of cigarettes below the MED threshold; still, they remain free to set a price below the MED. The impact of the MED on retail price, given the pre-tax price, is shown below in **Figure 20**.

Figure 20 - Impact of the MED on retail selling price



3.6.1.2 The purpose of the MED and its use by the MS

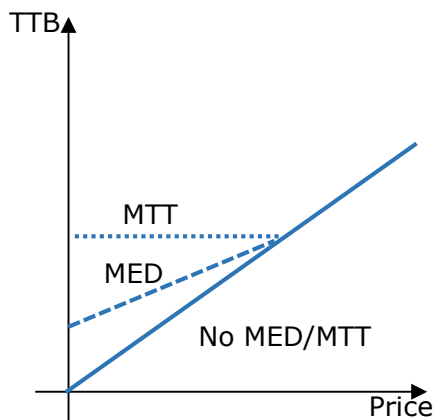
Based on the information retrieved from public authorities and economic operators during the fieldwork, the use of the MED across MS varies, in terms of how the provision is implemented, its market coverage, as well as its purposes. With respect to the latter, these include:

1. Protecting revenue stability, and in particular minimising the impacts of price competition or changes in the cigarette market structure on tax revenues;²²⁹
2. Promoting tobacco control policy goals by raising the entry price of cigarettes;
3. Indicating a 'quasi-minimum price'; though minimum prices for cigarettes were declared incompatible with the Directive by the CJEU,²³⁰ the level at which at the MED kicks in may provide signals to market players about the 'minimum acceptable price'.

With respect to national implementation, the MED was adapted to their own ends by several MS. Until 2014, Italy, France and Spain had imposed a super-MED, which is a MED with variable thresholds. In a nutshell, the MED was set at two levels: a lower one which kicked in at price X, and a higher one, which kicked in at price Y lower than X. In this way, the effect on the MED was stronger for cigarettes below the second threshold, so that their marketing became even more unprofitable. However, in 2014, the CJEU stated that the Directive should be interpreted as precluding a national provision that did not set an identical MED for all cigarettes, but rather provided for a different MED for cigarettes below a certain price.²³¹

Another interpretation of the MED is the Minimum Total Tax (MTT). The MTT provides a tax floor to the total tax burden. Differently from the MED, which provides a floor to the excise duty only, the MTT also includes VAT in the minimum tax. For this reason, it has an enhanced effect on the taxation of low-cost cigarettes, as it compensates for the progressive decrease of the VAT amount when the retail price decreases (see **Figure 21** below). As a consequence, it allows public authorities to control a larger share of the price of low-cost cigarettes.

Figure 21 – The economic rationale of the MTT



Given the possible variations of purposes and implementation, it comes as no surprise that the MED has a very different impact on the national cigarette market structures. The market share of cigarettes below the MED threshold vary from country to country - among the MS visited, from 0% in Ireland to 88% in Portugal - as well as from year to year, sometimes abruptly. The market coverage results of a complex combination of (i) the national MED provisions and rates; (ii) changes in the excise rates or structure; (iii) decisions of economic operators; (iv) consumers switching towards

²²⁹ This objective is particularly important in countries with a high ad valorem component, because price competition is more profitable and less costly for economic operators, and because the growth of the low-cost segment at the expense of the mid and premium ones may result in a lowering of tax revenues even for constant cigarette consumption levels.

²³⁰ Case C-221/08, Judgment of the Court of 4 March 2010 — European Commission v Ireland.

²³¹ Case C-428/13, Judgment of the Court of 9 October 2014 Ministero dell'Economia e delle Finanze and Amministrazione Autonoma dei Monopoli di Stato (AAMS) v Yesmoke Tobacco SpA.

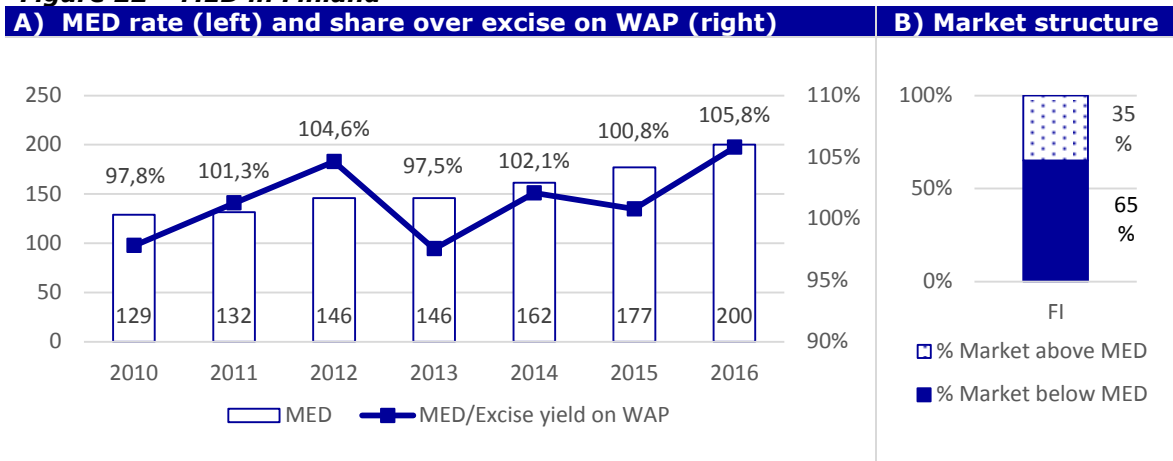
different price segments; (v) changes in the WAP or MPPC, to which the MED is sometimes anchored.

Here below, the information collected concerning six of the seven MS selected for the fieldwork – Sweden does not provide for a MED, because taxation of cigarettes is mostly based on the specific component – as well as Portugal and Finland, is reported. For each MS, the level of the MED, the underlying legal mechanism (where relevant), the purposes which it serves, and the impacts on the market structure are discussed.

Finland. Finland is the MS where the MED is the highest as a proportion of the excise yield on WAP, and the third highest in absolute terms, after Ireland and France: in 2016, it amounted to €200, corresponding to 105.8% of the excise duty on WAP. One of the reason for such a high ratio consists of the fact that the MED in year t is compared with WAP in years t-1; with respect to year t, the government considers the MED to be closer to the excise duty on WAP. In terms of market share, in 2015, products subject to the MED represents to about two-thirds of the cigarette consumption. In this respect, 2015 is a peak year, whereas in the earlier period cigarettes covered by the MED varied between 26% and 47%.

In Finland, the MED complements an excise structure where the *ad valorem* component is preponderant, set at 52% of the retail selling price. In this way, the Finnish government aims at achieving both a high taxation of premium cigarettes (in absolute value), as well as a high taxation of low-cost brands (in relative terms). The MED thus supports the entry price of cigarettes, a parameter which is considered crucial for tobacco control policies. Also, the MED ensures that the prices of the least and the most expensive cigarettes move in parallel when the excise rate is increased. Such a market fine-tuning worked very precisely: since 2008, the difference between the 5th and the 95th percentile of the cigarette price distribution remained stable, at about 50€/1000 pieces, or 1€ per pack of 20 cigarettes.

Figure 22 – MED in Finland



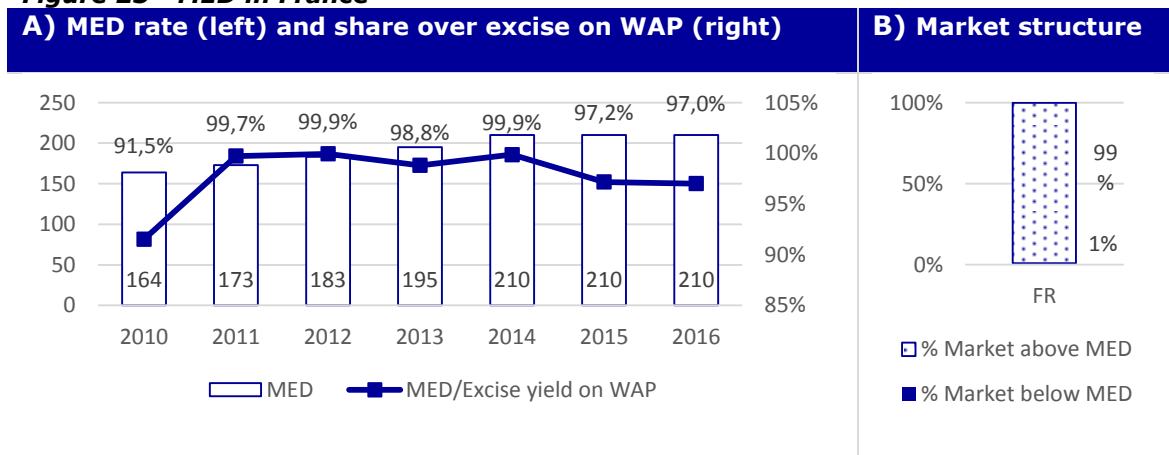
Source: EDT (July 2016), Interviews.

France. In 2016, the MED was set at € 210 per 1000 pieces, or 97% of the excise yield on WAP; since 2011, this ratio remained between 97% and 99%. The MED is just below the entry price for cigarettes. Though this is not required by the excise law, economic operators consider the MED as the minimum entry price that the government would ‘accept’ on the market without starting a fiscal reaction, i.e. a tax increase. Public authorities also confirmed that the purpose of the MED is to keep the entry price at a sufficiently high level, and to prevent price wars in the low end of the market. Both the Ministry of Public Health and NGO acknowledged that the mechanism is effective for this objective. Indeed, only about 1% of cigarettes sold in the market have a price below the MED threshold

What are the reasons why the MED in France sets a *de facto* minimum price, even though manufacturers remain obviously free to go below the threshold? What makes the difference in this respect is the credibility of the threat of a fiscal reaction by the government. While excise duties are set by means of primary legislation, the MED can be raised via a ministerial decree enacted by Ministry of Budget, up 10% of current rate. This power has never been used, and the MED is increased each year largely in parallel with excise rates. Still, the existence of such risk makes economic operators more likely to abide by the government intent not to have cheap cigarettes, the price of which falls below the MED level, on the market. Indeed, any price war or introduction of ultra-cheap cigarettes could trigger a MED increase, which would make the move unprofitable for all players.

France was one of the MS, together with Italy and Spain, which had in place a super-MED. When the super-MED was removed, following the CJEU judgment, the system was reworked along the lines described above, without losing its effectiveness.

Figure 23 - MED in France



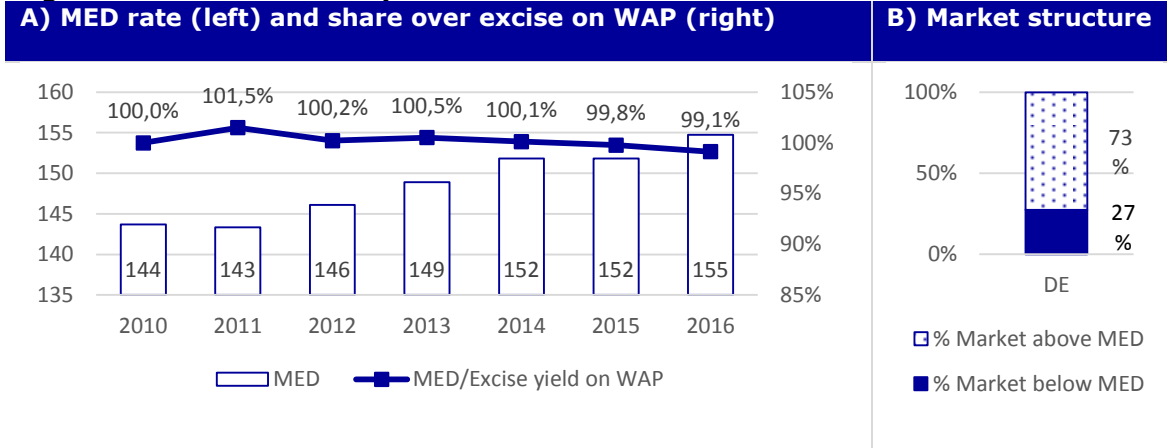
Source: EDT (July 2016), Interviews.

Germany. Germany adopts the MTT, which is a dynamic minimum excise tax, set at € 196.36 per 1000 pieces minus VAT. It means that when the VAT goes down for lower retail prices, the MED is increased to keep the total tax burden constant. The MED corresponds to about €155,²³² or 99% of the excise yield on WAP. Since 2010, the MED has been constantly at about 100% of the excise yield on WAP.

According to the economic operators, MTT is used to preserve revenue stability and to govern the market structure. The MTT rate has been increased annually, in parallel with the increase in the excise duties. Today, slightly more than one quarter of the cigarettes consumed are sold at a price below the MTT threshold. The low-cost segment is populated especially by retailers' private brands, the packs of which are sold at an entry price of about €4.35.

²³² EDT (July 2016).

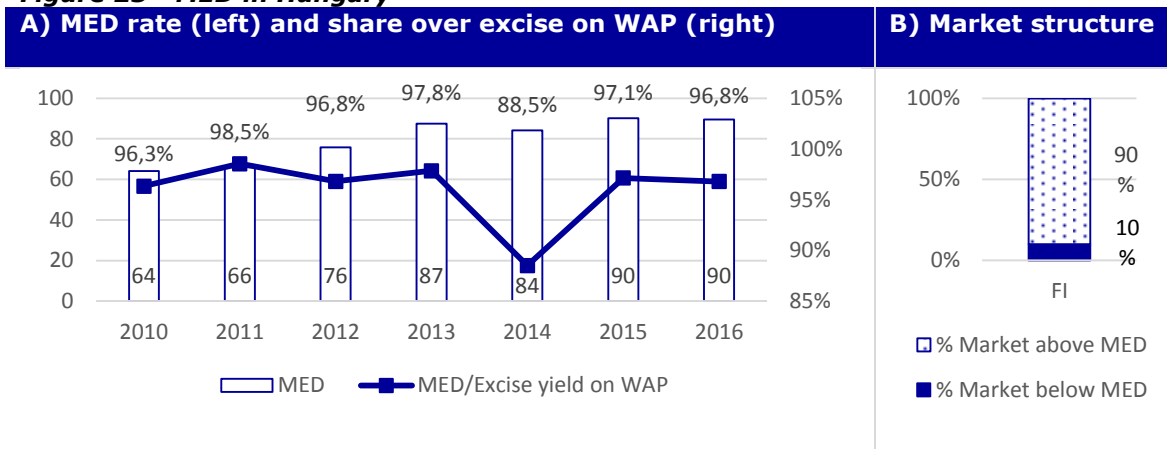
Figure 24 - MED in Germany



Source: EDT (July 2016), Interviews.

Hungary. In Hungary, the MED is set at €89.5, corresponding to about 97% of the excise yield on VAT. Its level is set in the excise law and it is not automatically updated when the excise yield is; the MED does not include VAT, and there is no plan for the government to introduce such a change. The purpose of the MED in Hungary is to ensure revenue stability and to reduce incentives for price competition. The last 'price war' occurred in 2010 and led to a compression of market prices towards the bottom. In Hungary, most of the market is above the MED: though estimates differ, the market share below the threshold is assessed at about 10%. In any case, the MED is neither intended to function nor perceived as a minimum price.

Figure 25 - MED in Hungary

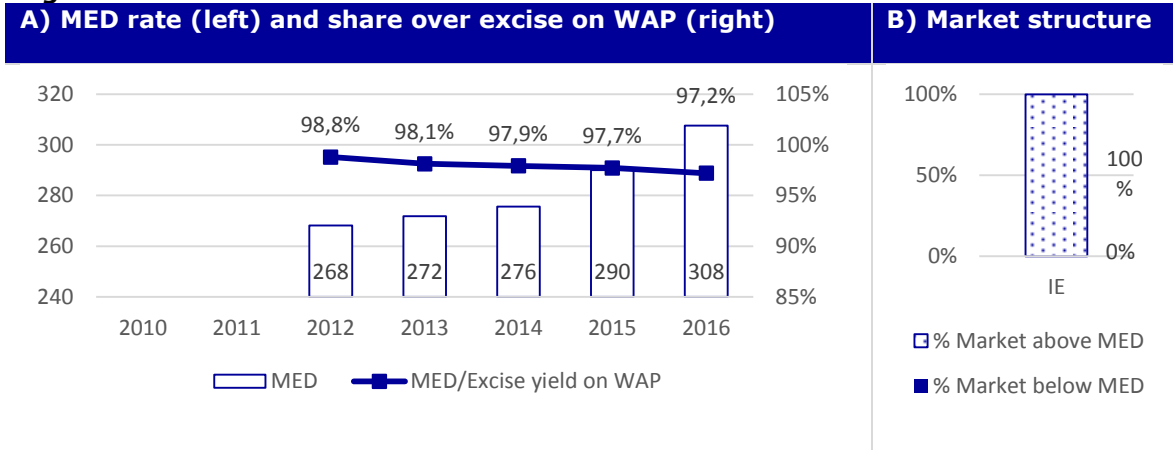


Source: EDT (July 2016), Interviews.

Ireland. In Ireland, the MED was introduced as of 2012. Previously, there was a minimum price, set at 97% of the previous year MPPC, which was then struck down by the CJEU. Currently, the MED is set at €308 per 1000 pieces (the highest in the EU), corresponding to about 97% of the excise yield on WAP. However, even though the MED is so high, and even though there is no longer a price floor, no cigarette is sold below the MED threshold. This is due to Ireland having a very high specific component, which represents 66% of the TTB (one of the highest shares in the EU). This implies that low-cost cigarettes are practically unprofitable.

The MED kicks in at €7.75 per pack of 20, while the entry price is over €9.00. In recent years, there has been a downtrading in the market, so that the value segment, consisting of packs sold at 9-10€, now represents about a quarter of the market (this segment was less than 10% in 2011). This should be attributed mostly to the economic crisis and the overall increase in taxation, and thus price, of cigarettes.

Figure 26 - MED in Ireland

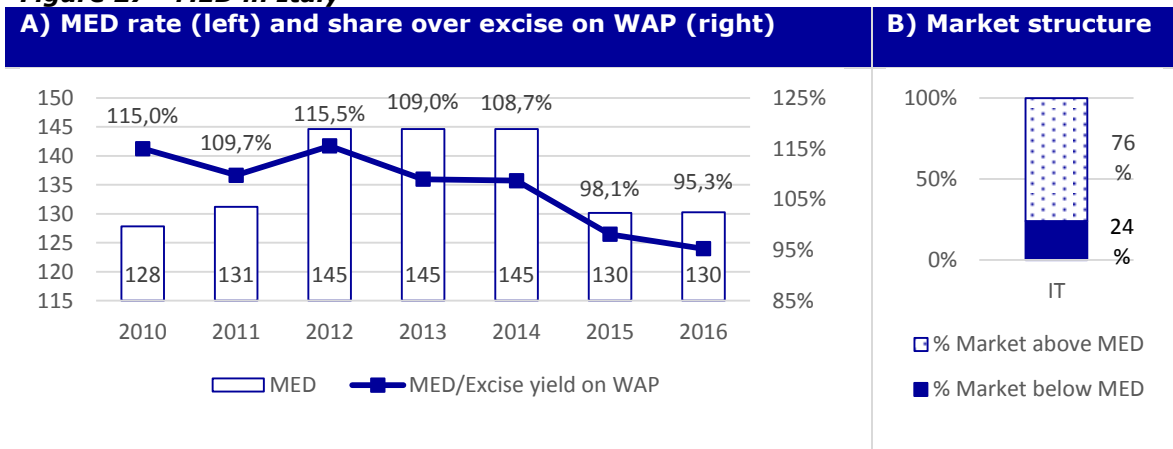


Source: EDT (July 2016), Interviews.

Italy. Italy had in place the super-MED until 2014: the first MED-level was set at 100% of the excise duty yield on MPPC, the second one at 115%. When the system was considered unlawful by the CJEU, the super-MED was substituted by the MTT, set at € 170/1000 cigarettes; deducting VAT for comparison purpose, this corresponds to a MED of about €130/1000 cigarettes,²³³ that is around 95.3% of the excise yield on WAP.

In Italy, the MED is used mainly to govern the market structure and to control the price-differential between premium and low-cost brands. Under the super-MED, the price gap between premium and low cost cigarettes was about €0.70; only 4% of the cigarettes were marketed below its threshold. Once the super-MED was eliminated, the price gap increased to €1.20, the cheapest pack was sold at €3.80, more products started to be marketed below the MED, and consumers started switching to cheaper brands because of the larger price-differential. Cigarettes below the MED reached between one-fifth and one-quarter of the market. This led the public authorities to introduce the MMT, which kicks in at about €4.40 per pack of 20, and progressively over-increases the excise yield to compensate for the lower VAT on cheaper brands. The MMT is considered more effective than the MED in controlling the low-end of the market. Nowadays, the entry price is at about €4.20 per pack, and about 15% of the market is represented by cigarettes below the MED.

Figure 27 - MED in Italy

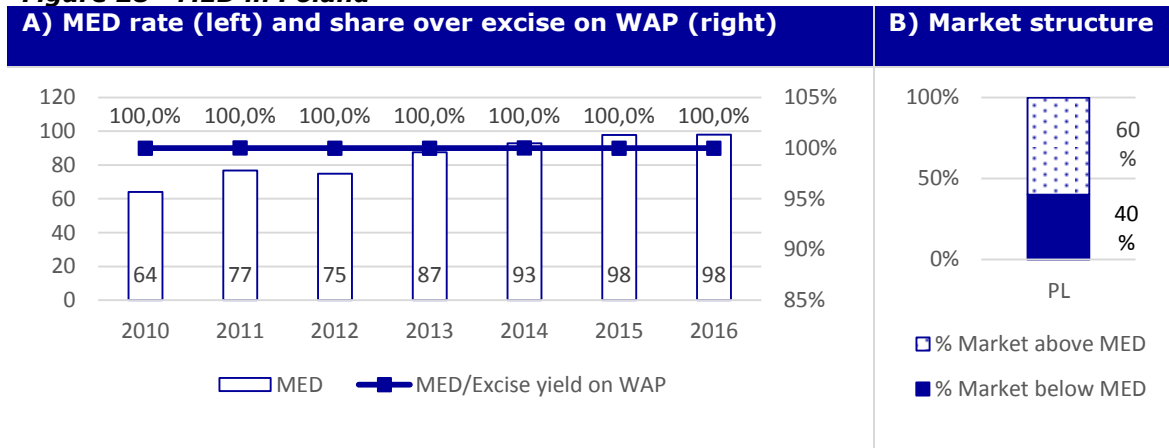


Source: EDT (July 2016), Interviews.

²³³ Ibid.

Poland. In Poland, the MED corresponds to the excise duty on WAP, and over the last 6 years it never moved away from the 100% ratio. This means that the excise duty and the MED move in parallel. However, while the MED was constant in relative terms, the share of market below it increased, because cigarette manufacturers entered into a price competition when the excise duties were raised (especially in 2014-2015). In 2015, cigarettes below the MED represented 40% of the market, up from about 12-13% in 2013-14. The MED was thus insufficient to prevent price competition, but was successful in reducing its impacts on tax revenues, thus providing a higher degree of stability.

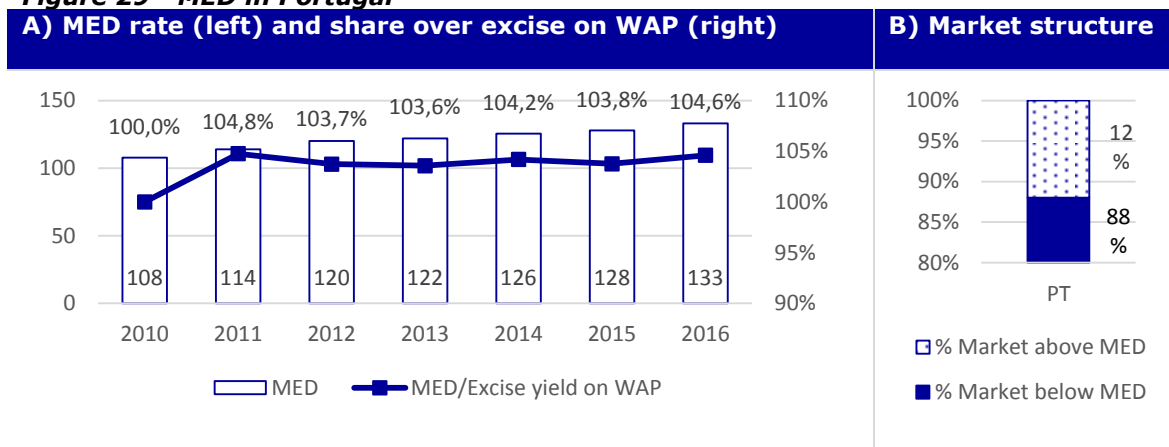
Figure 28 - MED in Poland



Source: EDT (July 2016), Interviews.

Portugal. Portugal is one of the two MS, together with Finland, where the ratio of the MED over the excise yield on WAP is the highest, currently at 104.6%. This corresponds to a very large share of the market being covered by the MED, as 88% of the market brands fall below it. Also, in Portugal the MTT has been recently introduced, set with reference to the excise yield on MPPC. In Portugal, the MED is used to compress the market: by reducing price differentials, consumers have limited incentives to down trade to low-cost cigarettes. Hence, market, price, as well as revenue stability is ensured.

Figure 29 - MED in Portugal



Source: EDT (July 2016), Interviews.

3.6.2 Problem Analysis

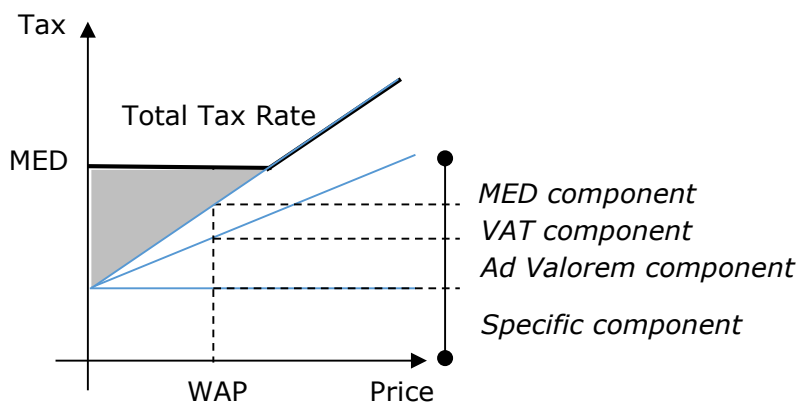
3.6.2.1 Legal uncertainty of the MED provisions and the relation with the mixed structure

From both the Ramboll Evaluation and the Commission Report, it is evident that MS have different interpretations of MED provisions, in particular with respect to its relationship with the mixed structure. For instance, some countries maintain that the mixed structure is an issue separate from the MED. Others agree that when the MED is set at a level equal to or lower than the excise duty on WAP, the mixed structure requirements are certainly fulfilled, but that this may not be the case when the MED is higher. In other cases, MS verify whether a sufficiently large share of the market (e.g. 50%) is not subject to the MED, but rather to the mixed structure.

With respect to the relation between the MED and the mixed structure requirements, this could create a conflict when the MED is higher than the excise duty on WAP, as the requirements on the mixed structure is calculated on WAP. Such a possible conflict could arise in case the MED were considered *de facto* as a form of specific taxation. Because in this case the minimum share of the *ad valorem* component would not be ensured. However, the MED has never been interpreted as such, also by the CJEU.

Another possible interpretation would be that the MED is an incremental component of the mixed structure, separate from the specific and *ad valorem* ones. In this case, there would be no implicit upper limit to the MED. If the MED were considered an incremental component on top of the specific and *ad valorem* ones, it would correspond to the length of the segment inscribed in the shaded triangle in **Figure 30** below. In this case, it could apply also to cigarettes at or above WAP, provided that the shares of the specific and *ad valorem* components on TTB at WAP respect the prescriptions of Art. 7 of the Directive.

Figure 30 - MED as incremental component



As an example, **Table 17** below analyses the tax components at WAP for Finland, where the MED over the excise duty of WAP is the highest. The share of the various components, under this interpretation, would respect the mixed structure requirements. Similar results are also valid for Portugal, as, under such interpretation, the share of the incremental MED at WAP would be of 3% and that of the *ad valorem* component would be of 21%. Noteworthy, in both countries the MED could be set at still higher level compared to the excise yield on WAP, so to cover the whole cigarettes market, without breaching the mixed structure requirements. However, this would practically run contrary to the duty of MS to tax cigarettes based on both per quantity and per value tax bases.

Table 17 - Share of the various components at WAP – Finland and Portugal

	Finland		Portugal	
	€/1000 pieces	% of TTB	€/1000 pieces	% of TTB
Specific	41.50	16%	90.85	52%
Ad Valorem	147.56	58%	36.47	21%

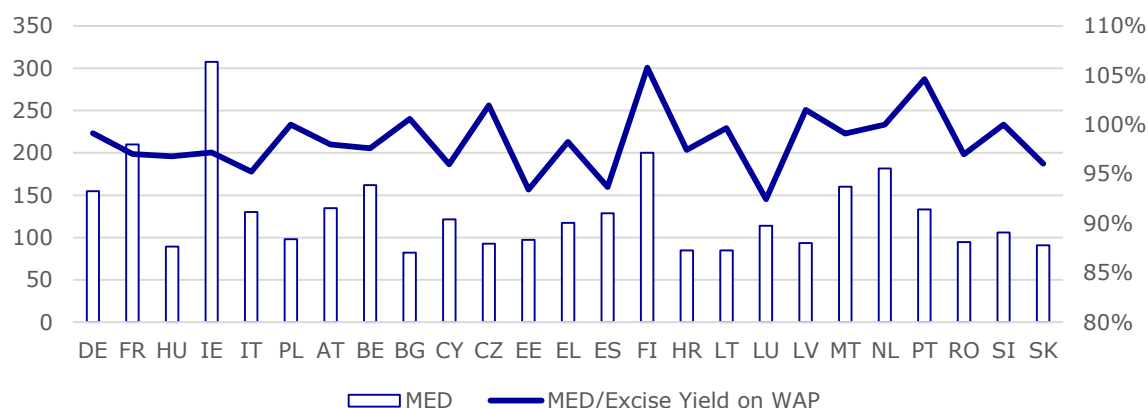
<i>Sub-total</i>	189.06	-	127.32	-
MED (incremental)	10.94	4%	5.87	3%
<i>Total Excise Duty</i>	200.00	-	133.18	-
VAT	54.91	22%	40.11	24%
TTB	254.91	100%	167.43	100%

Though most public authorities agree that the MED provisions remain somewhat uncertain, they are not opposed to a text which appears vague, because this enhances their flexibility and capacity to use it as a tool to govern the cigarette market and ensure budget stability. Importantly, economic operators also report that the uncertain interpretation of MED provisions and their relation to the mixed structure is of limited concern. Indeed, in terms of legal clarity, national transposition measures, rather than the EU rule, matter for economic operators, and none of them complained about a lack of legal clarity of the national frameworks. Obviously, each economic operator has its own substantive preferences on the MED, and this also depends on its positioning on the cigarette market, and in particular its shares of the low-cost vs. premium segments.

Since the legal uncertainty is not perceived as creating costs for public authorities and economic operators, the issue at stake seems to be whether the current wording of the Directive implies an upper limit to the MED equal to the excise yield on WAP. However, as shown above in **Table 17**, the decision to remove the limit was taken by the legislators when approving the Directive 2010/12/EU. Hence, it would be counter-intuitive that an explicit cap to the MED was removed in order to introduce an implicit one.

Figure 31 below provides a snapshot of the current level of the MED in the EU28 with respect to WAP. In 2016, five MS had a MED higher than the excise duty of WAP: Belgium, Czech Republic, Latvia, Portugal, and Finland. The highest relative level was that of Finland, at 105.8%. In 2015, six MS were in a similar situation: further than Czech Republic, Finland, and Portugal, this was the case for Bulgaria, Germany, and Italy. Such a variability suggests that, in some cases, the exact ratio also depends on the way in which WAP is calculated (as it refers to the previous year), and not only on a deliberate national tax strategy. Furthermore, deviations from the ratio are limited to few percentage points.

Figure 31 - MED: absolute value (€, left scale) and share of the excise yield on WAP (% , right scale)



Source: EDT (July 2016).

The other legal innovation in the MED area, that is the adoption of an MTT inclusive of VAT, has reportedly not created problems in terms of legal uncertainty so far. It does create different economic impacts, or rather larger economic impacts of the same

nature; nevertheless, its implementation has proceeded smoothly from the point of view of both public authorities and economic operators.

➤ **DYNAMIC BASELINE SCENARIO**

A key message from the public authorities interviewed is that they do not expect to change their MED system in the near future, as they are satisfied with their current interpretation and implementation. Hence, the Consultants expect that, under the dynamic baseline scenario, there will be no changes at national level. Certainly, the situation could change in case the CJEU were called to interpret other aspects of the MED provisions. At the same time, MS concerned would most likely react to minimise disruptions, as already happened when the minimum price and the super-MED were struck down. This reaction could result in either another different implementation of the MED, or changes to the mixed structure (given that, in economic terms, the specific component can play a similar, though not equivalent, role).

Problem drivers	Adverse Effects	Expected evolution
Legal uncertainty of the MED provisions and the relation with the mixed structure	<ul style="list-style-type: none"> • Possibility that MED higher than 100% of the excise duty on WAP is in conflict with the mixed structure. 	<ul style="list-style-type: none"> • No major changes at national level expected.

4 DEFINITION OF POLICY OPTIONS

4.1 New Products

4.1.1 Electronic cigarettes

4.1.1.1 Introduction of a harmonized tax for electronic cigarettes

The main regulatory option on e-cigarettes that is analysed in this Study consists of including them as excise goods in the scope of a possible revised Directive 2011/64. In principle, this approach would respond to both problem areas identified in the previous Sections, i.e. the adverse effects of current fragmentation and the monitoring gap. In order to properly appreciate the potential effects of this option, it is necessary to specify in more detail the possible tax structure and other features of this new category.

- **Tax 'trigger'.** The first tax framework for e-cigarettes adopted in the EU was the Italian full *ad valorem* tax, which addressed indistinctly all e-cigarette parts, hardware and consumables alike. Following a judicial case this approach was soon dropped and replaced by a specific tax on consumables. Beside this early experience, no other country ever considered devices excisable, and this option is therefore discarded in the Study. As regards the nicotine content of e-liquids, the situation across the EU is more varied: some MS exempt nicotine-free liquids from taxation, while others tax all e-liquids indistinctly. Latvia has a mixed approach and applies a specific tax per liquid volume plus a certain amount per nicotine concentration. The excisability of nicotine-free liquids is controversial. In Italy, for instance, it has been declared disproportionate by an Administrative Tribunal.²³⁴ In addition to legal uncertainties, there are also practical difficulties, since nicotine-free products can hardly be distinguished from food flavours and flavours for other uses and customs control may be technically very complex. On the other hand, addressing only nicotine-containing liquids may create a loophole allowing to avoid taxes through the separate purchasing of nicotine-free liquids (tax exempted) and concentrated nicotine solutions (available through various online outlets). Banning liquids with a concentration higher than 20mg/ml, the TPD2 may however contribute to reduce/prevent this risk.
- **Tax base.** In most of cases, MS have introduced taxes on e-liquids irrespectively of the actual concentration of nicotine. The only exception is, as seen, the Latvian system. In Italy, following a tribunal sentence suspending the application of excise duties on nicotine-free products, various operators have unilaterally adopted a 'light tax', substantially claiming that only the nicotine component of e-liquids is subject to the tax. This interpretation may fuel the debate on the actual tax base for a harmonised excise duty on e-cigarettes. In the USA, none of the jurisdictions currently taxing e-cigarettes have a per-nicotine concentration regime, but reportedly some States (Indiana, Maine, Montana, and New Mexico) are considering it.²³⁵ Taxing nicotine seems however impractical and has no precedent in the conventional tobacco legislation. DG TAXUD has recently commissioned to the JRC a study on the identification of the 'excisable element' of e-liquids.²³⁶ The study revealed *inter alia* that there is a high level of imprecision in the concentration of nicotine declared on refill containers, which would make a per nicotine taxation (based on self-declaration of manufacturers) subject to significant

²³⁴ A ruling of the Constitutional Court on this provision is pending.

²³⁵ Drenkard S., "Vapor Products and Tax Policy", The Tax Foundation, Fiscal Facts no 505, March 2016.

²³⁶ "Provision of scientific-technical support activities to DG TAXUD-C-2 for the identification and characterisation of the 'excisable element' of liquids used in e cigarettes in order to possibly implement a harmonised fiscal measure in the Member States", JRC Technical Report, 2016.

distortions. In this sense, the burden of control and tests may be disproportionate. Finally, a per-nicotine tax may encourage the illicit trade of liquids with high concentrations of nicotine.

- **Tax structure.** None of national tax regimes have an *ad valorem* component. Some US jurisdictions have adopted this approach on the wholesale price. An *ad valorem* tax based on the retail selling price would be more complex and burdensome to administer for all players than a flat specific rate per liquid volume. Moreover, it would penalise high quality premium products and provide a competitive advantage to cheap imported ones.
- **Minimum rate.** The current tax rates applied to e-liquids across the EU vary between € 0.06 per ml in Latvia (assuming a standard nicotine concentration of 10mg/ml) to € 0.385 per ml in Italy.²³⁷ Croatia has temporarily set the tax rate to zero. In the harmonisation of tax treatment, the choice of introducing or not a positive minimum rate may evidently lead to different results. In this Study both approaches have therefore been considered and assessed. It is worth noting, however, that these two approaches should not be considered as mutually exclusive. As in the case of Croatia, the harmonisation of the tax regime for e-cigarettes may include a first phase at zero or negligible rate, followed by a second phase where a positive duty enters into force.

Summing up, the regulatory option retained and assessed in this Study consists of **extending the EU harmonised system to nicotine-containing e-liquids, by means of an ad hoc fully specific tax structure based on the volume of liquid, with or without establishing a minimum rate.**

As regards the expected impact of this regulatory option, **Table 18** below briefly illustrates the impact areas that seem relevant and non-negligible, including both intended and unintended possible effects. These impacts will be analysed in greater detail in Section 5.

Table 18 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Introduction of a harmonized tax structure for electronic cigarettes, with: (i) no minimum rate, or (ii) a positive minimum rate	• Monitoring and control	• Improved availability of market data and information on consumption trends.
	• Market Development	• In the event a positive minimum rate is imposed, a negative impact on growth can be expected.
	• Substantive compliance and administrative costs for businesses	• Economic operators should adopt the requirements of the excise system.
	• SME competitiveness	• Small players are comparatively more hit by an increase of the administrative burden. Market consolidation is possible.
	• Enforcement costs for public authorities	• This would affect especially MS that have not introduced national tax regimes.
	• Tax revenues	• In the event a positive minimum rate is imposed, a certain increase in tax revenue can be expected. In some MS with a national tax on e-cigarettes, the tax loss due to cross-border shopping may decline.

²³⁷ Portugal had a higher rate of € 0.60 per ml until the end of 2016, which was however reduced to € 0.30 since 2017.

	<ul style="list-style-type: none"> • Single Market functioning 	<ul style="list-style-type: none"> • Reduction of the current distortions due to different tax regimes, and removal of administrative barriers to cross-border competition.
	<ul style="list-style-type: none"> • Legal and administrative certainty 	<ul style="list-style-type: none"> • Possible prevention of legal disputes and further fragmentation.

4.1.1.2 Fostering MS cooperation and debate

There are no evident alternative to the regulatory approach to address the stated issues. However, in the event the results of the impact assessment do not support the policy change, there would remain room for fostering the debate among MS at EU level and the cooperation on specific aspects, in line with what is already happening within the Indirect Tax Expert Group (ITEG), and under the *Fiscalis Project*.

Initial lessons from the introduction of national tax regimes are becoming available, but since in most of cases these regimes have been introduced less than one year ago, it is necessary to wait a little longer before data on outcomes and implementation issues could be consistently discussed between MS delegates. Ideally, as the evidence piles up, MS should be encouraged to exchange information on their national experiences with a view to determine 'what works' and the possible optimal way to deal with these products. These may eventually lead to more structured collaborations and initiatives.

Furthermore, it is expected that in the first half of 2017 the first monitoring data collected under the aegis of TPD2 will become available. These data will represent the first comprehensive EU-level source of information on the e-cigarettes industry and its market. Appropriate mechanisms may be therefore put in place for reporting, taking stock and discussing this information, in the light of the debate on the fiscal treatment of these products. Based on the initial outputs, MS and the Commission may agree on complementary measures that may result necessary to ensure a thorough and detailed monitoring of these markets.

4.1.2 Heated tobacco and novel non-combustible products

4.1.2.1 Harmonization of tax treatment for heated tobacco products

Unlike e-cigarettes, all MS where HTP is commercialised impose some sort of excise duty, but legal and administrative approaches differ significantly, and legal uncertainties seemingly hinder circulation. The adoption of a harmonised tax category for these products may help overcoming these difficulties and – if well designed – may avoid that in perspective similar products receive a different fiscal treatment.

In principle, there are two main ways to harmonise the tax treatment of HTP under a revised Directive 2011/64, namely:

- (i) creating a separate tax category for these products;
- (ii) re-defining one of the existing category (most likely 'other smoking tobacco' - OST)²³⁸ to include HTP.

²³⁸ The early version of *HeatStick*, commercialized in certain MS, did not have the aluminium foil to prevent they could be smoked 'as is', and would therefore attract the tax treatment of cigarettes. The product was therefore reviewed. It can be safely assumed that HTP manufacturers would in any case adjust their products so as to avoid the risk of being taxed as cigarettes, and the recourse of the OST category for the impact assessment seems therefore plausible.

The choice is not trivial, and deserve more in-depth analysis. A separate category would add very little complexity and burden to the legal and administrative process but compared to an expanded OST would have the advantages of permitting: (i) more freedom in the modulation of tax rates (i.e. rate applied to HTP would not affect, for instance, pipe tobacco); (ii) a separate monitoring of excise yields from HTP. On the other hand, the creation of a separate category for heated tobacco would require to work out a plausible definition of combustion, and how to cope with the possible diversion of tobacco to a different use than what is intended for. The existing products have been engineered to make this practice technically or economically unattractive, but the new category may encourage the development of new 'borderline' products (i.e. both consumable and third-party devices capable to generate 'smoke' from the existing HTP).

With respect to the possible tax regime for HTP, the following considerations apply:

- **Tax base.** The consumable parts of existing HTP come in different shape and containers. *HeatSticks* are in some respect similar to cigarette rods, *Ploom* tobacco is contained in small pods, *GLO iFuse's Neopod* is similar to certain e-cigarettes closed-tank refill, with the tobacco component kept in a small receptacle on the top of the cartridge. A 'per unit' approach may work for *HeatSticks* but it would be unsuitable for other existing and possibly novel HTPs. For this reason, a per volume approach seem more flexible and future-proof. In the event of an expanded OST category, a 'per weight' approach would apply by default. The 'per weight' approach requires to establish if the weight relates to the consumption unit (e.g. including the capsule) or the mixture (including non-tobacco elements) or the tobacco content. By analogy with the current Article 2(2) of the Directive, which extend exciseability to certain products containing substances other than tobacco, the 'total weight of mixture' approach seems more coherent with the general policy orientations.
- **Tax structure.** In line with the above consideration made for electronic cigarettes a fully specific structure may be easier to administer and it is *de facto* the current regime applied in most of the MS where HTP is currently present. On the other hand, it should be noted that: (i) the amount of tobacco used in HTP is much smaller than in the case of conventional tobacco products; (ii) the amount of tobacco varies greatly among existing products. In this sense, a specific-only regime may unduly limit the room of manoeuvre of national authorities to modulate their tax policies in response to market evolution. This issue seems particularly acute in the event of an expanded OST category. HTP has a clear market advantage in MS that applies a (generally low) fully specific rate, and this is where tax revenue losses may be more significant (unless the country changes the tax structure or rates, thereby affecting other OST products).
- **Tax rate.** In the event of an expanded OST, the existing tax rates for this category would apply. These may be used as a benchmark for a possible minimum rate also in the case of a separate tax category, in order to prevent any tax-induced effects on price and market development. A zero rate seems implausible considering: (i) MS widespread agreement on the excisability of HTP; (ii) the absence of small start-ups in this segment (which would be more vulnerable to both substantive compliance and administrative costs). The minimum rate applied should also discourage the risk that various 'borderline' HTP are developed to exploit the more favourable tax treatment.

Summing, up the regulatory option retained and assessed in this Study consists of **including HTP products in the harmonised system by either extending the scope of current 'other smoking tobacco' category, or creating a new ad hoc category with the same structure and involving a minimum rate.**

Table 19 - Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Harmonization of tax treatment for HTP through: (i) an expanded OST category; or (ii) a new tax category.	<ul style="list-style-type: none"> Monitoring and control 	<ul style="list-style-type: none"> Better control over movement under EMCS. Improved availability of market data in the event of a separate tax category.
	<ul style="list-style-type: none"> Legal and administrative certainty 	<ul style="list-style-type: none"> Possible prevention of legal disputes and further fragmentation. In the event of a separate tax category, it can be difficult to define non-combustible products avoiding loopholes and incentives for 'borderline' products.
	<ul style="list-style-type: none"> Single Market functioning 	<ul style="list-style-type: none"> Facilitation of cross-border movement, with reduction of the administrative burden.
	<ul style="list-style-type: none"> Tax policy and revenues 	<ul style="list-style-type: none"> Mixed effects on tax revenue (both excise yield and loss due to substitution). Diverse effects on the freedom to adjust tax policies to individual country's needs.

➤ **OTHER NON-COMBUSTIBLE PRODUCTS**

The possible revision of the Directive may envisage a further category able to capture novel non-combustible products that are not e-liquids for e-cigarettes or HTP. These products may include new non-tobacco nicotine delivery platforms, non-liquid inhaling products etc., all of which are still at the prototype stage. It is difficult to predict future evolutions but according to some stakeholders, it would be prudent to foresee at this stage a wide-enough residual category of new products for the delivery of nicotine without combustion (which are not snus, chewing tobacco, and tobacco for oral use).

4.1.2.2 Non-binding guidelines on a coherent treatment of HTP

An alternative, non-regulatory approach to deal with HTP taxation is to issue non-binding guidelines to Member States encouraging a uniform and coherent tax treatment and with a view to facilitate the sealing of the necessary administrative arrangements to move these products across the border. Since MS largely agree on the fact HTP should be subject to excise duty, this approach would be relevant and proportionate. Non-binding guidelines may suggest the use of one of the existing tax categories and indicate different approaches based on the different characteristics of products. They may also advise on the possible use of EMCS and the other features of the EU excise system. Evidently, they won't have the power of a legal interpretation of the Directive, and cannot establish an explicit tax category for HTP. MS will always have the choice of not following the guidelines and opt for a different approach.

The main advantage of this approach is that it won't require a legislative revision, and may cope more flexibly with emerging new products. On the downside, it won't provide legal certainty, and may be much less effective in improving single market functioning and products monitoring.

4.2 Raw Tobacco and Tobacco Refuse

In this Section, the policy options considered for addressing the issues identified with respect to raw tobacco and tobacco refuse are discussed. In Section 4.2.1, the policy options addressing illicit trade of raw tobacco are presented; Section 4.2.2 considers the possible revision of the definition of smoking tobacco provided in Art. 5.1.a to address the retail sale of raw tobacco to avoid taxation; and Section 4.2.3 considers the possible revision of the definition of tobacco refuse. No option is considered for reconstituted tobacco, as no market or regulatory failures were identified concerning this intermediate product.

4.2.1 Inclusion of raw tobacco under the excise system

The introduction of raw tobacco among excisable products would address two problems:

- 1) Illicit trade, as raw tobacco would become monitored as any other excisable product, including i.a. storage in tax warehouses, moving accompanied by an excise document, and tracking via the ECMS system (mandatory for cross-border shipment); this 'monitoring effect' would be independent of the excise rate.
- 2) Retail sale of raw tobacco, due to the lower availability of illicit raw materials.

In line with the IIA, this policy option focuses on introducing raw tobacco under the excise system with a zero rate, hence with the aim to ensure a better monitoring and more effective enforcement for fighting illicit trade. The problem of tobacco put up for retail sale is tackled by the possible revision of art. 5.1.a, described below in Section 4.2.3.

Further details of this options are as follows.

- **Excise rate.** As anticipated, the aim of this option is not to raise additional tax revenues on raw tobacco, and this is why the rate would be set at zero, or to a small positive amount that allows at least to recover collection costs.²³⁹ Indeed, raw tobacco would probably be moved in excise suspension until reaching a tobacco product manufacturer, and then be transformed into an excisable product, never being released for consumption. For this reason, even though the Directive were only to impose a minimum excise duty, as for any other tobacco product, the assumption is that MS would not adopt a positive rate or that – even if some MS adopt a positive rate – raw tobacco is never released for consumption.
- **Definition of raw tobacco.** This option requires introducing a definition of raw tobacco in the Directive. It is preliminarily proposed to draw upon existing national frameworks and define raw as any tobacco which is not part of a living plant, not incorporated in a tobacco product, or not a tobacco product itself.²⁴⁰
- **Operators covered by the excise system.** As a consequence of the proposed definition, the whole tobacco value chain, including growers, would become part of the excise system. Other definitions could be envisaged in

²³⁹ In principle, if a 0 rate was applied to raw tobacco, it could be immediately released for consumption (i.e. after harvesting), thus preventing further monitoring via the excise system. However, based on art. 33 and ff. of the Horizontal Directive, the monitoring tools and documents would still apply when raw tobacco released for consumption is moved or held in MS other than the one where the release took place, thus capturing cross-border movements.

²⁴⁰ Cf. in particular the UK Tobacco Excise Act and the Polish Excise Act.

order to exclude growers, for instance by defining making raw tobacco excisable only after the first processing. However, this possibility should be discarded at an early stage because it clearly appears that part of the problem with illicit trade starts already at growers' level, and because, even if this was not the case, illicit traders could then refocus their activities in the non-monitored part of the value chain.

- **Type of excisability.** Finally, a full excisability is assumed. Determining that raw tobacco should be excised only in certain circumstances (i.e. when sold to non-authorised operators outside of the value chain) would in fact require the setting up of a registry of authorised operators, a situation that is further considered in the option described in Section 4.2.1.1 below.

Table 20 below provides an overview of the relevant impacts, which will be analysed in details in Section 5.2.

Table 20 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Inclusion of raw tobacco under the excise system	<ul style="list-style-type: none"> • Substantive compliance and administrative costs for economic operators 	<ul style="list-style-type: none"> • Increase of costs for growers, first processors, and other raw tobacco intermediaries subject to the excise system. • Increase of costs for manufacturers, since their supplies or raw tobacco become subject to the excise system.
	<ul style="list-style-type: none"> • Crime: illicit trade 	<ul style="list-style-type: none"> • Reduction in the illicit trade of raw tobacco. • Reduction in the illicit trade of tobacco products.
	<ul style="list-style-type: none"> • Tax revenues 	<ul style="list-style-type: none"> • No direct increase in tax revenue from raw tobacco (zero rate). • Indirect recovery of tax revenues on illicit tobacco products.
	<ul style="list-style-type: none"> • Enforcement costs for public authorities 	<ul style="list-style-type: none"> • Additional costs linked to monitoring and auditing an additional excisable product and a new class of economic operators.
	<ul style="list-style-type: none"> • Tobacco control policies 	<ul style="list-style-type: none"> • A reduction in the consumption of illicit products could facilitate the achievement of tobacco control policy goals.
	<ul style="list-style-type: none"> • SME and competitiveness 	<ul style="list-style-type: none"> • Small companies, especially growers, can be disproportionately affected by the compliance and administrative costs. • The competitiveness of the EU raw tobacco industry (growing and first processing segments) could be put at a disadvantage.

4.2.1.1 Options concerning trade of raw tobacco not requiring the revision of Directive 2011/64

Here below, two policy options not requiring a legislative revision of the Directive are described:

- 1) 'stepping-up efforts against the illicit trade of raw tobacco', which aims at improving the enforcement of the current legal requirements; and
- 2) 'considering administrative regulation of the sector' which, based on national best practices and experience, suggests to (re-)introduce at EU level a regulatory framework for the tobacco sector.

➤ **STEPPING-UP EFFORTS AGAINST ILLICIT TRADE OF RAW TOBACCO**

A possible non-regulatory option provides for increasing national enforcement actions against the illicit trade of raw tobacco, both in countries where a specific framework is in place, but also in countries where this is currently not the case. Actions could include:

- 1) voluntary and coordinated commitments by MS to increase controls on raw tobacco operators;
- 2) better exchange of information, especially to track cross-border trade flows;
- 3) better coordination with other monitoring tools, e.g. VAT/INTRASTAT;
- 4) dissemination of national best practices.

In principle, these efforts would help in fighting illicit trade, though the enforcement costs associated and their effectiveness would need to be determined. However, this option has been discarded at an early stage for the following reasons:

- 1) Enforcement policies remain within the national sphere of competence and outside a possible revision of the Directive. MS could, and did, already act in this direction.
- 2) Some of the problems identified depend on the lack of a proper legal framework for monitoring raw tobacco. Additional enforcement efforts were deployed following a stiffening of the underlying legal requirements rather than in isolation.

➤ **CONSIDERING ADMINISTRATIVE REGULATION OF THE SECTOR**

Drawing upon national best practices, the European Commission could propose the reintroduction of a regulatory framework for the tobacco sector, similar to the situation that was in place under the CMO. This option would require a legislative intervention at EU level, but not necessarily a revision of the Directive.

Such administrative regulation would need to cover the following pillars:

- 1) Definition of raw tobacco and of the scope of the regulatory framework in terms of activities (e.g. growing, curing, first processing, trading, transporting, and transforming raw tobacco).
- 2) Registration or authorisation of economic operators intending to deal with raw tobacco, such as growers, first processors, traders, manufacturers.
- 3) Ban on sales for non-authorised operators, or, alternatively, selective taxation when raw tobacco is sold to non-authorised operators. The economic sanctions or the selective taxation should be set at a significant multiple of the commercial value of the product concerned and in line with the corresponding excise on finished products.
- 4) Obligations for growers to enter into a written contract with an authorised first processor or trader before the transplanting phase, with information on the surface dedicated to raw tobacco, the expected yields and, following to the contract closure, the delivered quantity.
- 5) Recordkeeping obligations of the stocks and flows of raw tobacco handled by the authorised economic operators.

The framework could be alternative to the inclusion of raw tobacco within the excise system, but also complementary to it, hence making it possible to consider selective rather than full excisability. This would bring the system close to the current frameworks in Poland and Slovakia, where, based on a definition and a register of authorized operators, raw tobacco is considered excisable only when traded with non-authorized operators.

4.2.2 Raw tobacco put up for retail sale: revision of Art. 5.1.a

Obviously, any option able to curb the illicit trade of raw tobacco would also reduce the availability of raw tobacco for retail sale. However, the problem described above in Section 3.2.4.2 can be tackled not only by limiting its supply, but also by closing the loophole that allows, in certain MS, to sell untaxed bulk tobacco that needs further non-industrial processing to become smokable. This objective could be achieved by revising the definition of smoking tobacco included in Art. 5.1.a, that is 'tobacco which has been cut or otherwise split, twisted or pressed into blocks and is capable of being smoked without further industrial processing'. The issue here is to make sure that any form of tobacco sold at retail which is not smokable, but can become so by means of small refinement, is encompassed in the definition of smoking tobacco, in line with the recent CJEU interpretation.

The Ramboll Evaluation suggests adding the wording 'in a tax warehouse' to the definition, so that all tobacco which does not need further industrial processing, or which may undergo further processing outside of a tax warehouse shall be considered excisable. The rationale would be that most of legitimate manufactures also have a tax warehouse in which tobacco is transformed – though there could be exceptions, as in the case of snus producers.

Another possible solution would be to add a 'put up for retail sale' clause to the definition, making it similar to that of tobacco refuse. In this case, all 'tobacco which has been cut, or otherwise split, twisted, or pressed into blocks' should be excised when put up for retail sale. This would eliminate the problem of operationalising the clause of 'further industrial processing' for retail products, but would open a debate with respect to what should be defined as 'put up for retail', as it is already the case for tobacco refuse. To define 'retail', reference could be made to packaging and quantity, as proposed below in Section 4.2.3 for tobacco refuse. Indeed, in at least one country, the UK, quantity is already among the parameters considered by customs authorities to impose excisability, so that when small quantities of raw tobacco (less than 20 kg) are found, they are considered as 'other smoking tobacco' and taxed accordingly. Retail could be then defined by making reference to a lower (e.g. 20 kg) threshold below which raw and processed tobacco should always be presumed for retail, and a higher threshold (e.g. 80 kg) above which raw and processed tobacco should not be considered for consumer sales. In between, customs authorities would retain a discretionary power, which could be used to tackle 'borderline' cases. As a closing provision, a requirement should be introduced so that if a buyer re-packages raw or processed tobacco into smaller boxes for further sale, this should be considered excisable.

Another possibility to clarify the definition would be the identification of the consignee. By making reference to Art. 6 of the Directive, where the term 'manufacturer' is defined,²⁴¹ Art. 5.1.a. could be updated by stating that 'tobacco which has been cut or otherwise split, twisted or pressed into blocks and is capable of being smoked' should not be considered excisable when it is under the control of or intended for a manufacturer. The attention would then be moved from the quality of the product, to the nature of the consignee.

The Commission could also consider keeping the regulation unchanged while providing MS with a clarification of cases in which the necessary further processing can be presumed to be 'industrial' or not. This could be done by means of non-binding guidelines.

²⁴¹ 'A natural or legal person established in the Union who converts tobacco into manufactured products prepared for retail sale shall be deemed to be a manufacturer'.

Table 21 below provides an overview of the relevant impacts, which will be analysed in details in Section 5.2.

Table 21 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Revision of the definition of smoking tobacco provided in Art. 5.1.a	<ul style="list-style-type: none"> • Legal certainty for economic operators and public authorities 	<ul style="list-style-type: none"> • Improved legal certainty for legitimate traders of raw tobacco.
	<ul style="list-style-type: none"> • Substantive compliance and administrative costs for economic operators and enforcement costs for public authorities 	<ul style="list-style-type: none"> • Possible costs to adapt to the new definition.
	<ul style="list-style-type: none"> • Tax revenues 	<ul style="list-style-type: none"> • Recovery of tax revenues on raw tobacco put up for retail sale.
	<ul style="list-style-type: none"> • Crime: illicit trade 	<ul style="list-style-type: none"> • Reduction of current illicit trade. • Pre-emption of new 'borderline' products.

4.2.3 Tobacco refuse: revision of Art. 5.1.b

Art. 5.1.b defines 'tobacco refuse put up for retail sale [...] and which can be smoked' as smoking tobacco, and thus includes it among excisable products. Conversely, tobacco refuse which is either not smokable or sold in bulk is not considered smoking tobacco. The magnitude of the regulatory problem identified with respect to this definition is small, with only one case of misclassification reported, and the emerging problem of the retail sale of tobacco refuse in Sweden. Also, issues concerning the diversion of tobacco refuse to illicit trade are considered as minor to negligible.

Of the two-prong test enshrined in Art. 5.1.b, the problem does not seem to lie in the 'smokability' clause. As witnessed by customs authorities and also confirmed by several economic operators, there is a class of tobacco refuse which can be smoked in a pipe for testing purposes, if consumer experience is not taken into account. To bring more clarity, the smoking test has just been codified and ring-tested,²⁴² and, apparently, it does not create problems in its application to tobacco refuse, or high enforcement costs.²⁴³ Hence, the attention should focus on the 'put up for retail' clause. Indeed, both economic operators and public authorities expressed concerns about its legal clarity. The regulatory option would then concern a better definition of when tobacco refuse should be considered for bulk or retail sale.

Two avenues for clarification can be explored:

- 1) First, retail vs. bulk sale could be defined depending on the nature of the economic operators to which tobacco refuse is sold. When sold to tobacco manufacturers (including of reconstituted tobacco) or other manufacturing industries (e.g. cosmetics or nicotine producers), it could be presumed that tobacco refuse is not put up for retail. This definition would imply a verification not of the physical quality of the good and of its packaging / way of transport; rather, the customs authority should verify the nature of the consignee.

²⁴² Cf. Explanatory notes 2016/C 121/05, Annex A.

²⁴³ Cf. DG TAXUD, "Customs 2020 Report CLEN Action 2 Ring test on tobacco products, Discussion meeting 20 October 2015, Budapest, Hungary".

- 2) Alternatively, retail vs. bulk sale could be defined based on the physical property of the transport itself, that is the way in which tobacco refuse is shipped. Usually, it travels in 140 to 220 kg cartons – the exact weight depends on the type of refuse – without any further internal packaging (e.g. bags, pouches, or tins). To the contrary, there would be hardly any legitimate reason for a manufacturer to purchase tobacco refuse sold in small packages. However, setting a precise quantity limit to distinguish bulk from retail could give room for illicit players to play around, and thus market tobacco refuse in ‘borderline’ packages, just slightly above the limit. For this reason, it is suggested to introduce a double threshold: when sold in small packages (e.g. 5 kg or less)²⁴⁴ tobacco refuse should be considered as put up for retail sale; when sold in large packages (e.g. 100 kg or more), tobacco refuse should be considered as sold in bulk. In between, a margin of manoeuvre would be left to customs authorities, to control and eventually seize or impose excises on shipments which could be considered illicit or borderline. Also, a requirement should be introduced so that the buyer cannot re-package a bulk of smokable tobacco refuse into smaller boxes for sale, otherwise it should automatically lose the non-excisability.

This clarification could be achieved by means of a legislative revision, or the publication of non-binding Commission guidelines. At present, the Directive does not provide the legal basis necessary to adopt secondary norm, such as Commission Regulation. The case of tobacco refuse definition is an example where such approach may be effective. Should the Directive be revised, policy-makers may consider to introduce this instrument since this would allow in the future to deal more flexibility with issues of this kind.

To the contrary, the option to remove the words ‘put up for retail sale’ from article 5.1.b, i.e. to include all smokable tobacco refuse among excisable products, should be discarded at an early stage, because the magnitude of the regulatory problem identified does not justify such a radical intervention. Truly, this would eliminate any uncertainty on the treatment of smokable tobacco refuse, but its value, which amounts in average to 0.50 €/kg, is too small for operators to bear the costs associated with the excise system. As reported by economic operators, at that point tobacco refuse would become too costly to store and transport, and it would be discarded or re-used in-house (in case of manufacturers’ waste). Also, the OPC showed limited support for this option (33% of supporters against 45% of respondents who did not agree with the proposal). Another option which could have similarly large impacts would be to require that tobacco refuse does not travel in a ‘smokable’ form, so that the parts of tobacco waste that are fit for smoking should be further cut or ground before shipping. However, again, the magnitude of the problem identified and its current potential would not justify such a measure on a proportionality ground.

Table 22 below provides an overview of the relevant impacts, which will be analysed in details in Section 5.2.

²⁴⁴ The CN code distinguishes between tobacco refuse sold in packages below 500 grams and above. However, given the progressive increase of size of FCT boxes, especially for MYO and MYV product, that threshold is considered as too low to provide a sufficiently low risk that a product could not be diverted to consumers.

Table 22 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Definition of the clause 'put up for retail sale' for tobacco refuse	<ul style="list-style-type: none"> • Legal certainty for economic operators and public authorities. 	<ul style="list-style-type: none"> • Improved legal certainty for traders of smokable tobacco refuse.
	<ul style="list-style-type: none"> • Administrative costs and cost savings for economic operators and enforcement costs for public authorities. 	<ul style="list-style-type: none"> • Possible costs caused by the need to adapt to the new definition.
	<ul style="list-style-type: none"> • Crime: illicit trade. 	<ul style="list-style-type: none"> • Reduction of the potential for illicit trade of tobacco refuse.

4.3 'Borderline' Cigarillos

4.3.1 Reduce the incentive for 'borderline' cigarillos

The baseline situation assessment conducted in Section 3.3 showed that the issue of tax-induced substitution of cigarettes with 'borderline' cigarillos with similar characteristics have been largely and effectively addressed over the past few years with the implementation of a revised product definition (and the end of derogations for DE and HU), and with the adoption by MS of appropriate tax structures and rates reducing the incentives for low cost products. With few modest exceptions (RO, SK and SL), the market of cigars and cigarillos is declining in all MS and there are no signs this trend is going to reverse soon.

On the other hand, low-cost products with characteristics similar to cigarettes, including products manufactured and branded by big tobacco companies, are still commercialised in various EU countries. Germany and Spain remain the most developed markets for these products, but in various other countries the consumption is modest but not negligible. Estimates on consumption patterns and other evidence suggests that as long as there is a significant price difference, some consumers may be tempted to switch from cigarettes to cheaper cigarillos products. The softer rules that the TPD2 imposes on these product may in the future represent an additional incentive to switch. In this respect, possible options may be considered to prevent that an excessive tax differential gives new stimulus to substitution processes.

Specifically, two regulatory options for the revision of Directive 2011/64 have been identified in the initial phase of this Study, in accordance with the Commission's Inception Impact Assessment, namely:

- 1) Introducing a **mandatory mixed rate structure or specific rate** (per 1 000 pieces) for cigars and cigarillos.
- 2) **Aligning the minimum excise duty** of cigars cigarillos with that of manufactured cigarettes.

A third option consisting of creating a separate category for 'borderline' cigarillos was discarded at an early stage given the impossibility to operationalise a distinction between 'borderline' cigarillos and other filter cigarillos of similar size, without making recourse to highly subjective and potentially arbitrary criteria.

Option (1) is motivated by the fact that an *ad valorem* structure weighs comparatively less on cheaper products, thus providing an advantage to 'borderline' cigarillos. Indeed, these products have become popular especially in MS where a fully *ad valorem* taxation provided them competitive advantage, such as ES, HU, PT etc. However, overtime the national tax regimes have evolved and today only three countries have a pure *ad valorem* structure, namely: Finland, the Netherlands, and Greece. All other countries, have introduced a MED or have switched to a mixed structure. In this respect, the rationale for this option appears thin. The three countries that have to switch to a mixed structure includes one (FI) where the problem is not reported, and another (NL) where it is reportedly limited. In Greece, low-price cigarillos seem more widespread but the consumption is steadily declining since 2010 and – if need be – it is always possible for Greece to introduce a MED, like Spain and Portugal recently did. Other countries like BE, IT, HU, ES, PT, LU and SI, would have to change their *ad valorem* structure into a mixed structure, although they have already introduced a MED that effectively addressed the issue of 'borderline' products. However a mixed structure would be less effective than a MED in tackling low cost products and may result in an increased tax burden also for the entire category. For these reasons, option (1) seems to respond poorly to the problem identified and therefore it is not developed further.

Option (2) seems in principle more coherent with the objectives of reducing the incentive for 'borderline' cigarillos that lies precisely in the tax differentials between them and manufactured cigarettes. In its Inception Impact Assessment the Commission formulated this option in the following terms: "[to] align the minimum of excise taxes (i.e. through a mechanism similar to the MED on cigarettes) on other product categories with those of cigarettes". The option derives from the findings of Ramboll Evaluation, which identified as a possible solution to the issue of 'borderline' products "a high ad valorem with a MED for cigars /cigarillos equal to the MED (or the excise tax applicable at the level of the WAP) for cigarettes".²⁴⁵ This finding seemingly reflected the positive experience of certain MS with the voluntary use of MED to control 'borderline' cigarillos, and suggest its systematisation as a mandatory mechanism to be included in a revised Directive.

Before analysing the impact of this option it is important to clarify certain aspects of the current formulation that seem problematic, and to elaborate a more plausible approach. First of all, it has to be considered that the adoption of a MED on cigarettes (Art. 8(6)) is optional and its transformation into a mandatory rule is not on the agenda. In this sense, 'pegging' a mandatory MED on cigars and cigarillos to the voluntary MED on cigarettes is not feasible. Secondly, the alternative approach of setting the MED for cigars and cigarillos at the level of excise applied to cigarettes at the WAP level is also problematic since it would deprive MS of the freedom to establish separate tax regimes based on the specificities of the domestic markets and their needs. It would also add a layer of complexity and unpredictability in the calculation of the excise duty payable by cigars/ cigarillos that would be poorly acceptable since it would be based on the market dynamics of a different product. The same considerations would apply in case of a more straightforward alignment with the minimum overall excise for cigarettes (Art. 10).

Going back to the policy purpose of this hypothetical regulatory change, it should be borne in mind that the aim is to avoid that there are cigarillos on the market significantly cheaper than cigarettes and able to induce a certain level of substitution. Evidently, prices cannot be regulated, but it can be assumed that, especially at the bottom segments of the market, any tax increase would be entirely passed on the retail sale price. Establishing an equivalence between the minimum excise levied on cigarettes and that on cigarillos would however not lead to the approximation of price levels since notoriously the production costs of cigarillos – even machine made – are much higher than for cigarettes, and they have certainly increased since the requirement of a natural tobacco wrapper entered into force. Precise estimates are not available (and they would change case-by-case depending on the manufacturer), but based on stakeholders' feedback it can be assumed that in order to be sustainable, the revenue after tax (comprising industry and trade) for cigarillos should be twice as much as for cigarettes. This means that applying the same excise amount to cigarettes and cigarillos may lead to very different price levels, which is beyond the objective of the regulatory revision and would contradict previous policy orientations on the importance of production costs in determining the tax rate for cigars and cigarillos.

All in all, and considering the existing uncertainties, a hypothetical fair approach to the matter would therefore consist in establishing a minimum MED for cigars and cigarillos, not explicitly pegged to the excise level of cigarettes and determined taking into account the greater production costs of these product and their tax bearing capacity. This MED may be established in the revised Directive in a way that does not distort any individual MS market, and MS should be free to increase it as they deem necessary, based on their policy needs. In a way, this approach would be tantamount to revise the rates established under Article 14.2(a), but with the advantage of

²⁴⁵ Ramboll Evaluation (2014), p.61.

minimising unintended effects for products falling outside the aim of the revision. The option may or may not include a fixed amount.

Table 23 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Establishment of a MED on cigars and cigarillos to deter the commercialisation of potential substitutes of cigarettes	<ul style="list-style-type: none"> Market Development 	<ul style="list-style-type: none"> A negative impact on the sales of low-price cigarillos. Certain products may eventually disappear of the market.
	<ul style="list-style-type: none"> Tax revenues 	<ul style="list-style-type: none"> Reduced substitution may reduce 'tax gap' (but only part of consumers would go back to cigarettes). 'Borderline' cigarillos may disappear so limited tax revenues can be expected.
	<ul style="list-style-type: none"> Unintended effects on competition 	<ul style="list-style-type: none"> The provision would affect all cheap cigarillos, regardless of their characteristics ('borderline' or not).

4.3.2 Harmonise excise product definition and CN definitions

The disparities in the definition of cigars and cigarillos used in the excise product definition and CN classifications, combined with the impossibility to code certain product differently in the EMCS may be a source of legal uncertainty, disputes and EMCS malfunctioning. It must be said that the extent and the frequency of concrete issues is limited but it nonetheless constitutes an unnecessary burden for economic operators and customs authorities alike. The matter has been dealt with so far on a case-by-case basis through BTIs, but more structured solutions can be envisaged, in particular:

- Revision of Art. 4.1(a).** To bring article 4.1 (a) in line with the corresponding CN explanatory notes, i.e.: "(a) an outer wrapper of natural tobacco covering the product in full including, where appropriate, the filter (but without any further layer partially covering the outer wrapper), but not, in the case of tipped cigars, the tip;" Typically, 'borderline' cigarillos have a further layer of paper covering the natural wrapper at the level of the filter, but also other ordinary cigarillos may have it, so this cannot be considered as a distinctive feature. This option would require all these products to remove this additional layer otherwise they would be consistently taxed as cigarettes. To what extent this may deter consumers from switching is difficult to say, and it cannot be excluded that certain manufacturers will develop new ways to maintain the visual similarity with cigarettes.
- Adaptation of EMCS.** A pragmatic alternative is to fix EMCS so as it allows to enter a CN code and an EPC code²⁴⁶ that correspond to different categories of products under the two different classifications, which would be in line with the existing legislation. This may appear not ideal when it comes to reconciling data, but EMCS is not used to this end. This measure could be implemented at very limited costs and without a legislative amendment. However its technical and legal feasibility has to be ascertained.

²⁴⁶ In accordance with Annex II of Commission Regulation No 684/2009

4.4 Fine-Cut Tobacco, including Roll-Your-Own and Make-Your Own

To address the problems identified in Section 3.4 above, two regulatory policy options have been considered:

- 1) The approximation of minimum excise levels of FCT and FMC, presented in Section 4.4.1.
- 2) The introduction a new tax category for MYO, presented in Section 4.4.2.

4.4.1 Approximation of taxation of FCT and FMC

The Commission could raise minimum excise level of FCT to approximate it further with respect to FMC by means of a legislative revision. This regulatory option would aim at reducing tax-induced market distortions, securing tobacco control goals, and ensuring the stability of tax revenues.

The minimum excise level depends on two parameters: the approximation rate chosen, and the conversion rate between FCT and FMC established. The Consultants opted for three approximation rates: 66%, which is the current level aimed at by the Directive, 100%, which corresponds to full alignment, and an intermediate scenario, set at 80%. With respect to the conversion rate, two values are taken into consideration in the analysis: 1g per stick equivalent, which is the current implicit value, and 0.75g per stick equivalent, which is the conversion rate the industry mostly apply, as emerged from fieldwork interviews. This results in six scenarios for further assessment, summarised in **Table 24** below.

Table 24 – Scenarios for the policy option

FMC minimum excise duty	Approximation rate	FCT minimum excise duty	
		Conversion rate: 1g per stick equivalent	Conversion rate: 0.75g per stick equivalent
90 €/1000 pcs	66%	€/kg 60	€/kg 80
	80%	€/kg 72	€/kg 96
	100%	€/kg 90	€/kg 120

The approximation of minimum levels does not necessarily correspond to the approximation of the total tax burden (TTB) on FCT and FMC, since the actual rate applied by MS often depart from the minima established in the Directive. In this sense, the real differential between FCT and FMC is determined by national policies and the Directive may only influence it. For this reason, in the impact analysis section, an assessment of the approximation of real TTB is also conducted based on the same six scenarios described above. While this analysis does not concern a Directive revision in strict sense, it may provide useful estimates of the impact of a change of national policies.

Table 25 below provides an overview of the relevant impacts, which will be analysed in detail in Section 5.4 below.

Table 25 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Approximation of taxation of FCT and FMC	<ul style="list-style-type: none"> Market effects 	<ul style="list-style-type: none"> Increase in the taxation is expected to reduce the demand for FCT and increase the demand for cigarettes or other cheap tobacco products.
	<ul style="list-style-type: none"> Tax revenues 	<ul style="list-style-type: none"> Variation in the consumption of FCT and FMC will affect tax revenues (both increases and decreases are possible).
	<ul style="list-style-type: none"> SME competitiveness 	<ul style="list-style-type: none"> The FCT sector presents a higher density of SME compared to the FMC sector, which may be thus more than proportionately hit by the reduction of the demand.
	<ul style="list-style-type: none"> Cross-border approximation 	<ul style="list-style-type: none"> Higher minimum excise levels on FCT would decrease tax differentials across MS.
	<ul style="list-style-type: none"> Tobacco control policy 	<ul style="list-style-type: none"> The increase in taxation of FCT may reduce overall consumption of tobacco products.
	<ul style="list-style-type: none"> Crime 	<ul style="list-style-type: none"> Part of current FCT consumers may resort to illicit products.

4.4.2 Introduction of a separate tax regime for MYO

The second option considered is the possibility to introduce a separate tax category for MYO products. The rationale would be twofold: (i) to tackle a fast-growing tobacco market segment, hence curbing consumption and thus better enabling tobacco control policies; and (ii) to compensate for the tax revenue loss due to substitution of MYO-Volume products, subject to a lower taxation per stick.

However, from the fieldwork, the following considerations emerged:

- 1) There is a limited appetite by MS for introducing a new tax category for MYO, which is, in most cases, not perceived as a threat to tobacco control policies or budget revenues.
- 2) There is hardly any precise information, let alone any consensus, on the exact differentiation between RYO and MYO, as products may vary depending on producer strategies and consumer preferences.

To introduce a new tax category for MYO, the cut width would seem the most reliable basis for its definition, because: (i) customs laboratories are already used to measure cut width to differentiate FCT from 'other smoking tobacco'; (ii) it does not change with time (unlike humidity); (iii) it is less variable than the share of expanded tobacco or other commercial claims. However, boundaries between RYO and MYO are currently vague and depend on each producer's commercial strategies. MYO products exist on the market with a cut-width similar to RYO. Should a clear boundary be introduced, it can be expected that products will be reformulated in an attempt to escape higher tax rates, resulting in the creation of 'borderline' situations, which could then affect also MS in which MYO is not at all significant at this stage.

Most importantly, tax-induced substitution seems to concern FCT as a whole, rather than specifically MYO. There are markets in which the entry and fast growth of the MYO and MYO-volume segments did not translate into a growth of the FCT market (e.g. France from 2012 onwards), as well as markets in which the FCT market experienced a significant growth, but the presence of MYO and MYO-volume remained marginal (e.g., Italy and France). Hence, the current tax system does not seem to distort market competition in favour of MYO. This is confirmed by the fact that the IIA does not include MYO among the categories for which a regulatory intervention is considered.

For these reasons, the Consultants consider that defining a new tax category within FCT is not justified at this stage, and recommend further monitoring of trends in the RYO, MYO and MYO-Volume segments, encouraging MS to collect sufficiently granular information.

4.5 Water-pipe Tobacco

As detailed in Section 3.5.2, two main issues have been identified in connection with the EU WPT market. Firstly, the knowledge of the market is very limited, due to its significant illicit share and to WPT being classified and therefore monitored together with other products falling within the residual category of 'other smoking tobacco'. Secondly, a large share of WPT consumed in the EU is estimated to come from illicit sources – such as international smuggling and bootlegging – thus evading taxes. This results in revenue losses for national administrations, and in competitive disadvantages for 'good players'.

In line with the Inception Impact Assessment,²⁴⁷ one policy option has been taken into consideration, namely the creation of a new, separate excise category specifically for WPT. This solution may allow a more effective monitoring of the WPT market, addressing the current information needs. Moreover, it may allow to modulate the WPT tax rate as deemed necessary to remove the incentives for illicit trade, while avoiding that a tax reduction may translate into a greater consumption. At the same time, however, there is a risk that a separate tax category may create unintended incentives for 'borderline' products, aiming at exploiting eventual classificatory loopholes.

The creation of a new category may in principle generate administrative burden for national competent authorities, linked to the need to adjust the existing excise system and to carry out the product tests that may be required. However, interviews with various national tax authorities indicate these costs would be negligible and are therefore excluded from the analysis.

Table 26 – Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Introduction of a separate tax category for WPT	<ul style="list-style-type: none"> Monitoring and control 	<ul style="list-style-type: none"> Improved monitoring of WPT market trends. Better enforcement and contrast to tax evasion.
	<ul style="list-style-type: none"> Market functioning 	<ul style="list-style-type: none"> Reduction of illicit trade and of competitive disadvantages for 'good players'.
	<ul style="list-style-type: none"> Tax revenues 	<ul style="list-style-type: none"> Possible increase of tax revenues as a result of reduced illicit trade, but mitigated by lower revenues from licit trade.
	<ul style="list-style-type: none"> Legal and administrative certainty 	<ul style="list-style-type: none"> Risk of 'borderline' products development, and classificatory uncertainties.

²⁴⁷ IIA, Option 1(d), page 5, 2016.

4.6 Minimum Excise Duty on Cigarettes

A reduction of the legal uncertainty linked to the current formulation of the MED provisions could be brought about by means of legislative revision or non-binding guidelines. The two options are presented here below.

4.6.1 Clarification of the nature of the MED by means of a legislative revision

The possible conflict between the MED and the mixed structure requirements could be tackled by in opposite directions:

- 1) The revision could consolidate the *status quo* by confirming that a MED higher than the excise duty at WAP is not *per se* breaching the mixed structure requirements (and also clarifying when a breach occurs) This corresponds to the dynamic baseline scenario, since the existing MS interpretations also include the imposition of a MED higher than the excise duty on WAP.
- 2) The revision could specify that the MED shall be considered as equivalent to a specific form of taxation, and hence it should be limited to 100% of the excise duty on WAP, because of the need to respect the mixed structure requirements. This corresponds to the policy change scenario.²⁴⁸

Impact areas concerned and the expected effects are summarised here below in **Table 27**.

Table 27 - Overview of impact areas of the proposed policy option

Regulatory Option (Revision of Directive 2011/64)	Impact Areas	Nature of Impact Expected
Clarification of the nature of the MED	<ul style="list-style-type: none"> • Market effects 	<ul style="list-style-type: none"> • Variation to the MED could lead to changes in the cigarette market structure. • Lack of a limit could lead to the MED to cover all or most of the cigarette market.
	<ul style="list-style-type: none"> • Tax revenues 	<ul style="list-style-type: none"> • Variation in the MED regime could affect revenue stability.
	<ul style="list-style-type: none"> • Tobacco control policy 	<ul style="list-style-type: none"> • Variation in the MED regime could change entry price of cigarettes.

4.6.2 Clarification of the nature of the MED by means of non-binding guidelines

Another possibility for the Commission would be to keep the current formulation unchanged and to adopt non-binding guidelines to clarify the MED provisions and their relation with the mixed structure requirements. However, this option has been discarded at an early stage based on the feedbacks received from public authorities of the MS. With respect to the policy objective described in point (2) above (Section 4.6.1) a non-binding document would be evidently insufficient / inappropriate to establish a 100% of WAP limit in the application of the MED. With respect to policy objective (1) above, i.e. consolidation / clarification of the status quo, guidelines may be adopted but it would be largely pointless, since MS would like the MED implementation to remain flexible and adjustable to country needs and, in case, they would be reluctant to modify their approaches based on a non-binding document.

²⁴⁸ The analysis does not consider the options which were already considered incompatible with the 'letter and the spirit' of the Directive by the CJEU, such as the super-MED.

5 IMPACT ANALYSIS OF POLICY OPTIONS AND COMPARISON

5.1 New Products

5.1.1 Impact Analysis of Harmonising Taxation of E-cigarettes

5.1.1.1 Administrative and Compliance costs of Harmonisation

The first aspect to consider in the event of an introduction of a new harmonised category for e-cigarettes regards the possible extra burden it may impose on economic operators and public authorities for its administration and enforcement. These costs would exist regardless of any positive tax charge, whose effects are analysed further below. For the analysis of these costs it is useful to distinguish between the costs incurred by public authorities and the costs for economic operators.

➤ ADMINISTRATIVE AND ENFORCEMENT COSTS FOR PUBLIC AUTHORITIES

The initial cost for introducing a new harmonised category in the country system is generally viewed as modest and non-quantifiable by the tax authorities of the MS analysed.²⁴⁹ It would essentially consist of adapting the regulatory framework and the administrative system by adding a new code, and developing guidance and instructions for its implementation. As national excise systems are in constant evolution, these one-off changes would be incorporated in the ordinary administrative processes of the competent authorities and would reportedly not lead to a noticeable increase in the related burden.

More substantial costs can be expected from the regular administration of the new tax, i.e. collection costs, tax-payer services, and the continuous maintenance of the excise system. As a benchmark for anticipating the scale of these costs, reference can be made to the comprehensive work of the OECD Forum on Tax Administration.²⁵⁰ Based on this OECD survey, the average collection cost – intended as the ratio of administrative costs and revenues – can be estimated at 1.1% in a large sample of EU countries. In the event of a zero tax rate (as in the case of Croatia) this component can obviously be neglected, but in the case of a positive tax, the applied rate should at least cover these collection costs. In this sense, a zero rate would probably be more cost-efficient to administer than a very light tax.

The enforcement of a harmonised tax on e-liquids would face in principle the same challenges of conventional tobacco, worsened by some product-specific features. As for tobacco, the adoption of an EU-wide tax would require an appropriate level of control over illicit trade and fraud, which in the case of e-cigarettes would likely regard the smuggling of high concentration nicotine for the illicit manufacturing or self-preparation of nicotine-containing liquids from nicotine-free ones. As compared to tobacco, nicotine would be significantly more difficult to seize, due to its size and anonymous appearance. It is sufficient to consider that one litre of pure nicotine with

²⁴⁹ The Ramboll Evaluation could not provide a systematic assessment of the regulatory costs for competent authorities connected to the EU excise systems. Administrations do not generally have activity-based reports with such degree of granularity. The authorities consulted were therefore not in the position to provide an estimate of the possible additional administrative costs of extending the excise system to e-cigarettes, but all of them concurred they would not represent a relevant impact. Moreover, various counterparts clarified that it would be very difficult to extract activities related to this process from the constant flows of system updates and staff trainings that characterised tax administration. No separate budget would be allocated to specific tasks like this.

²⁵⁰ OECD, "Tax Administration 2013", produced by the Forum on Tax Administration. It is a unique and comprehensive survey of tax administration systems and practices across 52 advanced and emerging economies (including all OECD, EU, and G20 members). <https://www.oecd.org/ctp/administration/tax-administration-series.htm>

99% concentration may cost less than € 500, and allows to prepare some 10,000 bottles of 10ml of e-liquid (conservative estimate). In a MS like Italy with a tax rate of € 0.385 per ml, only one litre of smuggled nicotine may translate into a potential tax evasion of €38,500. At the same time, the high level of fragmentation would impede establishing anti-fraud agreements with the industry, as for conventional cigarettes.

All MS currently applying a national tax on e-cigarettes are facing issues with the control of movements of non-duty paid products across the border or through online outlets, as well as under-the-counter mixing practices. This has emerged as one of the main causes for the limited tax revenues collected e.g. in IT, PT and LV. On the other hand, the level of effort needed to effectively tackle e-cigarettes tax evasion in these countries seems disproportioned if compared to the size of this market and to the more significant issue of tobacco tax evasion.

➤ **SUBSTANTIVE COMPLIANCE AND ADMINISTRATIVE COSTS FOR ECONOMIC OPERATORS**

The inclusion of e-liquids among excise goods would extend the provisions of Directive 2008/118 to these products as well, including among other things information obligations such as the need for economic operators to obtain an authorisation, as well as substantive obligations, such as requirements on holding and storing products. The extension of these rules to e-liquids would add-up to the recent entry into force of TPD2, which also introduced new norms regulating notification and commercialisation of products and registration of operators.

For the analysis of the potential regulatory burden that the tax harmonisation would bring to operators, two recent evaluations provide relevant benchmarks and estimates, i.e. the Evaluation of Directive 2011/64 (2014) and the Evaluation of Directive 2008/18.²⁵¹ These sources have been triangulated with results from interviews with economic operators in MS already applying a national tax.

The aggregated estimates provided in **Table 28** are based on the assumption of a number of 'manufacturers' (both producers and importers, and not including retailers) in the EU comprised between 1,000 and 2,000 players. At present, due to the absence of specific registration and authorisation requirement, some small operators are engaged in both retailing and small-scale manufacturing (mixing of third party products). Should a specific authorisation become necessary, some of them would probably discontinue the small-scale manufacturing and stick to the retail activity. A certain consolidation can be therefore expected.

Table 28 – Estimated impact of regulation on economic operators

Activity	Estimated impact
Pre-authorisation of economic operators (including tax warehouse keeping) – Information Obligation	<ul style="list-style-type: none"> According to the Ramboll Evaluation, the time spent on this activity can be significant, ranging from 1 to 20 days for a first-time authorisation or for the renewal (depending on the countries). The evaluation of the Horizontal Directive suggests 7 man/days as a plausible average parameter Assuming an average labour cost (including overhead) of € 150 / day, the aggregated administrative cost for the entire EU industry would be between €1.0 mn and €2.0 mn.
Production/Holding/Storage of tobacco products – Substantive Obligation	<ul style="list-style-type: none"> Setting up a tax warehouse in MS that already require it (e.g. Italy) may cost some €5,000 to € 10,000 for a small player (the vast majority of e-cigarettes operators). Assuming a proper depreciation period, this may translate into substantive compliance costs of more than € 1,000 / year – i.e. €1.0 to

²⁵¹ Ramboll Management Consulting, "Evaluation of current arrangements for the holding and moving of excise goods under excise duty suspension", DG TAXUD, 2015. Hereinafter 'Evaluation of Horizontal Directive'.

Activity	Estimated impact
Recordkeeping duties – Information Obligation	<p>€2.0 mn EU-wide.</p> <ul style="list-style-type: none"> In the case of tobacco, the administrative costs of carrying out all activities related to the production and storing have been estimated to be between 1 and 4 FTEs on a permanent basis (record keeping, notification and reporting). The level of operations of the tobacco industry is obviously much greater than for the e-cigarettes industry. Moreover, e-cigarette operators confirmed they already carry out much of these activities as part of their ordinary business. Assuming an incremental cost of 0.3 FTE per business on a permanent basis the overall impact would be some € 10 mn - € 20 mn per year.
Trade and logistics of tobacco products – Information Obligation	<ul style="list-style-type: none"> With the tax harmonization, the movement of e-liquids under duty suspension would require the utilisation of the EMCS system. In terms of possible burden two aspects have to be considered: (i) the investment to set up and maintain the system; and (ii) the costs of operating it. The Evaluation of Directive 118/2008 estimates the set up and operating costs of the system to be relatively affordable for SMEs, i.e. between € 600 and € 1,200 / year (including depreciation) – i.e. some € 1.0 to € 2.0 mn for the entire industry.²⁵² Operating EMCS may require some 12 staff/minute per single operation, i.e. some €3.8 on average. This is a negligible administrative cost for tobacco companies, also given the large dimension of average shipments. It is difficult to predict the number of EMCS operations that the e-cigarettes industry may generate. A handful of major B2B operators with significant cross-border trade may perhaps have to use EMCS on a daily basis, but for the majority of micro to small players shipments through EMCS would be a rare occurrence. Assuming on average one shipment per week per company the total cost would be of € 0.2 – 0.4 mn. However, the introduction of EMCS has generally reduced the administrative costs of logistics for operators, therefore in this area savings may eventually exceed costs.
Financial Guarantees – Information Obligation	<ul style="list-style-type: none"> The Evaluation of the Horizontal Directive showed that MS apply a variety of different methods for calculating and applying the financial guarantees requested to operators. These may primarily regard (i) stocks, with requested guarantees often amounting to 10% of the value (but up to 100%); or (ii) movements, calculated as a certain fraction of daily/monthly/or yearly movements under duty suspension. Some MS (e.g. RO) already require a financial guarantee from e-cigarettes operators in relation with their amount of stocks. Assuming an average overall guarantee of 15% (for simplicity applied to the entire stock value and including also the guarantee on movements), and a fee of 1% applied by banks to SMEs, the total yearly administrative cost for the industry would be between €3.0 and €4.0 mn.

Based on the above estimates, the aggregated regulatory costs for economic operators potentially stemming from information and substantive obligations would amount *ceteris paribus* to some € 15 – 30 mn / year, i.e. some € 15,000 per business or some 1.3% of the current market value. These impacts refer to a typical small business, since the majority of e-cigarettes businesses hardly reach 15 employees²⁵³. As long as they enter or expand their activities in this segment, also big tobacco

²⁵² The Ramboll Evaluation put forward much greater estimates, most likely in connection with the much larger size of tobacco companies.

²⁵³ Relatively larger 'independent' manufacturers are emerging also in this area, e.g. Gaiatrend (FR), Flavourart (IT), Cut Ice (UK), to name a few.

companies would have to cope with these requirements, but even if certain investment may result more expensive than for SME it can be reasonably assumed that regulatory costs would represent a minor obstacle to these large players, especially since they are already under the excise system. In this sense, large player may eventually enjoy a certain competitive advantages from increase market entry obstacles. For certain micro companies with up to 3 employees the amount of administrative and substantive costs may be non-negligible, especially since they very recently had to cope also with the TPD2 compliance costs. An assessment of such costs have not been conducted yet, but anecdotal evidence collected from interviews suggests it ranges between € 50,000 and € 500,000 per business. In this sense, in the event of a tax harmonisation with a low or zero minimum rate, tax regulator may consider extending exemptions or introducing a simplified regime for operators below a certain size, as it is done for instance for certain alcohol products.

Finally, it is important to consider that the ultimate impact on economic operators may vary significantly from MS to MS depending on the national rules for the excise system, and any possible 'goldplating' MS could apply. For instance, in MS where the distribution of tobacco is subject to a State monopoly, the inclusion of e-cigarettes among excise goods may pose questions on whether the current vape-shops would be still be able to sell these products or whether their distribution would have to be restricted to licensed tobacconists. A similar rule adopted recently in Hungary has eliminated specialized shops and reportedly e-cigarettes are currently difficult to find on the market.

5.1.1.2 Market effects and tax revenue

This Section focuses on the possible market impacts of a harmonised 'positive tax' (i.e. nonzero) on e-liquids, and the corresponding tax revenue levels that can be expected. As detailed in the previous Sections, there is a lack of detailed and robust data on the e-cigarettes market, making a rigorous econometric assessment with statistical significance unfeasible. On the other hand, a series of estimates more or less accurate have been collected in the course of the Study from a number of direct (interviews, OPC) and indirect (scholars' articles, industry reports, commercial databases) sources. These estimates have been weighted in order to draw plausible assumptions about the key variables needed to estimate the potential market effects of a harmonised positive tax, namely: volume of sales, price levels, and elasticity of demand. The simplified model developed in the following pages presents a high degree of uncertainty in all these variables, and for this reason an interval of confidence in strict sense could not be calculated. Still, the approach utilised is consistent with the methodology used by other analysts and researchers for similar simulations,²⁵⁴ and may provide decision-makers with a reasonable prediction of the likely impact of a positive tax on e-cigarettes.

The analysis focuses on the economic and fiscal impact of a non-marginal minimum tax. The possibility of introducing a harmonised tax with a zero or very low rate has not been assessed in this Section since it would not affect price levels and therefore consumer demand. In other words, it would be tantamount to the current no tax scenario. In particular, two scenarios have been developed:

- A moderate minimum tax of **€ 0.10 per ml** of nicotine-containing liquid. This is the tax band adopted for instance in Romania and Greece and, as described below, corresponds approximately to the possible price increase of 20% investigated in the OPC.
- A high minimum tax of **€ 0.30 per ml** of nicotine-containing liquid. This is the tax band adopted in Portugal (since 2017) and Finland, and is somehow halfway the

²⁵⁴ Some examples are available in the papers submitted along with the OPC questionnaire.

level of Italy and that of Hungary and Slovenia. It corresponds to a price increase that is slightly in excess of the +50% scenario investigated in the OPC

➤ **PRICE LEVEL**

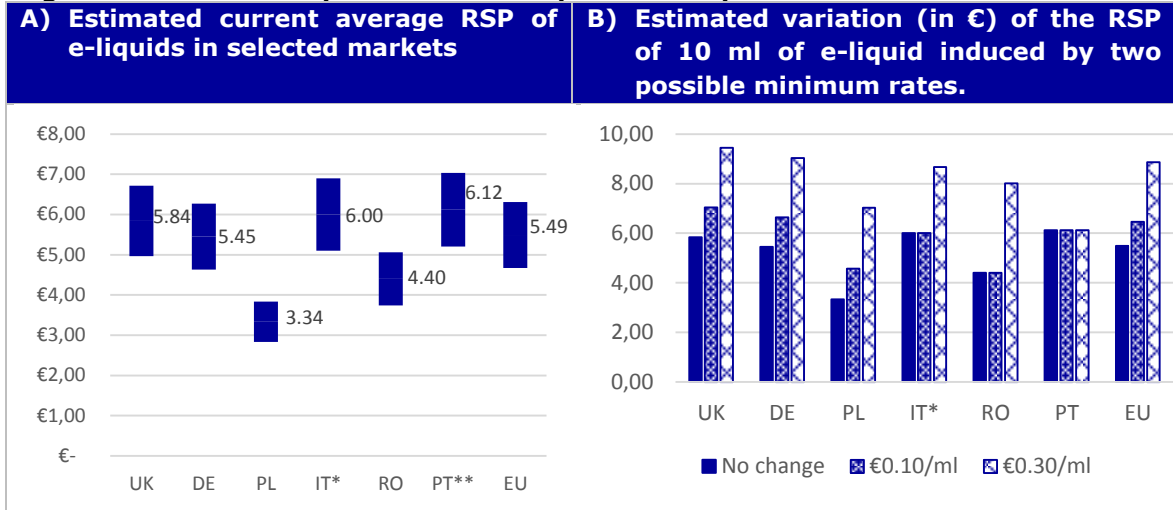
The introduction of a minimum tax on e-liquids would have in the first place an impact on price levels. Interviews with economic operators largely confirmed that they would have to pass-on to consumers any increase in their costs that may exceed some 5% of the current price level. In other words, economic operators may be seemingly able to internalise only the administrative costs connected to the implementation of a harmonised tax and, possibly, a very light tax. More substantial tax levels would be directly reflected on the retail selling price (RSP). Since products are also subject to VAT, the final impact of the excise duty on price would be magnified. In the case of Italy, the effects of a €0.385 / ml tax could have led a pre-tax product priced at € 5.0 to nearly double its post-tax price²⁵⁵, in Romania the RSP of a 10 ml bottle has increased from € 3.0 to €4.4.

In MS not taxing e-liquids, the price level has been quite stable over the years. However, most of economic operators reported that an increase is expected in 2017 as a consequence of the burden imposed by the TPD2. This increase will likely fall in the 5%-10% range. There are evidently differences between price segments, which depend mostly on the origin of the product. Instead, the flavour, the mode of sale, and the level of nicotine concentration do not typically affect the end-price of products. Since sales are not currently monitored it is difficult to estimate a weighted average selling price, but the triangulation of: (i) the price levels of some popular online outlets, (ii) *Euromonitor* estimates, and (iii) individual economic operators estimates allowed to identify a reference median price and a plausible price band in a few selected countries. (**Figure 32A**). Extrapolating these estimates at EU level (weighing by estimated market size), the average price of a 10 ml container of e-liquid is approximately € 5.50.²⁵⁶ This estimate regards open-tank refill liquids. The closed-tank and cig-a-like segments have different and generally higher price levels (per ml), but as seen currently represent a minor share of the market. Also 'do-it-yourself' products are a minor share of the market, and their average price is very difficult to estimate since every component has a wide price band, and the amount of dilution may vary significantly depending on the choice of consumers.

These assumptions allow to estimate the variation in price levels possibly caused by the introduction of a harmonised minimum rate. Such variation may still differ across MS based on the current price levels and the country's VAT. **Figure 32B** shows how the RSP would eventually change in the selected countries in relation to the two options considered for the minimum tax, i.e. €0.10 and €0.30 per ml.

²⁵⁵ In Italy various players apply the 'light tax', for this reason the average end-price is lower than predicted
²⁵⁶ This estimate refers to 2017 prices, so it already includes the possible effects of TPD2. In this sense, this result is consistent with some analysts' pre-TPD2 estimation of € 5.0 per 10 ml as the average EU price of e-liquids.

Figure 32 – Estimated price level of e-liquids and impact of national taxes



Note: (*) In Italy various players apply the 'light tax', for this reason the average end-price is lower than predicted. The effects of the 'light tax' are similar to a tax rate of €0.10 / ml applied to the whole market; (**) In the case of Portugal, the current prices reflect the reduction of the excise from € 0.6 to € 0.3 since 2017.

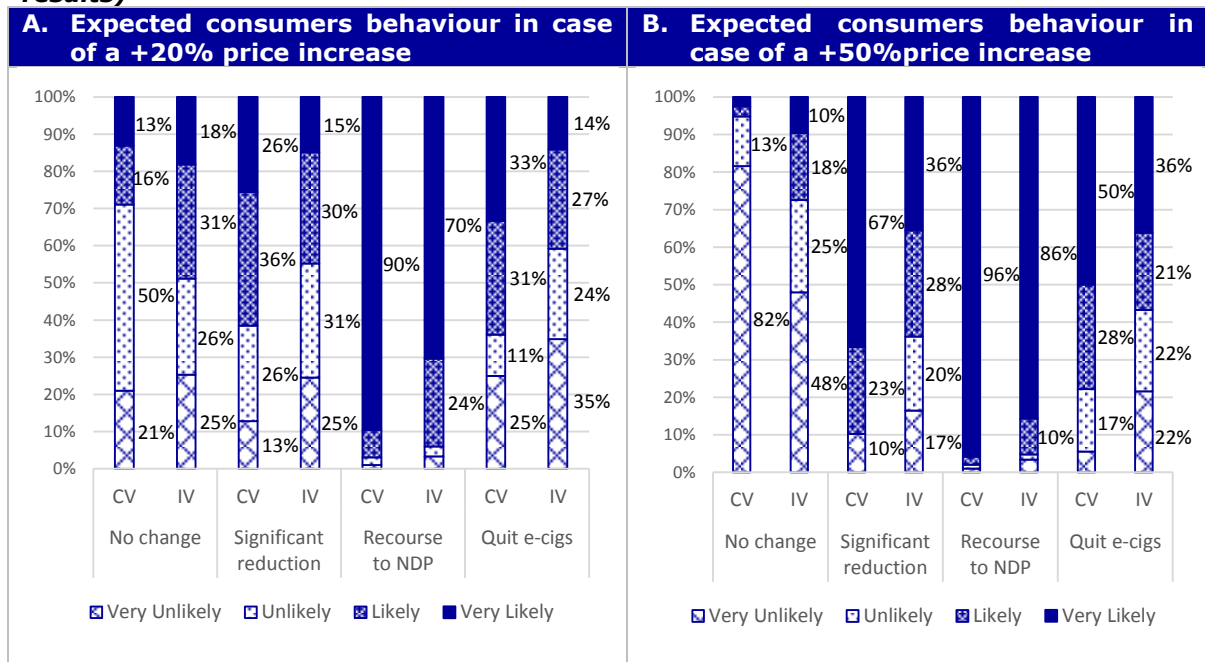
Source: Author's elaboration.

➤ IMPACT ON THE DEMAND

As discussed in Section 3.1, various surveys have shown that e-cigarettes users are quite price-sensitive. This is confirmed also by the results of the OPC carried out in the framework of this Study (**Figure 33**). The results should be taken with caution, given the inevitable self-selection bias of open consultations, but allow identifying a range of possible reactions, including: (i) quitting e-cigarettes; (ii) reducing consumption; (iii) minimise or avoid taxation making recourse to products non-duty-paid in the country of consumption; and (iv) no change. Some of these behaviours may evidently be enacted in parallel (i.e. reducing consumption and trying to avoid taxes). E-cigarettes businesses generally provided a much bleaker outlook than individual vapers. However, these were not confirmed by in-depth interviews and by the analysis of specific country cases.²⁵⁷ In this sense, vapers' responses appear to predict more accurately the likely impact of a harmonised tax on the demand.

²⁵⁷ In IT, RO and PT the price increase that followed the introduction of national taxes was generally greater than 50% but – with the possible exception of Portugal where price increase was +150% – the number of consumers quitting e-cigarettes was lower than what the e-cigarettes business responses to the OPC would indicate.

Figure 33 – Reaction of consumers to a possible increase of e-cigarettes prices (OPC results)



Source: OPC results.

The results of the OPC, combined with the available literature on e-cigarettes demand and cross-checked with what seemingly happened in the MS that have introduced a national tax, allow to formulate the following assumptions on the possible impact of a price increase on consumption levels.

The demand for e-cigarettes is elastic, i.e. the possible reduction in consumption is more than proportional to the price increase. In the existing literature the elasticity coefficient has been estimated from as low as -0.8 (-1.15 in the long term)²⁵⁸, up to -2.1²⁵⁹. Some economic operators conventionally use the average value of scholars' estimates (-1.55) in their models.²⁶⁰ Some analysts²⁶¹, have drawn from specific countries' experience an estimated price elasticity of -1.72 (PT) and -1.39 (IT). The OPC suggests that only a minority of vapers would maintain their consumption levels. Assuming that a 'significant reduction' stands for cutting by half the current consumption level, the survey data suggests an average elasticity of approximately -1.76. In the absence of more accurate estimations, it appears reasonable to use in this exercise the average value of the various estimated coefficients, i.e. **-1.50**.

- Intuitively, the elasticity correlates with price levels, however the absence of granular evidence does not allow to set plausible assumptions on the variation of elasticity at various price levels, therefore in this Study a constant elasticity is postulated.
- The share of vapers that would potentially not quit or reduce but would rather look for cheaper alternatives can be significant according to the OPC results. These alternatives may include a greater recourse to 'do-it-yourself', both using licit channels (buying nicotine bases respecting the TPD2 limits) or illicit channels (buying online or under-the-counter much cheaper highly concentrated nicotine). The current 'cross-border shopping' occurring between countries that do and countries that do not have national taxes may continue due to persisting price

²⁵⁸ Stoklosa M. et al. (2016).

²⁵⁹ Zheng, Y., et al. (2016).

²⁶⁰ KPMG, Unpublished paper; BAT, Supporting document to the OPC.

²⁶¹ See PwC, Supporting document to the OPC.

differentials. Additionally, opportunities would be created for illicit trade of products across the external borders of the EU. In this sense, a price increase may not only reduce the demand but also shift it significantly to other channels.

➤ **ESTIMATED MARKET EFFECTS**

A simple model has been developed to estimate the possible market effects induced by the introduction of a harmonised excise duty in the EU. The exercise consists of predicting the possible variation in the current market value of e-liquids under two scenarios: (i) a minimum tax of €0.10 per ml ('moderate tax'); and (ii) a minimum tax of €0.30 per ml ('high tax'). For the baseline situation and the price elasticity coefficient, the assumptions and estimates formulated in the previous Sections have been applied.²⁶² Estimates have been calculated for six selected MS and the EU on the whole, extrapolating the weighted outcome from individual MS. The results of the assessment indicate that:

- In quantitative terms, the EU market may experience a reduction in market sales of about 1,000 lt. of e-liquid on an annual basis in the event of a moderate tax, and of more than 2,000 lt. in the event of a high tax. In the latter case, the market would be practically cut by half.
- The high reduction in sales volume would be somehow mitigated by the price increase, leading to a global sales value decline of nearly 10% in the case of a moderate tax, and of 23% in the case of a high tax. The impact will be differently distributed. Where a national tax already exist the impact will be more limited or nil, while especially where price levels are low (e.g. PL) the impact could be significant (down to -36%). The sales value includes also the tax component, therefore the net income of industry would be lower, as detailed in the next Section.
- It can be assumed that part of the consumption would switch to the legal 'do-it-yourself'. This practice is already common also in MS where there is no national tax, and may account for some 15-20% of sales by volume. It is realistic that some of the expected losses on ready-to-vape liquid may be recovered by economic operators through the increased selling of non-excised products and 'do-it-yourself' kits. If one-third of the lost consumption would switch to 'do-it-yourself', and the current price differential was maintained, economic operators would recuperate respectively some €80 mn (moderate tax) or €260 mn (high tax).
- Another share of consumers may turn to the illicit channels but any estimate of the emerging black market would be premature.
- A reduction in consumption may also drive down the sales of hardware. According to the OPC a certain amount of vapers may quit in the event a harmonised tax is introduced. Using respondents' perceptions as a proxy, quitters may amount to some 14% in the case of a moderate tax and 36% in the case of a high tax. A parallel reduction in the e-cigarettes liquids and hardware markets would correspond to an economic loss of €170 mn and € 442 mn respectively.

²⁶² The 'arc elasticity' formula has been used in this exercise, in consideration of the fact a big variation is expected on a category of products with varying starting prices and sales quantity, and given the absence of a specific demand function for these products. In practice, as compared to basic 'point elasticity', the arc elasticity defines the mid-point elasticity between the two selected points and may mitigate somehow the overall effects. This approach seemed more appropriate to describe what concretely happened in MS that have introduced a taxation on e-liquids. The use of a single point elasticity would have returned negative values for some MS, which is contradicted by the reality. The same approach was used also in the PwC contribution to the OPC.

As mentioned in the previous Sections, the absence of robust and validated market data requires to interpret with great caution and as purely indicative the estimations put forward in this assessment.

Table 29 – Estimated market impact of a possible harmonised excise duty on e-liquids

MS	Baseline			Impact of a tax of €0.10 per ml			Impact of a tax of €0.30 per ml		
	Average price per ml (in €) (est. Jan. 2017)	Volume of e-liquid (thousand lt.)	Value (e-liquids) € mn (est. 2016)	Average price per ml (in €)	Volume of e-liquid (thousand lt.)	Value (in € mn)	Average price per ml (in €)	Volume of e-liquid (thousand lt.)	Value (in € mn)
UK	0.58	1,500	870	0.70	1,130	791	0.88	714	671
DE	0.54	433	234	0.66	321	212	0.90	198	178
IT	0.60	238	143	0.60	238	143	0.84	142	120
PL	0.33	458	151	0.45	283	128	0.70	137	96
PT	0.61	2	1	0.73	2	1	0.98	2	1
RO	0.44	32	14	0.44	32	14	0.67	17	11
Oth	0.55	1,431	787	0.67	1063	712	0.91	658	599
EU	0.55	4,094	2,200	0.65	3,069	2,001	0.87	1,868	1,676

Note: In the case of Italy, the level of price reflect the widespread 'light tax' approach adopted by economic operators. Therefore the current market situation does not reflect the impact of the statutory tax of € 0.385/ml, but it is roughly equivalent to the €0.1/ml scenario. The estimation of the impact of a harmonised tax of € 0.3/ml is made on this baseline.

In Romania the current level of taxation is approximately equivalent to the first scenario (€0.1/ml), so no change is envisaged. In Portugal both scenario would be below or equal to the current national tax, so no change is envisaged.

A price elasticity of demand of -1.5 is assumed for all MS.

Source: Author's elaboration. For the sake of consistency, the figures used in the baseline come from a single source i.e. the *Euromonitor International* forecast for 2016. However, some national industry data are more conservative, especially in DE and PL.

There are diverging views on the possible medium-term growth of the e-cigarette market. Some analysts forecast a continued growth, up to USD 32.0 bn by 2021 (worldwide). This is also coherent with the *Euromonitor* projections of an average 20% annual growth. This outlook is consistent with the typical market growth model describing the market penetration of new products. The diffusion curve is a S-shaped curve characterised by high growth rate in the take-off phase, which slows down as the market becomes more mature. E-cigarettes are seemingly in this crucial phase of development, which is also characterised by a rapid innovation cycle and market structure changes.

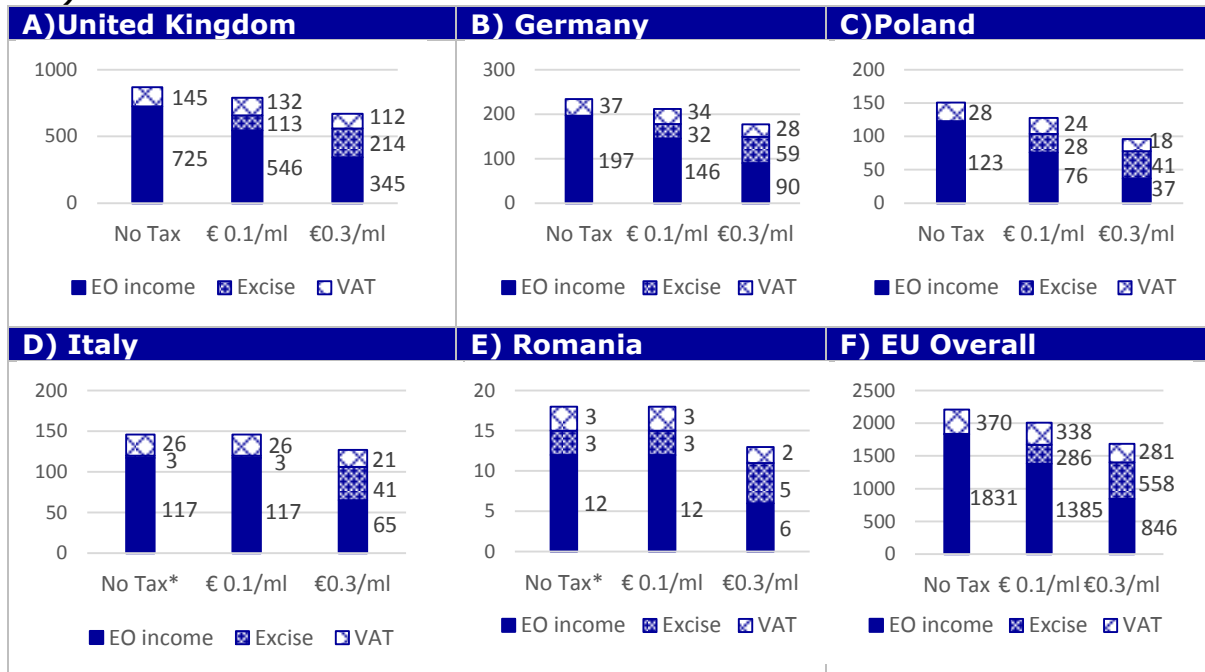
However, evidence from interviews returned a less optimistic picture. In MS with a national tax, economic operators have already faced major market shifts, which led to a significant reduction of retail outlets (in PT and IT), and a substantial loss of competitiveness against foreign players and domestic 'bad' players (non-compliant with the tax regulation). As new countries have recently introduced similar tax schemes, similar issues will likely materialise (e.g. in Hungary). Another source of uncertainty affecting all markets, concerns the ultimate impact of TPD2. In the second half of 2016, virtually all European operators had to made significant investments to comply with TPD2 requirements. These have overstretched the financial capacity of SMEs and are expected to have an adverse impact on demand due to both (i) price increases; (ii) product limitations (especially tank size). Finally, economic operators in some MS lament an excess of negative propaganda and of emphasis on the potential health risks of e-cigarettes. All this factors may possibly cool down the growth perspective of e-cigarettes, even in the absence of a harmonised EU-wide tax.

➤ **IMPACT ON TAX REVENUES**

The impact of a harmonised tax on market developments would have direct repercussions on tax revenue generated. Both excise duty revenues and VAT revenue

would be equally affected. In the example developed in this Study, the overall revenue yielded by a moderate tax (€ 0.1 per ml) would amount to some € 0.62 bn (of which 54% of VAT), while the estimated revenue from a high tax (€0.3 per ml) would amount to € 0.84 bn (of which 33% of VAT). As compared to the current €0.38 bn collected (of which 98% VAT), the net tax gain seems all in all modest, and may be further reduced by a VAT loss on e-cigarettes hardware. On the other hand, the cost for the industry would be much more significant, with potential income losses (on e-liquids) between €0.45 bn and €1.0 bn (see **Figure 34**).

Figure 34 – Estimated tax yield of a possible harmonised excise duty on e-liquids (€ mn)



Note: (*) Italy and Romania currently have a national tax. In Romania the current rate is equal to the proposed moderate tax so this option would not lead to a change in revenues. In Italy the current rate is higher, but for effect of the 'light tax' unilaterally applied by the industry the current tax revenue does not correspond to the established rate. It is estimated that the effect of the 'light tax' on the market is equivalent to the scenario of a moderate tax.
EO: economic operators.

Source: Author's elaboration on **Table 29** results.

This analysis does not take into account the indirect effects on tax revenue of slowing down the switch between conventional tobacco and e-cigarettes. According to the OPC results, an increase in the price of e-cigarettes would inevitably lead to an increase consumption of conventional tobacco. Some scholars tried to estimate the cross-price elasticity of e-cigarettes and conventional cigarettes, but their conclusions vary significantly and cannot be used to quantify the extent of substitution.²⁶³ This substitution may cause a reduction of some 2.2% in tobacco tax receipts, and national taxes have been partly adopted with a view to prevent or slow down this process. This argument is however controversial, since it would ignore any potential broader socio-economic benefits induced by smoke quitting.²⁶⁴

The quantification of public health costs and benefits from the cross-product substitution between e-cigarettes and conventional cigarettes is, as seen, a central theme for discussion at the FCTC COP level, and is evidently outside of the scope of

²⁶³ Frontier Economics, confidential contribution to the OPC.

²⁶⁴ There is an abundant literature on this topic, including a study commissioned by DG SANTE: GHK, "A study on liability and the health costs of smoking", April 2012.

this Study. Nonetheless, in order to minimise tax-induced effects on consumption and switching, tax regulators may opt for a multi-staged incremental approach:

- **1st step:** tax rate equal to zero or a marginal amount sufficient to cover administrative and enforcement costs, but with practically no effect on price levels and market;
- **2nd step:** introduction of a moderated positive tax. At this stage, the industry and tax authorities would have absorbed the effects of step 1, avoiding compounded adverse impacts. If this step is scheduled well in advance, economic operators may have the time to modulate their price policies so as to minimise the demand shock that an abrupt price increase may cause;
- **3rd step:** where required, tax regulators may then increment the tax rate levied until they reach their targets. The knowledge acquired along the previous steps on the market dynamics and consumers' behaviour may help tax regulators to identify the optimal tax level, i.e. where tax revenues are maximised and the market disruption is minimised.

Given the different maturity of the e-cigarettes market across the EU, and the different tax bearing capacity of individual markets, this staged mechanism seems more appropriate for adoption at MS level than in the EU regulation.

5.1.1.3 Single Market functioning and competition

➤ LEVEL PLAYING FIELD

The introduction of non-harmonised taxes in certain countries inevitably affects the competitiveness of national operators *vis-à-vis* foreign ones²⁶⁵, and may create incentives for the development of informal cross-border trade of non-duty-paid products. **Table 30** below shows the estimated price differentials for a standard product (10 ml refill container) in tax-levying MS against neighbours. Similar considerations apply to the opportunity offered by cross-border online outlets.

Table 30 – Comparison of average price of e-liquids (10 ml) between selected bordering countries (with and without a national tax)

IT < > HR	PT < > ES	RO < > BG
€ 6.00* < > € 3.95 (*from € 5 to € 9 if 'light tax' or full tax is applied)	€ 6.12 < > € 4.61	€ 4.44 < > € 3.31

Source: Author's estimate based on a review of online outlets (not statistically significant).

In principle, the adoption of a harmonised tax across the EU may eventually lead to levelling the playing field, but primarily if a minimum positive rate is established. It can be argued that in the case of a zero or a low minimum tax, MS would likely maintain their current approach, and therefore the current tax disparities would persist. However, this requires two clarifications: (i) some national tax authorities have expressed their intention to introduce a positive tax on e-liquids in the event a harmonised approach is agreed at EU-level, so even in the absence of a EU-wide minimum tax, a certain degree of approximation can be expected; (ii) a harmonised approach would imply a greater monitoring and control over cross-border trade, and a possible reduction of cross-border shopping. So even if price differentials remain, the adverse effects for domestic operators' competitiveness would be reduced.

The regulatory costs of a tax harmonisation would have distributional effects. They would be borne primarily by operators (and public authorities) in countries that do not currently have national taxes, while in MS with a national tax would have minimal or

²⁶⁵ This sentence refers to the unfair competition domestic players may suffer from cross-border online outlets and to the incentives that are being created for cross-border shopping.

even positive impacts (e.g. economic operators may benefit from duty suspension when importing e-liquids from across the border). These may further contribute levelling the playing field, but only mildly, given the relatively limited overall burden envisaged.

➤ **SINGLE MARKET INTEGRATION**

At present, the access to a market where a national tax is levied generally implies that foreign players register in the country and comply with the required 'red tape'. The current variety of national rules may discourage certain companies to expand across their national borders and operate on a larger EU scale. The inclusion of e-liquids in the scope of the Directive 2011/64 would equally require manufacturers and traders to obtain an authorisation and to follow a set of rules (see Section on regulatory costs), but these would be common to all and there would be instrument like EMCS to facilitate cross-border movements. In this sense, harmonisation may indeed stimulate the integration of the single market, an easier circulation of goods, and some economies of scale. At present, the share of products manufactured in the country of consumption varies greatly, ranging from an estimated 75% in Italy²⁶⁶, to 50% in Germany, to 30% in Romania.

Some relatively larger operators may certainly take advantage of harmonised rules, but reportedly this has not been a major issue so far, since most of cross-border movements at present are business-to-business, and the regulatory burden imposed by national taxes is primarily borne by domestic distributors. Big tobacco companies and their affiliates may also be facilitated by harmonisation, given their vocation to operate on multiple markets. But in their views, the current situation, although not ideal, does not pose significant barriers and therefore would not justify *per se* a legislative intervention. Finally, the vast majority of small businesses operate almost exclusively on a national or sub-national scale. Entering new EU markets is not a strategic priority for them, and this regardless of the possible legal and administrative burden it may entail.

From a market functioning perspective, the introduction of a harmonised tax category and definition for e-cigarettes should be complemented by a coherent revision of the customs classification applied to this category of products, otherwise there would be the risk of fuelling uncertainties and classification burden. The revision of customs codes for e-cigarettes should take place at the WCO.

➤ **MARKET MONITORING**

As an indirect effect, the adoption of a harmonised tax category for e-cigarettes would enhance the availability of market information that would complement the monitoring system being set up under the TPD2. The cross-border flows would be better traced through the EMCS system, and MS would have additional evidence on the effects of their national tax policies for refining them. On the other hand, the excise system would not bring more detailed data on informal trade, which may possibly increase following the introduction of a positive minimum tax. Therefore this information shall continue being triangulated with the database and the studies that TPD2 requires MS to set up.

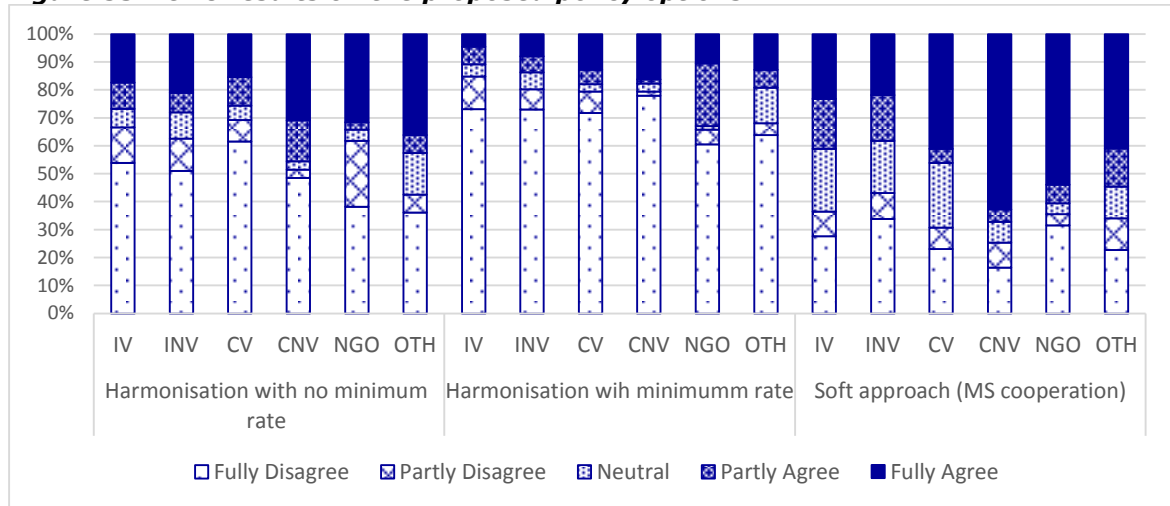
5.1.1.4 The public view on the proposed policy options

In conclusion, it is useful to summarise here the results of the OPC and the views of participants on a possible tax harmonisation of e-cigarettes. A clear majority of respondents oppose the introduction of a harmonised minimum tax on e-cigarette.

²⁶⁶ This figure likely includes Italian operators having moved their premises across the border.

Unsurprisingly the highest level of disagreement is among individual vapers. A tax harmonisation without establishing a minimum rate raised a somehow higher consensus. The majority of vapers and e-cigarettes operators are still against this approach but groups like NGOs and other types of respondents expressed more mixed positions. Instead, the majority of respondents in most of groups seem in favour of a soft approach, i.e. no inclusion of e-cigarettes among excise goods at this stage but promotion of MS dialogue and cooperation on this point (**Figure 35**).

Figure 35 - OPC results on the proposed policy options



Legend: IV: individual respondent vaper; INV: individual respondent non-vaper; CV: e-cigarettes company; CNV: non e-cigarette company; NGO: non-government organisation; OTH: other.

Note: The total number of respondent varies across questions. 'Don't know' answers not displayed.

5.1.2 Impact analysis of a harmonised classification for HTP

5.1.2.1 Single Market functioning and competition

Heated tobacco products are facing a similar degree of national-level fragmentation of tax regimes. In the absence of an EU harmonised approach nine MS to date have adopted national approaches. Unlike e-cigarettes, the lack of common rules is relevant for the commercialisation of HTP. Notwithstanding the diversity of approaches MS generally consider HTP as a substitute of conventional tobacco, and therefore a potentially excisable product. For this reason, prior to the commercialisation of HTP national authorities may require that a proper legal or administrative framework is in place. The absence of it may simply prevent HTP to be placed on the market. The administrative arrangements adopted by some MS often represent a temporary solution mostly avoiding the above barrier to commercialisation but various authorities consulted consider it less than ideal. These products are very recent, and the market is still a niche. Actually there is only one product, *iQos*, that at the time of writing is distributed on several EU markets. In this sense, the *ad hoc* approach may still work. However, with the possible market growth and the launch of a variety of new products, establishing a comprehensive legal framework will become unavoidable.

To sum up, the effects of a harmonised approach to HTP for Single Market functioning and competition may include:

- **Legal and administrative certainty.** Establishing a common harmonised approach to HTP would prevent that the variety of the legal and administrative arrangements adopted by individual MS grows out of control. With the proliferation of novel HTP the burden of dealing with each product on an *ad hoc* basis may become significant. The inevitable disparities of treatment across MS may eventually fuel disputes, with ensuing costs for both public authorities and

economic operators. The creation of a separate new category may consistently address the issues of 'smoking' and 'combustion', which lies at the basis of the current classification difficulty. The utilisation of one of the existing categories would instead provide less room of manoeuvre for using a definition based on the non-combustible nature of these products. On the other hand, any definition taking up the non-combustible nature of these products should be carefully drafted to prevent it offers loopholes for new 'borderline' products that may appear in the near future.

- **Removal of barriers to circulation.** The legal certainty induced by harmonisation may eventually remove the barriers to the commercialisation and circulation of HTP across the EU. In this sense, this would eliminate a sort of discrimination that exists *de facto* between HTP and conventional tobacco products. The adoption of EMCS would improve the monitoring and control over movements, also easing the related administrative costs. A separate new category would evidently allow a more precise monitoring of HTP market development than the use of one of the existing tax categories.
- **Unintended effects on other products.** In various MS, the temporary classification of HTP as 'other smoking tobacco' may have unintended consequences on the other tobacco products falling in the same category, such as pipe tobacco, since any adjustment of rates MS authorities may decide for HTP would equally apply to the others. The harmonisation of HTP under one of the existing categories would not change this situation but may actually worsen it, since it would extend it to MS that currently have a national non-harmonised tax category for HTP. Conversely, a harmonised separate tax category would allow competent authorities to modulate their fiscal policies on HTP without unduly harming other products. This would prevent unintended distortion of cross-product competition.

A possible revision of the **HS code** applied to this category of products is being discussed at the WCO level. Although commentators consider it unlikely, the process may lead to the customs classification of HTP in a different category than the current, residual heading 2403 99, and namely as homogenised tobacco, or smoking tobacco, or under heading 2402, along with cigarettes. Although there is no direct cross-references to customs codes in Directive 2011/64, a different classification in the customs system may evidently have consequences also on how MS view HTP for tax purposes.

5.1.2.2 Market effects and tax revenues

A full-fledged quantitative assessment of the impact of HTP taxation on market development and tax revenues cannot be performed due to the lack of reliable data on market trends and demand. With respect to the main HTP product currently commercialised in the EU, i.e. PMI's *HeatSticks* for *iQos*, the company reports allow to estimate the level of consumption at some 2.4 bn sticks in 2016.²⁶⁷ PMI estimates that some 1.4 mn of consumers worldwide have been converted to *HeatSticks*,²⁶⁸ of which some 0.4 mn possibly in Europe. While these figures are still small in absolute terms, it has to be considered that the product is still at the early stage of the commercial take-off. In all markets analysed initial trends are encouraging and PMI forecast to extend its production capacity from 15 bn sticks in 2016 to 50 bn sticks in 2017.²⁶⁹ Furthermore, more players may expand their operations in the EU in the near future.

²⁶⁷ Author's estimates based on corporate reports (see footnote 268).

²⁶⁸ <https://www.pmi.com/investor-relations/press-releases-and-events/event-details?EventId=5246131>

²⁶⁹ PMI Report to the United States Securities And Exchange Commission.

This is the case of, for instance: BAT's *GLO iFuse*, currently only available in Romania; JTI's *PloomTech*, currently only available in Japan.

If manufacturers' expectations are maintained, HTP may soon become something more than a niche product. As a reference, in the most mature Japanese market, *HeatSticks* account already for some 4.9% of the conventional cigarette market, against less than 0.5% in the EU. Given the close substitutability between HTP and conventional cigarettes the stability and predictability of excise revenue may be jeopardised by a steep growth of HTP in Europe. For illustrative purposes²⁷⁰ **Table 31** below compares, based on Author's elaborations of different information sources, the excise possibly levied on *HeatSticks* and on conventional cigarettes in a few MS where HTP is commercialised. Based on gross and unweighted estimates, in 2016 the excise yield of *HeatSticks* in the EU amounts to some € 85 mn (based on the MS where they are commercialised, reported in Table 31). If taxed as factory-made cigarettes the excise yield would have been some € 300 mn greater, i.e. still a tiny fraction when compared to the ca. €76 bn of excise revenue generated by cigarettes.²⁷¹

Table 31 – Estimated excise yield of HeatSticks in selected countries, and benchmarking with cigarettes²⁷²

	DE	DK	EL	ES	IT*	NL	PT*	RO	UK
HeatSticks									
€ per kg	22.0	99.0	156.7	22.0	203.2	99.2	201.2	87.0	147.0
€ per 1,000 sticks	6.8	30.7	48.6	6.8	63.0	30.8	62.4	27.0	45.6
Cigarettes									
€ per 1,000 sticks	156.2	160.8	119.3	137.2	136.8	181.5	133.0	97.6	353.1

Note: (*) For Italy and Portugal figures are based on Author's simulation.

Source: For Heatsticks data are based on Author's estimates. Data on cigarettes are based on EDT (July 2016).

On the other hand, as in the case of e-cigarettes, HTP is marketed as a reduced-risk product, and tax regulators may therefore consider if and to what extent encourage smokers switching to non-combustible products in the context of broader tobacco control policy goals. The scientific evidence on the risk profile of HTP is even scarcer than for e-cigarettes and this aspect cannot be considered in this Study. However, it can be noted that different approaches to the harmonisation of HTP may lead to different policies and to different effects. In particular:

- (i) A **separate tax category** would allow MS more freedom in adjusting national tax policies balancing tax revenue objectives with tobacco control objectives as deemed more appropriate to the country's priorities and tax bearing capacity. A zero tax option may be in principle considered given the novelty of the product, but it would probably have little support from MS authorities as the initial orientations suggest. At the same time there is insufficient scientific evidence to support the establishment of an optimal rate different from what is already practised in certain MS. In this sense, in a first phase tax regulators may opt to avoid any price shock and fix the harmonised minimum rate at a level comparable to OST.

²⁷⁰ The comparison regards two qualitatively different products and does not imply a judgement on the potential substitution between these products for which, as discussed in this Report, the HTP data are too recent and too scarce.

²⁷¹ Source: DG TAXUD, Excise Revenue Tables, July 2015.

²⁷² With the exception of Italy, in all other countries where Heatsticks are commercialised the 'other smoking tobacco' regime is applied (including MED where relevant).

- (ii) The ***inclusion of HTP in the OST category*** (for products with the required characteristics)²⁷³ besides legal complexities, would be largely neutral in terms of market effects and tax revenues, except in countries like IT where the national tax is set at a much higher level than OST. The current Directive 2011/64 would allow significant freedom to MS to adjust the rate applicable to OST category, including adopting a mixed structure and/or setting a minimum duty as per Art. 14.1 in countries like DE and ES where the OST rate is particularly low. The main downside, as seen, is that the same regime would apply also to other OST, so an increase in the tax rate would indirectly affect the end-price and sales of other products.

5.1.2.3 Alternative option: Guidelines

The alternative, non-regulatory approach would consist in issuing non-binding guidelines for Member States on a uniform and coherent tax treatment of HTP, as well as on cross-border movement and administration. As described previously, a one-size-fits-all approach may not be feasible, so every product, or class of similar product, may require a different approach, based on its feature and characteristics. With respect to tax categorisation, guidelines may only suggest to use either one of the existing categories or none of them, but cannot evidently create new tax categories or structures, which take into account the specific non-combustible features of HTP. The main advantage of this approach is that it won't require a legislative revision, and may more flexibly cope with emerging new products. Competent authorities of the MS would have a common reference to justify their choice, although it would not be legally binding.

This approach is not without difficulties and downsides:

- it won't provide legal certainty, and may not prevent disputes and judicial cases. On the contrary, since MS would maintain the option to tax HTP differently, there is the risk that MS approaches departing from the guidelines may more easily become subject of disputes;
- guidelines may only help in the correct implementation of the Directive but cannot obviously amend current product definitions. Some institutional stakeholders and manufacturers pointed out that a standard definition of what is 'smoking' and combustion, would be useful in order to establish whether HTP can be classified or not in one of the existing categories, such as 'other smoking tobacco'.
- the abovementioned negative effects for other products sharing the same category (e.g. OST) would apply;
- encouraging the use of one of the existing tax category may facilitate the use of EMCS and product circulation, but in the event some MS choose to disregard the guidelines, the current problems with single market functioning would persist. Eventually, economic operators and competent authorities may need to establish administrative arrangements on a case-by-case basis, thus neutralising the possible benefits of the guidelines;
- for the same reason, this approach may result not particularly effective for market monitoring purposes.

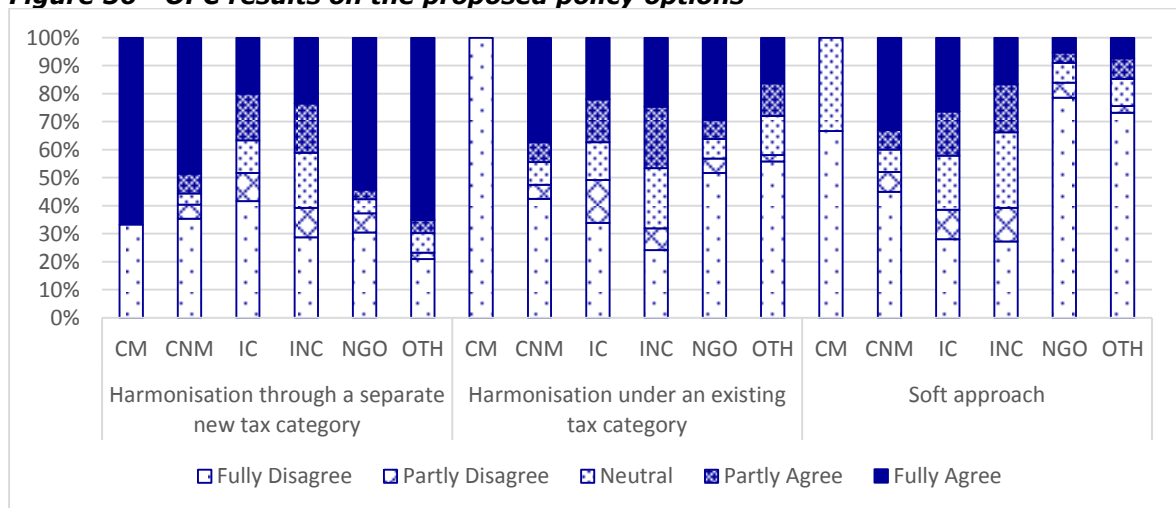
5.1.2.4 OPC results on this option

²⁷³ The early version of HeatStick, commercialised in certain MS, did not have the aluminium foil to prevent they could be smoked 'as is', and would therefore attract the tax treatment of cigarettes. The product was therefore reviewed. It can be safely assumed that HTP manufacturers would in any case adjust their products so as to avoid the risk of being taxed as cigarettes.

The results of the OPC with respect to possible tax harmonisation for HTP are reported in **Figure 36**. As compared to e-cigarettes it has to be considered that both the number of users who responded to the questionnaire and the number of manufacturers of these products is much smaller (only three manufacturers exist, all of which took part in the survey). Some disparity of views across sub-groups can be noted:

- With the exception of individuals, all sub-groups tend to agree on the approach of establishing a separate new tax category for HTP products, and to disagree with using one of the existing category. But other manufacturers not involved in HTP are more open to this possibility (this results seem influenced by the views of e-cigarettes manufacturers who may consider this option as a chance to avoid a separate tax also on e-cigarettes).
- The soft approach (i.e. in the OPC it was formulated as a Recommendation) received limited support among manufacturers and other respondents. The high level of disagreement among the 'other' subgroups seems related to the presence in this group of public authorities and related bodies who may fear the uncertainties and related burden that such approach may cause.

Figure 36 - OPC results on the proposed policy options



Legend: IC: individual consumer of HTP; INC: individual non-consumer of HTP; CM: HTP manufacturer; CNM: non-HTP manufacturing company; NGO: non-government organisation; OTH: other.

Note: The total number of respondents varies across questions. The number of CM is three. 'Don't know' answers not displayed.

Source: OPC.

5.1.3 Comparison of Policy Options

5.1.3.1 Harmonised treatment of e-cigarettes

Table 32 below summarises for comparative purposes the impact estimated for the different policy scenarios on the tax treatment of e-cigarettes that have been analysed in this Study. In particular three options have been considered:

- No change over the current situation (i.e. e-liquids are not subject to the harmonised tax under a revised Directive 2011/64). This scenario includes the expected evolution in the near future (dynamic baseline)
- The introduction of a harmonized tax structure for e-liquids, with no minimum rate (or marginal).
- The introduction of a harmonized tax structure for e-liquids, with a minimum rate of € 0.10 per ml (moderate tax) or € 0.30 per ml (high tax)

The three options are compared with respect to the various impact areas analysed at length in the previous Sections. For every impact area a summary judgment is provided including (i) a rating of the positive or negative effect expected from the perspective of the various target groups indicated; and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be aggregated straightforwardly.

Table 32 – Harmonised treatment of e-cigarettes, comparison of options

Impact area and target groups	A) No Change		B) Harmonised Tax with no or marginal minimum rate		C) Harmonised Tax with positive minimum rate	
Regulatory costs for businesses	0	Only in case of national taxes.	-1	Modest (also for SMEs). Almost nil in case of a zero. tax, or 'simplified' regime Distributed among MS.	-1	Same as scenario B.
Regulatory costs for public authorities	0	Only in case of national taxes.	-1	Modest, but hardly covered by revenue. Almost nil in case of a zero tax.	-1	Same as scenario B for administrations. Enforcement would be more problematic.
Single market functioning (for economic operators)	-1	Fragmentation may increase. Legal issues may emerge.	+1	Improved level playing field. Marginal effects on market integration.	0	Improved level playing field. Challenges from illicit trade.
SME competitiveness	0	No change.	-1	SME more vulnerable to regulatory costs (adding up to TPD effects).	-2	Same as scenario B. Tax effect lighter for closed-tank refill (large companies).
Market development (for economic operators)	+1	Expected growth, perhaps slowed down by TPD (and endogenous dynamics).	0	Modest incremental impact on the demand. Consumers risk perception possibly affected.	-1 to -2	Adverse effect on sales, moderate to high depending on tax level. Poor acceptance of the tax.
Tax revenues (for tax administrations)	0	It will continue being marginal, due to NDP trade.	0 to +1	No change, but possible reduction of NDP. Some more MS may still opt for a positive tax	+1	Excise yields diminished by tax avoidance and demand reduction. Trade-off from conventional products.
Monitoring and control (for public authorities)	+1	Improvement expected from TPD implementation	+1	Same as scenario A, with few additional data	+1	Same as A and B. Information gaps on NDP.

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- The policy options considered would have different effects in different areas and for different stakeholders. The 'no change' scenario over the current situation would help market development and is also supported by various stakeholders from the public health circles who consider e-cigarettes as an alternative to more dangerous tobacco products. A light harmonisation, i.e. without imposing a minimum tax, would minimise tax-induced market shocks and improved the level playing field for operators in MS that currently have a national tax on e-liquids. A positive tax may contribute to MS tax revenues (including to cover the administrative costs for competent authorities), also by means of slowing down switching from conventional tobacco. Against this framework, any strong decision would be controversial under a certain perspective, therefore a light-touch and cautious approach seems preferable at this stage.
- The non-harmonised tax regimes introduced in some MS had mixed results (although in many cases it is too early to tell). Part of the problem was precisely the absence of an EU-wide common framework that made law enforcement very complex; partly national tax regimes were often introduced without having a sufficient background knowledge of market size, industry structure, and demand features. In some cases these seriously affected the domestic industry and pushed consumers towards informal and potentially dangerous practices. These problems may persist also in the case of an EU-wide harmonised taxation.
- The implementation of the TPD2 envisages mechanisms for the registration of operators and the collection of data on sales and consumption, which in the future may help tax regulators to adopt more evidence-based policies and to monitor market developments.
- The implementation of the TPD2 also imposed a series of product restrictions and marketing requirements to operators, which are expected to have pervasive effect both on the industry and consumers. Most of these effects will become apparent in the near future and cannot be predicted, but overall an increase of retail prices and a market slow-down is likely. In general, the regulatory compliance costs of the TPD2 have been significant, especially for SMEs. Operators have not yet absorbed the costs of TPD2, so any new administrative costs imposed on them by a possible tax regulation may have disruptive impacts.
- In terms of fiscal revenue, the diffusion of e-cigarettes may imply a tax loss from conventional tobacco products, given their proven substitutability. Leaving aside important considerations on e-cigarettes impact on tobacco control, a substantial tax on e-liquids may indeed reduce the switch (or the 'dual' consumption), since the evidence available suggest vapers are price sensitive. On the other hand, the tax revenue generated by e-liquids would be modest since the market is small and, as individual MS experiences show, a tax on nicotine-containing liquids may be quite easily avoided (and evaded). The enforcement burden for authorities to prevent this would be excessive.
- Tax regulators may therefore consider to adopt a multi-staged path towards a possible tax harmonisation of e-cigarettes. This would involve at first collecting and pooling accurate data on markets and consumption, then adopting a harmonised and future-proof definition and tax category (taking into account the overall evolution of novel non-combustible products, as well as the ongoing standardisation processes). The final step would be the adoption of positive taxes, but this should be ideally left to each MS to decide based on actual market conditions and country's policy goals.

5.1.3.2 Harmonised classification of HTP

Table 33 below summarises for comparative purposes the impact estimated for the different policy scenarios on the harmonised classification of HTP that have been analysed in this Study. In particular, three options have been considered:

- (i) No change over the current situation (i.e. HTP is regulated by legal and administrative arrangements undertaken by MS individually). This scenario includes the expected evolution in the near future (dynamic baseline).
- (ii) The harmonised classification of HTP either under a new tax category or including them in one of the existing ones. In both cases, the current prevalent approach of a tax rate in line with OST is assumed.
- (iii) The adoption of a soft approach, consisting in issuing non-binding guidelines to MS to enhance their coherence in the approach to the taxation of HTP.

The three options are compared with respect to the various impact areas analysed at length in the previous Sections. For every impact area a synthetic judgment is provided including (i) a rating of the positive or negative effect expected; and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be aggregated straightforwardly.

Table 33 – Harmonised treatment of HTP, comparison of options

Impact area and target groups	A) No Change		B) Harmonised classification		C) Non-binding guidelines	
Legal and administrative certainty (for economic operators and public authorities)	-1	Fragmentation and related burden may increase. Legal issues may emerge.	+1	Classification no longer problematic. EMCS can be used. Risk of 'borderline' products (in case of a separate category).	0	It may enhance coherence of approaches. EMCS use unclear. Risk of fuelling disputes
Single market functioning and competition (for economic operators)	-1	Market barriers persist. Ad hoc administrative arrangements necessary	+2	Removal of market barriers, improved circulation. Unintended effects on other product (if an existing category is used)	0	Useful, but some MS may not take on. Eventual need for ad hoc arrangements.
Market development (for economic operators)	+1	Expected growth, but slowed down by current constraints	+2	Faster growth, possibly mitigated by positive tax regimes	+1	Similar to scenario B, but less effective
Tax revenues (for tax administrations)	-1	As substitution continues, possible tax losses from cigarettes	0	Substitution possibly accelerates. MS have more freedom (especially with a separate tax category) to offset revenue losses	0	Similar to Scenario B (MS may opt for national approaches)
Monitoring and control (for public authorities)	+1	Improvement expected from TPD implementation	+1	Same as scenario A, with few additional data (in case of a separate category)	+1	Same as scenario A

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,

-2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- A harmonised classification of HTP under a revised Directive would be effective in redressing the current legal and administrative uncertainties and constraints, which affect the commercialisation of these products in the Single Market. The HTP market is very recent and future developments are difficult to predict. The current *ad hoc* arrangements or the use of a soft approach (non-binding guidelines) may be considered as temporary solution, which provide tax regulator the time to better assess market trends and develop a suitable and future-proof definition for these novel products. As the variety and the market penetration of these products increase, a non-binding policy approach would not only become poorly effective but it may also contribute to legal uncertainty and disputes.
- Legal certainty would be provided only by an explicit categorisation, but defining HTP for tax purposes can be complex especially with respect to the intended use of tobacco for inhaling and not smoking. The current legal framework does not clarify the concepts of smoking and combustion. Any weak or vague definition may easily create loopholes for new 'borderline' products.
- To avoid the above definitory issues, HTP may be also included in the scope of the Directive without references to its intended use (e.g. adding it to the OST category). This would nonetheless require to reconsider the reference to 'smoke' in the smoking tobacco definition. It would also entail avoiding any consideration on the reduced risk offered by non-combustible products (whose evidence is however not definitive) and their possible contribution to smoke-free policies. The emergence of various alternative nicotine systems (including e-cigarettes) may instead require a comprehensive and consistent policy approach in a not too distant future.
- The inclusion of HTP in one of the existing tax categories, e.g. OST, may limit the freedom of national regulators in establishing the applicable tax regime, with possible unintended effects on the other products that share the same category, i.e. pipe tobacco.
- At the moment the substitution between HTP and conventional cigarettes is small in absolute terms. In the event of a fast penetration, as it happened for instance in Japan, the effects on tax revenues may become noticeable, given the current much lower taxation of HTP as compared to cigarettes. The extent and the speed of substitution may be different across countries, so a revised regulatory framework should not constraint MS capacity to modulate their policies based on the specificities of their national markets as well as their own balance between tax revenue objectives and tobacco control objectives.

5.2 Raw Tobacco and Tobacco Refuse

5.2.1 Inclusion of raw tobacco under the excise system

5.2.1.1 Regulatory costs for economic operators, impacts on competitiveness, and enforcement costs for public authorities

The inclusion of raw tobacco within the excise system would cause regulatory costs, in particular compliance and administrative costs for economic operators, and enforcement costs for public authorities. At a 0 or very small rate, i.e. assuming that no excise revenues are collected from raw tobacco, these costs are expected to represent the largest category of economic impacts for this policy option.

As a word of caution, it is difficult to retrieve punctual cost parameters from economic operators with respect to substantive or information obligations to which they are not yet subject. This is especially the case for growers, who currently have no or very limited information on the requirements to which excise operators are subject to, let alone the associated costs. To address this challenge, the Consultants opted for two strategies:

- 1) First, a deep-dive analysis was carried out focusing on companies operating part of their activities under the excise regime. In this case, feedback was collected on the hypothetical cost of 'extending' the excise regime to all their activities. Companies in such a situation were already familiar with the legal requirements, and thus could provide estimates on potential costs. However, (i) these companies would not have to invest from 0 with respect to warehouse requirements and software tools needed to handle the excise obligations; (ii) these companies would have to bear limited training costs, as their employees are already knowledgeable about the excise system; (iii) they are medium or large-sized companies.
- 2) Secondly, cost parameters were retrieved from the evaluation of the Horizontal Directive,²⁷⁴ where a quantification of some of the costs associated with the excise administration and the EMCS system is provided. The monetisation of labour inputs is based on the average EU salary for a clerk, retrieved from the Eurostat Earning Structure, and includes overheads.²⁷⁵

The population of companies that would bear the substantive compliance and administrative costs due to the inclusion of raw tobacco among excisable products is defined as follows:²⁷⁶

- 1) 55,000 growers;²⁷⁷
- 2) 57 first processors.²⁷⁸

With respect to administrative costs, the information obligations identified, and the related cost parameters, are as follows:

²⁷⁴ Ramboll Evaluation of Horizontal Directive (2015).

²⁷⁵ Set at €18.2 per hour, or €145.6 per day.

²⁷⁶ The analysis does not include additional costs incurred by manufacturers of excised tobacco products to handle the supply of excisable raw tobacco. These costs would be non-trivial, but still lower than in other cases, due to the fact that they are already subject to the excise system, already operating a tax warehouse and possessing the necessary equipment and software necessary to move goods in duty suspension. Also, the analysis does not include other economic operators (e.g. raw tobacco traders, manufacturers outside the tobacco industry), because there is no available estimate of the number of potentially concerned companies. However, the estimate is expected to be representative of the bulk of the costs generated.

²⁷⁷ DG AGRI, "Agricultural Trade Statistics 2005-2014", 2015.

²⁷⁸ Nomisma (2012).

- Authorisation to operate a tax warehouse. Each operator dealing with raw tobacco would need to ask the responsible customs office for such authorisation (art. 16 of the Horizontal Directive). Based on the results of the evaluation of the Horizontal Directive, the staff input required is estimated at 7 person/days, for a corresponding labour cost of €1,020.
- Costs related to the setup of the ECMS system, and in particular the purchase and operation of the necessary IT equipment. Based on the findings of the evaluation of the Horizontal Directive, investment costs are estimated at €500 for a micro company, €1,000 for small and medium ones, and €10,000 for large enterprises. Given operating cost roughly corresponding to the value of the investment, annual total costs are estimated as follows: €600 for micro companies, €1,200 for small and medium companies, and €12,000 for large companies.²⁷⁹
- Costs of moving goods under the ECMS system. The evaluation of the Horizontal Directive suggests a modal value of 12.5 minutes per movement, which translates into a staff cost of €3.8 per movement under the EMCS. These costs are considered already included in the operating costs discussed at point #3 above.
- Guarantee. In principle, the excise guarantee is set at a fraction of the excise payable on the stored or moved goods. The value of the guarantee is set at national level, and varies from 1% to 100% of stored or moved goods (on a daily/weekly/monthly or even annual basis). Given that a 0 rate is considered, it is assumed that no guarantee would be required.

With respect to administrative costs, the obligation identified and the related cost parameters are as follows:

- Setting up a tax warehouse. Based on information provided by the interviewees, the substantive compliance costs linked to the creation of a tax warehouse were considered more significant than the administrative costs due to the ECMS. The warehouse needs to respect EU and national requirements, e.g. as for securitisation and control of the stored materials. It is expected that those costs would range between €5,000 and €10,000 for small companies. Given an amortisation period of 25 years and a cost of capital set at 7%, this corresponds to annual costs of about €1,100. Investments for a medium or large company, based on estimates discussed with operators already part of the excise system, could be significantly larger, given the size of the warehouse necessary to e.g. stock one-year supply of raw tobacco for first processing. They could range between €200,000 and €1,500,000, with corresponding annual cost of €20,000 to €135,000.²⁸⁰ The lower end of the range is conservatively used for the quantification.

The estimation of the regulatory costs is provided below in **Table 34**. Average costs would amount to about €2,700 per grower, and €22,000 per first processor. Total costs are estimated at €150 mn, of which about € 60 mn substantive compliance and about €90 mn administrative costs, or €0.82 per kg of EU raw tobacco. These costs are large in comparison to the value of production, reaching about 35% of the market price of EU raw tobacco.²⁸¹ In comparison with the overall EU raw tobacco market,²⁸² they would represent about 8% of its value.

²⁷⁹ Assuming an amortisation period for IT equipment of 5 years.

²⁸⁰ Assuming a lower cost of capital for medium (6%) and large companies (5%).

²⁸¹ Considering, based on DG AGRI statistics, an average price of 2.35 €/kg, resulting in an output value of about €420 mn.

Table 34 - Regulatory costs in case of inclusion of raw tobacco among excisable products (€)

	Growers	First Processors
Administrative Costs		
Authorisation	56,100,000	58,140
EMCS	33,000,000	68,400
Substantive Compliance Costs		
Tax warehouse	60,500,000	1,140,000
Total	149,600,000	1,483,140
<i>Cost per company</i>	2,758	26,020

Source: Author's calculation.

These quantitative estimates, reporting a significant impact in terms of regulatory costs for economic operators, are corroborated by the qualitative findings retrieved from the fieldwork. Concerns are almost unanimously voiced by both economic operators – as expected – as well from public authorities in tobacco growing countries, including both ministries of finance and agriculture. Only customs and tax authorities in countries where there is no production of raw tobacco are hardly upset with the possible regulatory costs resulting from excisability.

Stakeholders and public authorities largely consider the costs arising from the inclusion of raw tobacco among excisable products as 'unbearable', especially for growers, who 'would not be able to meet the excise system requirements', with a slightly less negative view in countries where growers are larger or more organised. The impacts of these costs would trigger a 'disruption of the production of EU tobacco in Europe', and a public authority considered it as equivalent to a 'prohibition to grow raw tobacco'. Also, it is suggested that the cost increase could have the unintended consequence of pushing more growers toward the illicit market. First processors are also alarmed from costs *per se*, but to a lower extent, because, given the current requirements and checks to which they are already subject and their larger corporate structure, they would be in a better position to comply with the new requirements. However, they are very concerned with the impact on growers, as they also share the view that the system would disrupt the cultivation of raw tobacco in Europe, thus considerably shrinking their raw materials supply and wrecking their business.

A last consideration concerns the possibility for the upstream part of the value chain to pass-on costs to manufacturers of tobacco products. This scenario is considered unlikely, given that these costs represent a significant share of the current price per tonne, at about 35%. Already at this stage, EU raw tobacco is less competitive than raw tobacco grown in countries where labour costs are lower. Tobacco manufacturers have already increased extra-EU imports of raw tobacco following the end of the subsidy system, and they can be reasonably expected to increase them again in response to a significant price increase.

➤ **COMPETITIVENESS AND SME**

The amount of regulatory costs associated with these options suggest that the competitiveness of the upstream chain of the tobacco value chain – including growers and first processors – could be severely hampered. This consideration is reinforced given the limited possibility of passing costs onto manufacturers of tobacco products, since raw tobacco is a globally-traded commodity. In addition, growers, the population of which largely consists of micro and small companies, would be disproportionately affected, and this could lead to a significant exit of SME from the industry. On the

²⁸² Estimated at 800,000 tonnes.

positive side, stricter controls would reduce the availability of illicit tobacco and tobacco products in the market, so that licit players will bear a lower competitive pressure from the illegal value chain.

➤ **ENFORCEMENT COSTS FOR PUBLIC AUTHORITIES**

With respect to enforcement costs borne by public authorities, some of them voiced concerns that the inclusion of raw tobacco among excisable products could be a burden, in particular because of the management of the additional flow of authorisations and the need to control and audit a large number of new excise operators. However, as in the case of new products, it can be expected that the additional checks carried out by public authorities will not be significant, should the rate be set at 0, since there would be no revenues to be collected, and a limited need to implement a more sophisticated and expensive control system. Also, these enforcement costs would not be additional, considered the checks and enforcement controls that national authorities already carry out on growers and first processors under the current national frameworks.

In terms of enforcement benefits, customs authorities could bear lower legal costs linked to the identification and seizure of a suspect quantity of raw tobacco, given that under the excise legislation their powers can be more easily actioned in case of frauds compared to non-excised goods. The high enforcement costs due to the non-excisability of raw tobacco were mentioned as one of the most significant obstacles by customs investigation offices, together with the difficulty of following cross-border trade because of the lack of EU documentation and monitoring system. Excisability of raw tobacco may contribute reducing these enforcement costs.

5.2.1.2 Illicit trade, indirect impacts on tax revenues, and tobacco control policies

Regulatory costs described in section 5.2.1.1 above could be justified, in a net benefit perspective, should the reduction of illicit trade, and the consequent recovery of tax revenues on finished products previously manufactured with illicit raw tobacco, be sufficient. Given that lost tax revenues were estimated at about €1.2-2 bn²⁸³ and regulatory costs at about €200 mn, the inclusion of raw tobacco within the excise system should reduce trade of illicit raw tobacco by about 10-20% to achieve positive net benefits.²⁸⁴

Extending the EMCS and the other requirements of the excise system may enhance the monitoring of movements and make illicit trade more difficult, but it may not eradicate the problem, since there would remain a strong economic incentive for illicit activities and the actual minute monitoring of tobacco at field and transport level would remain complex and burdensome. In particular:

1. It is unclear to what extent excisability of raw tobacco, and the consequent easier identification and seizures of illegal trade flows, could constitute such a significant deterrent to illegal growers and operators. Most probably, growers in the legal value chain which also sell part of their production to illicit traders could no longer be able to do so due to the more granular controls.²⁸⁵ However, the deterrence effects may be not so effective on fully illicit players,

²⁸³ Cf. Section 3.2.4.1 above.

²⁸⁴ If the lost revenues due to the illicit trade of raw tobacco were at the high end of the range, 10% of € 2 bn would be sufficient to cover regulatory costs; if they were at the low end, approximately 20% of € 1.2 bn would compensate for regulatory costs.

²⁸⁵ Though the number of controls is not expected to raise significantly if the excise rate is kept at 0, controls would still be more granular, and thus effective due to the higher amount and quality of information available.

which are likely to remain outside the new system, and face only a higher risk of seizures in case of random or targeted checks. This concern was also expressed by several public authorities, which questioned the effectiveness of the excisability option in respect to the illicit side of the market.

2. The criminal organisations which currently purchase EU raw tobacco for the production of illicit cigarettes could shift their supply base to third countries and use non-EU raw materials. Hence, a decrease, however large, of the illicit trade of EU raw tobacco may not cause a corresponding reduction of the availability of illicit products, and hence a recovery of tax revenues.

The above considerations do not deny the contribution of a possible inclusion of raw tobacco among excisable products to monitoring and enforcement, especially in the MS that do not have an efficient monitoring system in place. However, the tax evasion possibly recovered is unlikely to outweigh the administrative and compliance costs incurred by economic operators and, to a lower extent, public authorities. At the same time, given that doubts persist on whether and to what extent the reduction of illicit raw tobacco would translate into a reduction of illicit manufactured products, benefits in terms of tobacco control policy linked to a possible lowering of tobacco consumption are also expected to remain small.

5.2.1.3 Non-regulatory options

The administrative regulation of the raw tobacco sector would, in principle, trigger similar types of impacts compared to the inclusion of raw tobacco among excisable products: creation of costs for economic operators and, to a lower extent, for public authorities; reduction of illicit trade and thus the recovery of tax revenues of finished products. To infer the magnitude of these impacts, the Consultant tried to retrieve evidence from the experience of MS with their national regulatory frameworks.

➤ SUBSTANTIVE COMPLIANCE AND ADMINISTRATIVE COSTS

Costs are likely to be lower, perhaps significantly, than in the case of inclusion in the excise system. Indeed, while economic operators and growers would still need to apply for registration and authorisation, to enter into written contracts, and to keep records of the stocks and flows of raw tobacco, they would not be subject to some burden linked to the excise system. In particular, they would not be required to set up a tax warehouse or provide a guarantee. For first processors, a regulated system would go only slightly beyond the current business-as-usual operations and legal requirements. Also in the case of growers, many of them are already subject to similar obligations at national level. For these reasons, economic operators unanimously considered that administrative regulation would generate far less regulatory costs than excisability of raw tobacco.

The overall costs of the tobacco monitoring system which has been set up in Italy suggest that this may be the case. Costs of controls amount to about €120,000 per year, or €3 per tonne of raw tobacco, which is a small fraction of the costs estimated above. While quantitative estimates could not be retrieved in other jurisdictions, economic operators subject to regulatory requirements in Hungary suggested that the level of administrative burden created is acceptable.

➤ EFFECTIVENESS

Robust information on the effectiveness of the current national systems could not be retrieved. On one side, there are national public or private systems that seem very effective in preventing illicit trade, as in France and in Italy. However, this could not constitute a telling evidence of effectiveness, because illicit trade of raw tobacco in these countries has never been a problem according to local public authorities – for

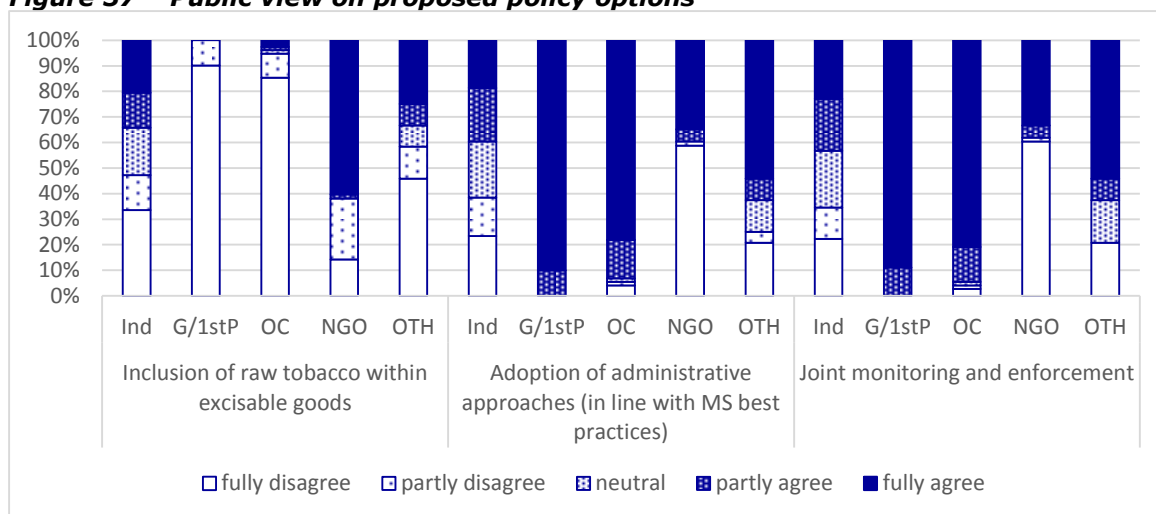
example, in Italy there were no evidence of significant illicit trade even before the introduction of the current system. In Poland, where considerable issues with illicit trade were reported, the system entered into force as of last year, so it is too early to assess its effectiveness. In Slovakia, a non-growing MS, the system was reportedly effective in reducing illicit trade of raw tobacco, including when sold at retail. However, this finding can hardly be extrapolated to MS in which growing and first processing activities take place, as these activities create greater risks of diversion into the illicit trade.

5.2.1.4 The public view on the proposed policy options

Figure 37 below illustrates the general public response to the proposed policy options to tackle the issue of illicit trade of raw tobacco. In particular:

- The tobacco industry – at all levels of the value chain – strongly oppose the inclusion of raw tobacco within the scope of the Directive and at the same time strongly agree with the other two non-regulatory options.
- To the contrary, NGO are in favour of making raw tobacco an excisable product and tend to disagree with the other two ‘soft’ approaches.
- The ‘other’ respondent group (which includes also a few public authorities) were more in favour of the non-regulatory options.

Figure 37 – Public view on proposed policy options



Legend: Ind: Private Individual; G/1stP: Grower or First Processor; OC: Other Company; NGO: Non-governmental organisation; OTH: Other.

Note: The total number of respondent varies across questions. ‘Don’t know’ answers not displayed.

Source: OPC.

5.2.1.5 Comparison of policy options

Table 35 below provides the multi-criteria analysis for the policy option considered, i.e. the inclusion of raw tobacco among excisable products with respect to the no change scenario, i.e. the absence of any regulation of raw tobacco at EU level, while national frameworks continue to enter into force or be enforced. For every impact, a summary judgment is provided including (i) a rating of the positive or negative effect expected (between -2 and +2); and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process, so the ratings provided cannot be summed or aggregated.

Table 35 – Inclusion of raw tobacco among excisable products – Comparison of Options

Impact area and target groups	No change		Inclusion	
Regulatory costs for economic operators	0	National regulatory systems are unlikely to generate significant costs on economic operators within the licit value chain	-2	Significant costs for economic operators, including both growers and first processors, up to 46% of current tobacco production value
Competitiveness and SME	0	Costs of the current system had no effect on the competitiveness of the European tobacco sector	-2	The costs would hamper the competitiveness of the European tobacco sector, and in particular of growers, the population of which largely consists of micro and small enterprises.
Enforcement costs for public authorities	0	No expected increase of enforcement costs in the following years	0	Excisability of raw tobacco could require additional enforcement resources. At the same time, authorities' powers could be used more efficiently
Crime: illicit trade (for public authorities)	0 / +1	Progressive introduction of national frameworks and their implementation is likely to reduce illicit trade, though possibly not sufficiently for cross-border movements	+1	Though the effectiveness cannot be estimated in quantitative terms, the excise system is expected to cause a reduction of illicit trade, providing public authorities with new or improved monitoring tools
Tax revenues (for tax administrations)	0	No significant changes to tax revenues from manufactured products are expected	0 / +1	Though positive impacts in terms of tax revenues from manufactured products can be foreseen, excisability of raw tobacco is not expected to significantly affect the availability of illicit products
Tobacco control policies (for public health stakeholders)	0	No expected impacts in the consumption of tobacco products	0	No expected impacts in the consumption of tobacco products

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- Illicit trade of raw tobacco is roughly estimated at 6,700-11,200 tonnes, that is between 0.8% and 1.2% of EU raw tobacco market (including EU production and net imports). Lost revenues on the amount of cigarettes which can be produced with illicit raw tobacco would amount to € 1.2 to 2.0 bn, that is 1.6% to 2.7% of the current revenues from cigarettes. The magnitude of the problem is therefore relevant, though lower than the illicit trade of manufactured tobacco products.
- The inclusion of raw tobacco among excisable products seems to be a disproportionate response, given the amount of costs associated. In particular, administrative and compliance costs for growers and first processors are expected to be significant, and would represent a cost increase of 35% compared to the current price of raw tobacco. With respect to the EU raw tobacco market, additional regulatory costs would amount to 8% of its value.

- The costs associated with this policy option would hamper the competitiveness of the European tobacco sector, and especially growers, which are by large micro and small companies. It is unlikely that these costs could be passed on to manufacturers of tobacco products, given that raw tobacco is a global commodity.
- Excisability is expected to bring benefits in terms of reduction of illicit trade, and, to a more limited extent, also of recovery of evaded tax revenues. However, this option should have a high effectiveness to bring the cost-benefit balance in positive. The analysis and the considerations put forward by several public authorities point out that this is unlikely to be the case.
- The re-introduction of a regulatory framework for the tobacco sector could have an effectiveness comparable to the excisability system. At the same time, it is expected to generate significantly lower costs on economic operators, thus improving the cost-effectiveness of a possible intervention.
- A problem of illicit trade of raw tobacco in the EU exists and, at the same time, the tools provided by the EU framework fall short of ensuring a sufficient monitoring and control of its trade flows. For this reason, MS have moved towards the design and implementation of dedicated regulatory frameworks. Though action can be recommended in this area, attention should be paid to how the monitoring system is set up and on its costs for economic operators.

5.2.2 Tobacco put up for retail sale: revision of Art. 5.1.a

5.2.2.1 Analysis of impacts

The possible revisions of the definition of smoking tobacco should first be assessed in terms of their legal clarity, evaluating their intended consequences, as well as possible unintended ones and their fitness to prevent the marketing of 'borderline' products. Once this assessment is carried out, impacts in terms of regulatory costs and tax revenues will be discussed qualitatively.

- Adding 'in a tax warehouse' clause. By adding this clause, all smoking tobacco which is intended for transformation outside of a tax warehouse could be considered excisable. This definition would fit the downstream part of the value chain, where licit FCT is manufactured by tax warehouse keepers, whilst raw tobacco for retail is produced and sold by operators outside of a tax warehouse. Also, when shops sell raw tobacco that requires further processing to consumers, such processing would clearly not be carried out in a tax warehouse, so that the product would become excisable. However, this revision could create problems in the upstream part of the value chain, where legitimate operators handle, store, and trade dried raw tobacco (hence potentially smokable) which is intended for further transformation outside of a tax warehouse. These operators include growers and grower groups managing curing facilities for the drying of raw tobacco, and first processors.
- Adding a 'put up for retail clause' so that all cut tobacco that is prepared for sale or sold to consumers, regardless of its properties and degree of finishing, is considered excisable. This would eliminate the problem of operationalising the 'further industrial processing' clause, hence closing the current loophole. While the 'put up for retail sale' clause worked quite well when applied to tobacco refuse, potential risks linked to the raw and processed tobacco markets are greater, given its much larger trade flows and output value. If 'retail' were defined based on quantity, such an approach would be in line with legitimate business practices, as economic operators never move small quantities or boxes of raw tobacco, which is usually transported in 100 to 200-kg cartons.

- Another possibility to clarify the definition would be the identification of the consignee, so that raw or processed tobacco should never be considered excisable when it is under the control of or intended for a manufacturer of tobacco products. The attention would then be moved from the quality of the product to the nature of the consignee. This change would probably draw a clear line between tobacco for further transformation and tobacco for retail. However, excise definitions of tobacco products included under the current Directive are objective, in so far as the excisability of the same product in the same condition (including packaging) does not depend on the nature of its consignee. Switching from a product-based to a counterpart-based definition could create further uncertainty.

All the options above present pros and cons in terms of legal certainty. The most robust approach would likely consist of adding the 'put up for retail clause', and define 'retail' based on the quantity and packaging features – something that could also been done at national level, provided that the definition adopted remains in line with art 5.1.a. In this case, raw tobacco for retail sale would be by definition excisable, and the associated tax revenues could be recovered. Nevertheless, when in Slovakia raw tobacco put up for retail sale was considered excisable, the market collapsed and revenues amounted to few hundred thousand euro over 2 years. Indeed, such a 'borderline' product exists only as long as it is not taxed or regulated; once taxation is applied, there is no rationale for it, hence no or negligible additional tax revenues should be expected from the revision of the definition.²⁸⁶

Revising the definition is not expected to create substantive compliance or administrative costs for economic operators, because the definition largely corresponds to the current business practices of legitimate players. At the same, there would be no additional enforcement costs for public authorities. However, while removing the 'industrial processing' clause could increase legal certainty, the new definition could create risks of 'borderline' products, in an area of the market where they have already emerged.

The Commission could also consider keeping the regulation unchanged and providing MS with a clarification of cases in which the further processing can be presumed to be 'industrial' or not. This could be even more the case as the CJEU has recently interpreted the definition, and in particular the 'without further industrial processing' clause as not covering "manufactured tobacco which is ready, or can easily be made ready, by non-industrial means, to be smoked". The clarification could be enacted by means of non-binding guidelines that may specify that when cut tobacco is sold in consumer-size packages and quantities and/or can be made smokable by simple consumers' actions (e.g. simple cutting, oven-drying), the 'further industrial processing' clause could not be invoked to exclude excisability. Useful inputs on the description of 'borderline' cases could be drawn from the customs authorities having already experienced the problem. This option could increase legal certainty, support MS in tackling raw tobacco put up for retail where and when they emerge, without creating further risks of new 'borderline' products that could be marketed following the revised definition. As a support to this analysis, it should be noted that several MS were already able to prevent the marketing of raw tobacco for retail sale under the current definition (e.g. Italy, the UK), and that other MS in which the problem was pressing (Poland, Slovakia) could tackle it with means already at their disposal, i.e. by revising their national framework or stronger enforcement.

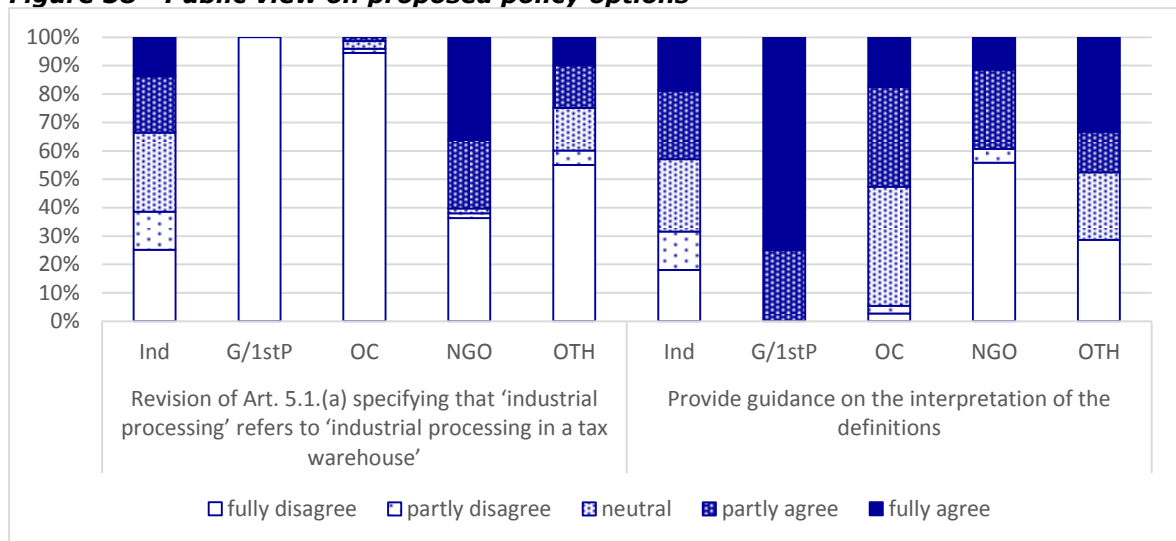
5.2.2.2 The public view on the proposed policy options

²⁸⁶ If not indirectly in case smokers of cut tobacco return to licit products. At the same time, however, they could also switch to other non-duty paid products, making recovery of tax revenues unlikely.

The OPC tested the stakeholders' opinions regarding the possible revisions of the text of the Directive aimed at clarifying the definition of smoking tobacco by adding the 'in a tax warehouse' clause. Such option was met with strong disagreement by the entire industry and the public authorities (included in the 'other' respondent group). NGO were in favour, while the views of individuals was mixed.

To the contrary, the non-regulatory option, which consists of providing MS with guidance for the correct interpretation of the definitions, received the full support of growers and first processors and good support/neutral stance on behalf of the rest of the industry and other respondents. The support of NGO was far more limited compared to the legal revision.

Figure 38 - Public view on proposed policy options



Legend: Ind: Private Individual; G/1stP: Grower or First Processor; OC: Other Company; NGO: Non-governmental organisation; OTH: Other.

Note: The total number of respondent varies across questions. 'Don't know' answers not displayed.

Source: OPC.

5.2.2.3 Comparison of policy options

Table 36 below provides the multi-criteria analysis for the policy option considered, i.e. the dynamic baseline scenario, the provision of non-binding guidelines, and the revision of the definition of smoking tobacco provided for in Art. 5.1.a. For every impact, a summary judgment is provided including (i) a rating of the positive or negative effect expected (between -2 and +2); and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be summed or aggregated.

Table 36 – Tobacco put up for retail sale: revision of Art. 5.1.a. Comparison of Options

Impact area and target groups	A) No Change	B) Non-binding Guidelines	C) Directive Revision
Legal certainty for economic operators and public authorities	+1 The CJEU judgment enhanced the clarity of the Directive with respect to the excisability of raw tobacco put up for retail sale.	+2 Guidelines on the operationalisation of the 'further industrial policy clause' could clearly identify raw tobacco put up for retail sale as an excisable product.	+2 A new definition could limit uncertainty in 'borderline' cases.
Regulatory costs for economic operators and enforcement costs for public authorities	0 No additional regulatory or enforcement costs are expected.	0 No additional regulatory or enforcement costs are expected.	0 A new definition could be in line with business practices, creating no impacts for economic operators. No enforcement costs for public authorities are expected.
Tax revenues (for tax administrations)	0 Tax revenues from raw tobacco put up for retail sale are and will remain negligible (where they are imposed).	0 Once properly taxed, raw tobacco put up for retail sale is likely to be sold in very small quantities.	0 Once properly taxed, raw tobacco put up for retail sale is likely to be sold in very small quantities.
Crime: illicit trade (for public authorities)	+1 MS are likely to control the appearance of untaxed tobacco products in the market even if no action is undertaken at EU level.	+2 Provision of guidelines, once properly implemented, could allow removing untaxed raw tobacco from the consumer market, while minimising the risk of new 'borderline' products.	+1 A revision of the definition could allow removing untaxed raw tobacco from the consumer market. Possible risks of new 'borderline' products cheating on the new definition.

Legend:

+2 major positive effect expected,
+1 moderate positive effect expected,
0 no effect or neutral impact expected,
-1 moderate negative effect expected,
-2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- In some MS raw tobacco for retail sale appeared on the market circumventing excise duties. Various MS were able to address the issue adopting measures to either prevent its marketing or bring this trade under control.

The proposed revisions of certain subjective terms of current definitions present challenges in terms of legal clarity, possible costs for legitimate players, enforcement cost for public authorities, and unintended risk of new 'borderline' products. Hence, the suggested course of action consists of keeping the definitions unchanged and provide guidelines on the criteria when raw tobacco should not be

considered for 'further industrial processing' and thus excisable, based on existing national experience and best practices.

- Should the registry of authorised operators of raw tobacco be implemented, this could help in distinguishing situations in which tobacco is legitimately moved along the value chain from situations in which 'borderline' traders try to market untaxed smokable tobacco.

5.2.3 Tobacco refuse: revision of Art. 5.1.b

5.2.3.1 Analysis of impacts

To respect the principle of proportionality, any clarification of Art. 5.1.b, by means of either a Directive revision or non-binding guidelines, should be as non-intrusive of the market as possible, given that the problem at stake is of a small magnitude.²⁸⁷ To this purpose, it should be verified whether the revision has the potential of providing legal certainty to both economic operators and public authorities, while limiting regulatory costs and incentives to illicit trade.

Providing a double threshold to define retail sale of tobacco refuse could possibly meet these objectives:

- 1) It provides legal clarity by providing a safe-harbour threshold for economic operators that produce, sell, or transform tobacco refuse.
- 2) It provides tax and customs authorities with a clear maximum threshold for considering small packages of smokable tobacco refuse as excisable, which does not generate any significant enforcement costs; to the contrary, a verification of the nature of the product (i.e. refuse vs. cut tobacco) or of the consignee would increase enforcement costs due to testing and investigation.
- 3) With respect to the risk of illicit trade, it provides customs authorities with the possibility of intervening, by seizures or the imposition of excises, on 'borderline' shipments of tobacco refuse, the packaging size of which is not sufficient to determine with certainty their intended use. Also, tax and customs authorities could impose excises when there are signs that the packaging has been tampered.
- 4) This option is not expected to generate any substantive compliance or administrative costs on legitimate economic operators, who already do not have any interest in selling small quantities of tobacco refuse and thus would not be affected. If any, a revision could produce administrative cost savings, to the extent to which companies do not have to provide additional proof of the nature of their shipment.

It remains to be determined the best tool to achieve these aims. Revising the definition of Art. 5.1.b in the text of the Directive would reduce the flexibility of the legal framework, especially in case 'borderline' products based on tobacco refuse should emerge in the market. Indeed, any future adjustment of the definition would continue to require a revision of the Directive. However, a legislative provision would provide the maximum degree of legal clarity, which cannot be obtained through non-binding measures such as guidelines. An intermediate solution could be the introduction of this definition in a secondary norm, such as a Commission delegated or implementing act. At present, this is not feasible, since the Directive does not

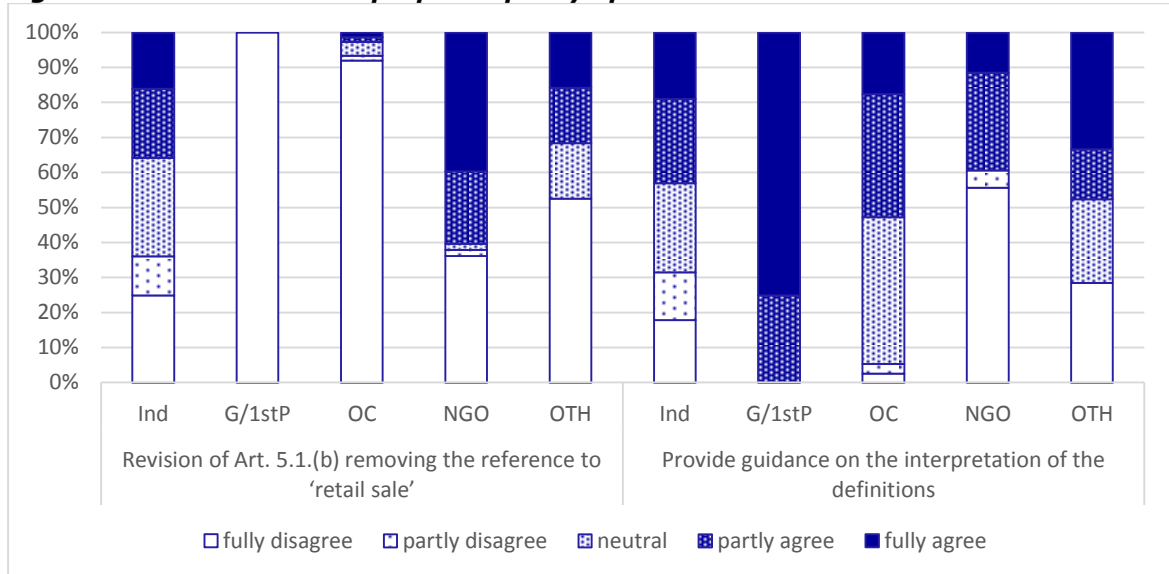
²⁸⁷ Cf. Section 3.2.4.4 above.

expressly envisage it. But this option could be considered for a possible future revision of the Directive, since it would allow to deal with this definitory issues more flexibly.

5.2.3.2 The public view on the proposed policy options

In the OPC, stakeholders were asked to provide their view on the revision of the definition of tobacco refuse. The option to consider all tobacco refuse, including when not put up for retail sale, excisable was met with quasi-unanimous disagreement by the industry. NGO were mostly in favour of such option, while the 'other' respondent group (including a few public authorities) disagreed. To the contrary, the industry was in favour of non-binding guidelines, an option much less appreciated by NGO.

Figure 39 – Public view on proposed policy options



Legend: Ind: Private Individual; G/1stP: Grower or First Processor; OC: Other Company; NGO: Non-governmental organisation; OTH: Other.

Note: The total number of respondent varies across questions. 'Don't know' answers not displayed.

Source: OPC.

5.2.3.3 Comparison of policy options

Table 37 below provides the multi-criteria analysis for the policy option considered, i.e. the revision of the definition of tobacco refuse provided for in Art. 5.1.b. For every impact, a summary judgment is provided including (i) a rating of the positive or negative effect expected (between -2 and +2); and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be summed or aggregated.

Table 37 – Tobacco refuse: revision of Art. 5.1.b. Comparison of Options

Impact area and target groups	No change		Revision of the Directive	
Legal certainty for economic operators and public authorities	0	The problem is minor and is not expected to change in the future.	+2	A double threshold could increase legal certainty, by defining both a safe-harbour for legitimate players, and minimum requirements below which the non-excisability could not be invoked.
Regulatory costs for economic operators and enforcement costs for public authorities	0	No significant costs are associated with the current version of the definition. No change foreseen.	0	The change in the definition is in line with the business conduct and needs of legitimate players, while it is not expected to increase costs for enforcement authorities.
Crime: illicit trade	0	Illicit trade of tobacco refuse is not considered a major problem and is not going to increase in the future.	+1	Customs authorities could retain the flexibility of imposing excises on smokable tobacco refuse in 'borderline' cases.

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- Any change to the legal framework for tobacco refuse should be weighed against the proportionality principle given the limited magnitude of the current problems.
- Excisability of tobacco refuse in all cases, i.e. also when sold in bulk, would generate excessive impacts on economic operators, and thus appears a disproportionate intervention.
- A two-threshold system, with a lower threshold below which tobacco refuse should be considered for retail sale and a higher threshold above which tobacco refuse should be considered in bulk, could provide economic operators and customs authorities with a clear and enforceable definition, while at the same time preserving the possibility for customs to intervene in 'borderline' cases.

5.3 'Borderline' Products

5.3.1 Impact from reducing the incentive for 'borderline' cigarillos

5.3.1.1 Market effects and Tax revenues

The policy option analysed here consists of establishing a mandatory minimum excise duty (MED) for cigars and cigarillos to replace the current optional one laid down in Article 14.1 of the Directive. The option may or may not include a fixed minimum amount per number of pieces or per weight. Evidently, if no positive amount is set at EU level, the impact of this regulatory change would entirely depend on MS choices, and is therefore unpredictable at this stage. For this reason, for analytical purposes, the scenario assessed here envisages the establishment of a fixed minimum amount of MED.

Given the paucity of disaggregated information on the category of 'borderline' (or low price) cigarillos, the assessment has been conducted simulating the effects of the introduction of such a measure in one country, Germany, whose market accounts alone for an estimated 50% of the total EU sales of these products. The assessment has been conducted using the official data on sales per price band. The data do not allow to distinguish between cigarillos with enhanced similarities with cigarettes and other low price products. However, the unit price seems a good proxy for identifying the target segment of products. It is important to underline that Germany currently applies a dynamic MED (i.e. including VAT) on this category. For simplicity, and to allow an easier extrapolation of results at EU level, the simulation developed here is instead based on a standard MED (i.e. excluding VAT). The analysis involves four steps, as described below.

- **1st step: estimating the quantity of low-price cigarillos**

The share of the cigarillos qualifying for being considered potential substitutes have been determined in relation to the price of cigarettes. Assuming a weighted average price (WAP) of cigarettes of € 0.269 / stick, and a minimum price of € 0.222 (reportedly the cheapest brand available in the country), two measures have been calculated: (i) the number and the share of cigarillos that have a retail selling price (RSP) lower than the cigarette WAP, and (ii) the number and the share of cigarillos that have a retail selling price lower than the cheapest cigarette brand. Both measures can be relevant, although it can be assumed that 'borderline' cigarillos in strict sense should be priced lower than any cigarette brand in order to induce substitution.

The results are reported in **Table 38** below. Depending on the threshold considered, low-price cigarillos (hereinafter 'LPC') account for 73-77% of the total volume and 44-48% of total value of the overall cigars and cigarillos category, in Germany. The weighted average price of LPC is approximately € 0.14 /unit.

Table 38 – Estimated share of low-price cigarillos on the total

Price Threshold	LPC quantity		Retail value		WAP of LPC segment
	mn units	share	€ mn	share	€ / unit
Below cigarettes WAP	2,391	77%	340	48%	0.142
Below cigarettes cheapest brand	2,274	73%	313	44%	0.138

Source: Author's estimates based on German authorities data.

- **2nd step: establishing a positive MED**

The second step consists of establishing an appropriate MED – structured as a specific amount per piece – that is able to neutralise the hypothetical tax-induced competitive advantage of LPC. In this step, it is important to consider the tax bearing capacity of

cigarillos, which is not the same as cigarettes given the substantial differences in the production process. This requires to estimate the minimum revenue floor, below which manufacturers may not be able to operate at a profit. Evidently, this measure varies greatly across operators, but a good proxy is provided by the current average 'revenue after tax' (RAT), calculated deducting all taxes (including VAT) from the retail selling price. It is reasonable to assume that in the event of a tax increase manufacturers of low price products would not be able to absorb the additional tax burden and would pass it on to final price. The average RAT has been calculated again for two samples: (i) cigarillos priced below the cheapest cigarette brand (LPC1) and (ii) cigarillos priced below the cigarette WAP (LPC2). For each sample, the MED have been calculated as the excise applicable to the RAT, which brings the final price to the level of cigarettes (including the VAT effect). As shown in **Table 39**, this leads to a possible MED of € 80 or € 86 per thousand pieces.

Table 39 – Estimated MED necessary to eliminate price advantages of low-price cigarillos

	Average RAT (€)	Maximum tax capacity (€)	Maximum excise capacity (€)	MED per 1,000 pieces (€)
LPC1 (priced below the cheapest cigarette)	0.106	0.116	0.080	€ 80
LPC2 (priced below cigarette WAP)	0.140	0.129	0.086	€ 86

Source: Author's estimates based on German authorities data.

- **3rd step: estimating price increase and market effects**

The price sensitivity of the consumers of cigarillos have never been investigated in-depth in the economic literature. The demand for traditional cigars is generally inelastic, due to their peculiar consumption patterns. Instead, it can be assumed that 'borderline' cigarillos smokers are highly sensitive to price, for the very nature of these products. In other words, if the main market driver of 'borderline' cigarillos is being cheaper than cigarettes, the closing up of price differential would in principle lead these products to disappear. However, as discussed, the hypothetical MED would not affect only 'cigarette-substitute' cigarillos but also some ordinary low-price cigarillos, for which consumers may be less price sensitive. According to OPC results, possibly less than 25% of the current consumers would keep on consuming cigarillos if their price was the same of cigarettes. About one third would opt for manufactured cigarettes while the majority would turn to other cheap alternatives (including the black market). Data are insufficient for a rigorous calculation of the elasticity of the demand to price for these products, but for analytical purposes it is reasonable to assume a coefficient of [-2], i.e.: a certain amount of increase in prices would cause a two-time decrease in consumption.²⁸⁸

The results of the analysis are reported in **Table 40** below. As a consequence of price increases the sales would drop by ca. 50% in volumetric terms and by ca. 30% in monetary terms, in both cases analysed (i.e. the above-defined LPC1 and LPC2 sample). In absolute terms the market loss for these products would amount to approximately € 100 mn. It has to be considered that the MED would affect not only the targeted low-price cigarillos but also a significant amount of other cigarillos that are currently yielding an excise below the established MED. The dimension of these unintended effects have been also estimated in **Table 40**. Considering the entire sub-sample of cigarillos that would be affected, the estimated market loss would be close to € 150 mn.

²⁸⁸ As in the case of new products (see Section 5.1), the lack of a clear demand function for these products, combined with a certain heterogeneity of products and a simulated major variation of price suggest to make recourse to the 'arc elasticity' (or mid-point elasticity) instead of the end-point elasticity.

Table 40 – Expected market effects of a revised MED

	Current Status			Expected variation			
	# pieces (mn)	Unit price (€) (weighted average)	Market value (€ mn)	# pieces (mn)	Unit price (€) (weighted average)	Market value (€ mn)	Var.
Low-price cigarillos							
MED at € 0.80 on LPC1	2,274	0.138	313	1,166	0.190	222	-29%
MED at € 0.86 on LPC2	2,391	0.142	340	1,146	0.203	233	-32%
All cigarillos							
MED at € 0.80	3,096	0.206	636	1,873	0.263	493	-23%
MED at € 0.86	3,097	0.207	640	1,776	0.271	482	-25%

Source: Author's estimates based on German authorities data.

- **4th step: impact on tax revenues**

The final step consists of estimating the variation in the tax revenue possibly induced by the hypothetical MED analysed and comparing it to the estimated 'tax gap' induced by substitution. The tax gap can be conventionally assumed as the difference between the excise currently levied and the corresponding excise levied if these cigarillos were taxed as cigarettes (at the WAP). This is evidently a strong assumption since in the absence of low-price cigarillos many consumers may not opt for cigarettes but to other cheap products, such as FCT. Based on OPC results, it is therefore assumed that only half of this consumption may translates into a tax gap²⁸⁹. Overall, the hypothetical tax gap in this exercise amounts to € 140mn.

Table 41 below provides the estimated tax revenue from the application of a MED of € 0.80 or 0.86, on the two sub-segments considered. The reduction in the demand due to the price increase is taken into account. The tax revenue variation compared to the current situation seems all in all modest: 15-18%. Additionally, the tax revenue would increase by a certain share due to consumers switching back to cigarettes (some one-third, according to OPC results).²⁹⁰ All in all, the increased revenue generated by these two combined effects may sum up to some € 18-22 mn, that is 13-15% of the estimated tax gap.

On the other hand, also the tax unintendedly levied on other non-target cigarillos would increase. If all cigarillos and not only target LPC are considered, the variation in the tax revenue would be more significant, i.e. up to some 53% - 56%. This means that the tax effect on non-target may be greater than that on target cigarillos.

²⁸⁹ This rough estimate combines the percentage of current cigarillos smokers who affirmed that in case of a tax alignment typical users would continue smoking cigarillos (ca. 20%) with those who affirmed the typical consumers would turn to cigarettes (ca. 30%). This is used as a proxy to estimate the share of consumers potentially willing to accept to pay more, and therefore the amount of current tax gap that can be recuperated.

²⁹⁰ As described in the previous footnote, according to some 30% of cigarillos smokers who took part in the OPC, the typical reaction of consumers to tax alignment could be to turn to cigarettes. In this sense the reduction of the demand analysed in table 40 would have a mitigated impact on tax revenues, due to a certain increase in tax revenues from cigarettes.

Table 41 – Estimated impact of a hypothetical MED on excise revenues

	Current tax yield (€ mn)	Excise revenue w/ MED at € 0.80 (€ mn)	Excise revenue w/ MED at € 0.86 (€ mn)	Var.	Est. revenue from reduced substitution (€ mn)	Est. reduced 'tax gap'
Low-price cigarillos						
LPC1	81.1	93.3		15%	5.8	13%
LPC2	83.5		98.5	18%	6.5	15%
All cigarillos						
	97.7	149.9	152.7	53% - 56%		

Source: Author's estimates based on German authorities data.

5.3.1.2 Other qualitative effects

The above simulation has two main implications for the other two impact areas considered in this Study, and namely:

- **Unintended effects.** The introduction of stricter tax measures aimed at approximating the price of 'borderline' cigarillos to the price of cigarettes may eventually have non-negligible distortive effects on the entire category. The different tax bearing capacity of certain products that are safeguarded today by a relatively low excise duty may be severely affected by a flat MED calculated so as to tackle 'borderline' products. In our simulation, about one-quarter of the potentially affected cigarillos were not in the target sample. Since 'borderline' products are more likely to be price sensitive, their quantity – hence tax yield – may drop following a tax increase, so most of the additional tax revenue may perhaps come from the non-target products.
- **Undermining of tobacco control.** Under many respects, the current risk of tax-induced substitution caused by 'borderline' cigarillos appears marginal, and insufficient to motivate a major tax overhaul. The level of consumption EU-wide is all in all small (some 7% of cigarettes) and declining, due to the recent regulatory and tax revisions. According to the OPC results, possibly less than 10% of current cigarillos consumers would reduce or quit smoking if their price was equivalent to that of cigarettes. In this sense, the impact on smoking prevalence of the measures considered would be limited.

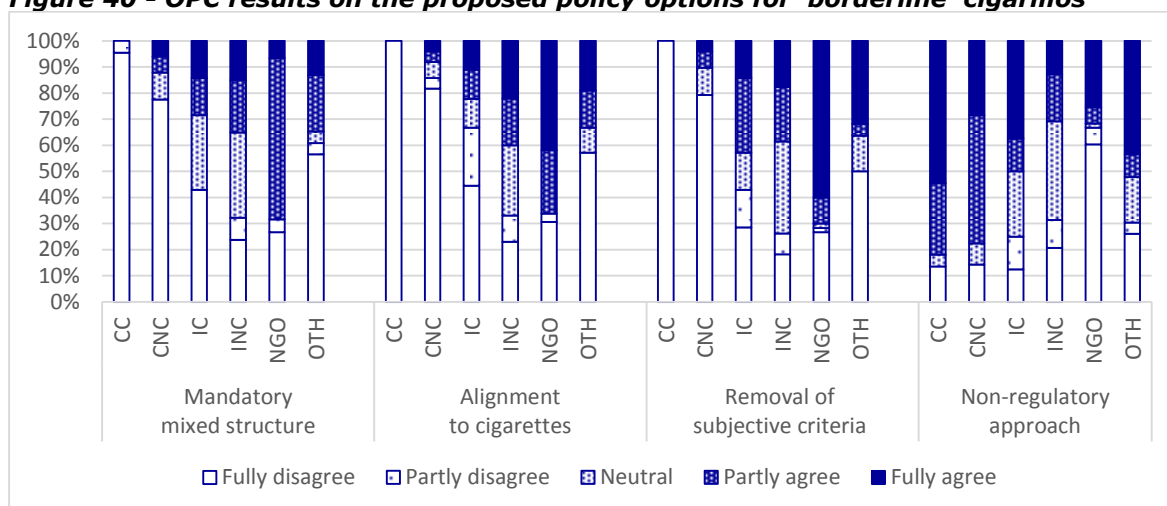
5.3.1.3 The public view on the proposed policy options

Four options were submitted to the open public consultation (OPC), of which three regulatory revisions of the Directive and a 'soft' policy option. As discussed in Section 4.3, the options eventually retained for the assessment were formulated slightly differently. However, the results of the OPC may still contribute to understand the orientations of the various stakeholders on this matter. The levels of agreement / disagreement with the proposed options within the different subgroups of respondents are shown in **Figure 40** below. In particular:

- "Introduction of a mandatory mixed structure or a specific rate (per 1 000 pieces) for the cigars/cigarillos tax category, to discourage the development of 'borderline' products." This option has been discarded due to its disproportionate effects across MS. Only NGOs seem in favour of this approach, as a way to increase the tax burden on this product, but it is not their preferred approach. Individual non-consumers' answers are polarised, while all other subgroups are at various extent not in favour of this option.

- (ii) "Alignment of the minimum excise taxes on cigars/cigarillos with those of cigarettes, to mitigate tax-driven substitution." This is consistent with the main option developed in this Study, although the formulation used in the OPC may suggest an even stronger tax burden increase. Unsurprisingly all companies and especially cigarillos manufacturers are strongly against this option. A few economic operators expressed a favourable opinion likely due to the potential market distortion currently induced by cigarillos. The results among other sub-groups are similar to option (i).
- (iii) "In the definition of cigars/cigarillos (Art. 4.1 of the Directive) the reference to 'normal consumer expectations' should be removed so as to reduce the risk of subjective interpretations." A higher degree of positive replies (although still a minority) can be noted in the 'others' sub-group, which includes public authorities and some experts. This suggests subjective definitions are potentially a cause of uncertainties and ensuing burden.
- (iv) Encouraging MS to use the instruments provided by the Directive to address the possible distortions, where relevant. This resulted by far the preferred option in all sub-groups (except NGOs and non-consumers who may consider it too soft against tobacco control targets). In line with the results of in-depth interviews. A solid majority of cigarillos producers (81%) and other companies (78%), as well as other respondents (53%) believe the Directive already provide MS with all instruments necessary to tackle 'borderline' products.

Figure 40 - OPC results on the proposed policy options for 'borderline' cigarillos



Legend: IC: individual respondent – cigarillos smoker; INC: individual respondent non-cigarillos smoker; CC: cigarillos manufacturer; CNC: non-cigarillos manufacturing company; NGO: non-governmental organisation; OTH: other.

Note: The total number of respondent varies across questions. 'Don't know' answers not displayed.

5.3.2 Impact from addressing classifications disparities

5.3.2.1 Administrative and compliance burden and savings

➤ REVISION OF ART. 4.1(A)

An example of a dispute related to the uncertain classification of cigarillos was analysed and reported in the Ramboll Evaluation. The matter of dispute was whether or not the filter has to be covered by the wrapper, and the inconsistency between the CN explanatory notes and Article 4(1) of Directive 2011/64. The excise product classification proposed by the manufacturer was challenged by the tax administration and to avoid further disputes a BTI request was formulated. The Evaluation estimated

some 9 staff/day of direct costs of the procedure. More significantly, the operator reported negative consequences from having to postpone by about two months the launch of the product.

The frequency of the above issues seem low. At present, there are 35 active BTI decisions in the category of cigars and cigarillos. Despite the fact that product details are not disclosed, general descriptions allow to discern that only a few rulings actually regard 'borderline' cigarillos. The marginality of the classification issue and related disputes was also confirmed by industry operators. One of the major players in this segment reported having only one court case ongoing at present. In this sense, the alignment of excise product definition and CN code is not expected to generate important administrative savings, but would make the recourse to BTIs and the risk of disputes even smaller than at present.

On the other hand, it may generate some compliance costs for the manufacturers of cigarillos that are currently subject to the 'dual' classification, i.e. the brand of cigarillos that have a further paper layer on the filter. The harmonisation of classifications would place them in the tax category of cigarettes, and eliminate their competitive advantage. In this sense, it can be anticipated that manufacturers would rather modify their product so as to remain in the tax category of cigars/cigarillos. It is however not feasible to estimate these indirect compliance costs, but it can be assumed it would vary significantly between big tobacco companies and independent manufacturers. Also the number of products requiring these modifications is difficult to determine. As a benchmark, in Germany – that is the most developed market for low-price cigarillos - there are nine mainstream products (i.e. selling more than 100 mn pieces / year) in the low price category of cigarillos.

➤ **ADAPTATION OF EMCS**

A pragmatic alternative would be to adjust EMCS so as it allows entering a CN code and an EPC code that correspond to different categories of products under the two different classifications (provided it results technically and legally feasible). This measure would not be distortive, since it would simply reflect the existing legislation, and it could be implemented at very limited costs and without a legislative amendment. The downside of this approach is that it would not entirely resolve the possible legal uncertainty around 'borderline' products. The feasibility and appropriateness from the perspective of EMCS functionality also need to be considered, since decoupling the two coding systems may become an incentive for borderline products.

5.3.3 Comparison of Policy Options

Table 42 below summarises for comparative purposes the impact estimated for the two main policy options considered to address the existing problems with 'borderline' cigarillos. Unlike other issues, in this case the two policy change scenarios are not mutually exclusive and can be enacted simultaneously, since they refer to two different aspects, i.e. (i) tax structure; and (ii) definition of the tax category.

In particular the options considered are:

- (i) No change over the current situation. The market for 'borderline' cigarillos evolves under the current conditions. Minor changes expected as a consequence of the TPD2.
- (ii) The establishment of a positive MED, calculated so as the price differential between low-price cigarillos and cigarettes is minimised.
- (iii) The harmonisation of the excise product definition and the CN classification with respect to the possibility of a further layer covering the filter.

The three options are compared with respect to various impact areas. For every impact area a synthetic judgment is provided including (i) a rating of the positive or negative effect expected; and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be aggregated straightforwardly.

Table 42 – ‘Borderline’ cigarillos, comparison of options

Impact area and target groups	A) No Change		B) Establish a positive MED		C) Harmonise excise product definition and CN definition	
Regulatory costs for businesses	-1	Modest burden due to legal uncertainties and rare disputes.	-1	Same as Scenario A.	0	Improved legal certainty. Positive effects mitigated by likely modification of products to comply with new definition.
Regulatory costs for public authorities	-1	Modest burden due to legal uncertainties and rare disputes.	-1	Same as Scenario A.	+1	Improved legal certainty. Minor costs to revise the system.
Single Market functioning (for economic operators)	-1	Minor substitution continues in certain geographical market.	-1	Substitution arrested, but non-target products significantly affected.	0	Visual similarities with cigarettes mildly reduced.
SME competitiveness	0	No change. Few SME in the segment of ‘borderline’ products.	-1	Adverse effects for non-target SMEs (manufacturer of other cheap cigarillos).	0	Same as Scenario A.
Market development (for economic operators)	0	No change, current decline in the cigarillos market possibly reversed by TPD effects.	-2	Rapid decline among low-price cigarillos (also non-target products).	0	Same as Scenario A.
Tax revenues (for tax administrations)	0	No change. Tax ‘gap’ stable	0 to +1	Limited increase in tax revenue from both higher excise and reduced substitution	0	Same as Scenario A.
Tobacco control policies (for public health stakeholders)	0	No change. Consumption stable at ‘niche’ level.	0 to +1	Modest positive effects on smoking prevalence.	0	Same as Scenario A.

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- The baseline situation assessment showed that the issue of tax-induced substitution of cigarettes with ‘borderline’ cigarillos has been largely and effectively addressed over the past few years with the implementation of a revised product definition (and the end of derogations for DE and HU), and with the adoption by MS of appropriate tax structures and rates reducing the incentives for low cost products. With few modest exceptions the market of cigars and cigarillos is declining in all MS and there are no signs this trend is going to reverse soon, although the softer rules that the TPD2 imposes on these product may in the future represent an additional incentive.

- On the other hand, low price products with characteristics similar to cigarettes, including products manufactured and branded by big tobacco companies are still commercialised in various EU countries. In Germany and Spain, consumption level is moderate but not negligible.
- The demand for these products is highly sensitive, so a certain increase in price would translate in a more than proportional decline in consumption. Establishing a fixed (and not optional) MED at EU level to eliminate the tax incentives for 'borderline' products can be effective to this end but would inevitably affect also non-target products, including those commercialised by SMEs. The proportionality of the intervention seems therefore dubious. In fact, based on the current definition of cigarillos, the distinction between 'borderline' products and ordinary low-price cigarillos has become highly subjective.
- The impact of substitution on tax revenue is currently limited, especially since MS have imposed higher taxes or MED on this category. Further increasing the tax rates would only modestly increase tax receipts. A significant share of current cigarillos smokers would not switch back to cigarettes but rather turn to other cheap products.
- Only a minority of consumers among the tiny subgroup of cigarillos smokers would seemingly reduce / quit smoking, therefore an increase in tax levels would have marginal effects on smoking prevalence. Under the current definition, the cigarillos have taste and characteristics less appealing to cigarette smokers than before, especially as regards young consumers. In this sense they represent a minor threat to tobacco control policies. Nonetheless, the possible emergence of flavoured cigarillos have to be closely monitored.
- The disparities in the definition of cigars and cigarillos used for excise duty purposes and in the CN classifications for customs purposes, combined with the impossibility to code certain product differently in the EMCS, may be a source of legal uncertainty, disputes and administrative burden. It must be said that the extent and the frequency of concrete issues is limited but it nonetheless constitutes an unnecessary burden for economic operators and customs authorities alike. An alignment of definitions would likely prompt the industry to modify products so as they can still be classified as cigarillos, so minor compliance costs (although indirect) can be expected.

5.4 Fine-Cut Tobacco, including Roll-Your-Own and Make-Your Own

5.4.1 Impact Analysis of Approximation of Taxation of FCT and FMC

In this Section, the impacts due to a further approximation of taxation of FCT and FMC will be discussed. First and foremost, in Section 5.4.1.1, the analysis will focus on market and tax revenue impacts. These impacts will be assessed quantitatively over a series of scenarios simulating possible changes to the minimum excise levels on FCT; furthermore, impacts of changes to the tax rates set by MS will also be presented. In Section 5.4.1.2, other impacts will be discussed with a quali-quantitative approach, including tobacco control, impacts on SME, and on crime. Section 5.4.2 provides the comparison of the policy options and the key findings.

5.4.1.1 Market effects and tax revenues

For the analysis of impacts triggered by the approximation of the minimum excise levels of FCT and FMC, three levels are considered: 66%, 80%, and 100%, calculated over the minimum excise currently set for FMC (90 €/1000 pcs). The simulation is carried out assuming two conversion rates: 1, which is the one currently implied by the EU framework and used in many cases by national policymakers, and 0.75, which is a reasonable value obtained from public authorities, industry estimates, and academic sources.²⁹¹ The six resulting scenarios are summarised in **Table 43** below.

Importantly - as discussed further below - not all the scenarios are equally realistic from a policy perspective. In particular, significant tax increase scenarios, such as uplifting the minimum rate above €/kg 90, may imply more than doubling the current minima in one step. This appears poorly feasible from a policy perspective and there is limited precedent of similar 'tax shocks' at EU or MS level. These scenarios are therefore largely theoretical. The absence of previous experience with similar 'tax shocks' also requires to take with caution predictions on demand trends and consumer behaviour for these extreme scenarios.

Table 43 - FCT minima under the various approximation and conversion rates

FMC minimum	Approximation rate	FCT minimum	
		Conversion rate: 1g per stick equivalent	Conversion rate: 0.75g per stick equivalent
90 €/1000 pcs	66%	€/kg 60	€/kg 80
	80%	€/kg 72	€/kg 96
	100%	€/kg 90	€/kg 120

Figure 41 below provides the causal chain of market and tax impacts that changes in the minimum excise level of FCT would trigger. First, in MS where the excise duty on FCT is lower than the minimum proposed in each scenario, taxation on FCT would increase and retail prices would go up accordingly. A pass-on factor of 1 is assumed, based on interviews with economic operators and public authorities, which means that the increase of taxation is fully reflected on prices. The increase in the price of FCT would trigger a reduction of consumption, which is estimated based on a point elasticity of demand of -1.4.²⁹² This analysis is carried out based on national data on excise rates and FCT consumption. In each MS, the reduction of demand for FCT has a

²⁹¹ Cf. Section 3.4.1 above.

²⁹² Point elasticity is preferred over arc-elasticity because: (i) it is in line with the literature on the impacts of taxation on non-'borderline' products (cf. Chaloupka F.J. and K. E. Warner, 1999, The Economics of Smoking, NBER Working Paper no. 7047); (ii) it is in line with the methodology used for estimating the own-price elasticity of FCT (cf. Gwarnicki C.T. et al. (2014), A Comprehensive Examination of Price Elasticities of Tobacco Products: Evidence from Commercial Store Scanner Data, Report for Tobacconomics); (iii) the analysis does not concern impacts on a product which was not previously taxed, as in the case of new products.

double effect on excise revenues:²⁹³ they decline because of the lower quantity of FCT sold, but this reduction in excise revenues is mitigated by the higher rate applied.

The lost demand for FCT corresponds, in part, to a lower consumption of tobacco products, due to individuals who quit smoking or reduce the consumption of FCT. However, part of the lost demand for FCT would shift to FMC. To estimate the additional FMC demand, various sources were resorted to, allowing to set this parameter at 35% of the lost FCT demand.²⁹⁴ However, when uptrading to cigarettes, consumers are budget-constrained because of the higher prices. Hence, the increased demand for FMC is reduced taking into consideration the relative price of FMC to FCT.²⁹⁵ Part of the lost FCT demand would also shift downward to cheaper tobacco products, which include licit products, such as low-price cigarillos, 'grey' products, such as raw tobacco for retail sale, as well as illicit products *tout court*.²⁹⁶

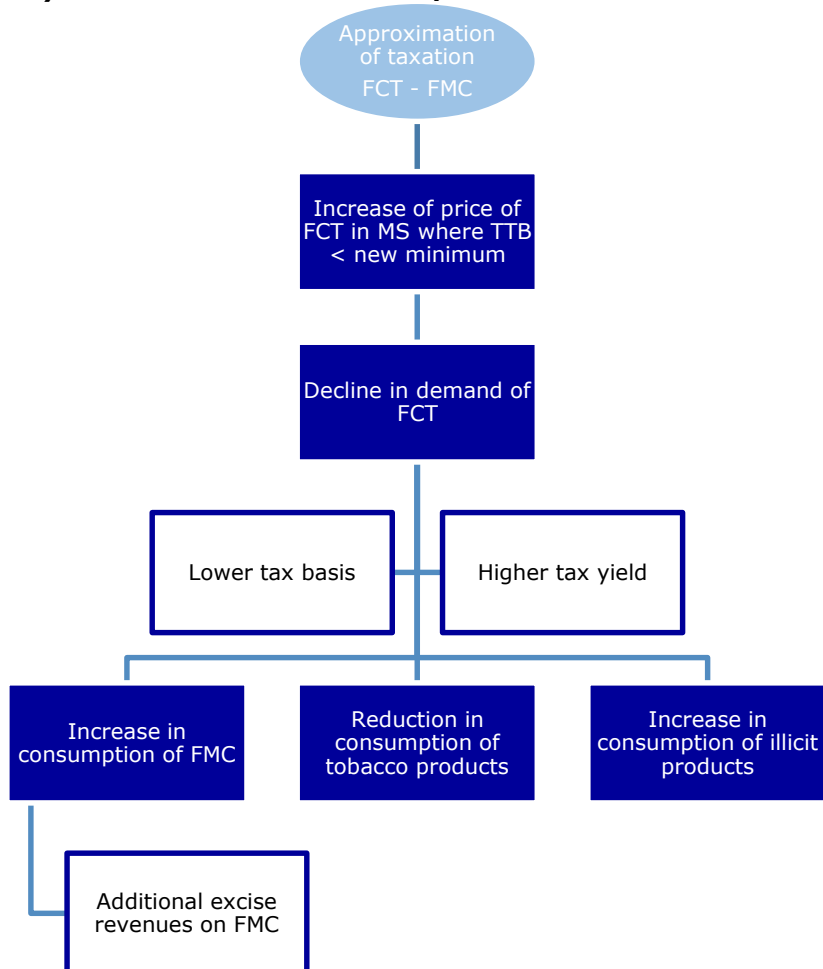
²⁹³ Indirect impacts on VAT revenues would also occur. These are not in the scope of the quantitative analysis conducted in this Section, but in terms of magnitude they would basically increase the excise duty impacts by a factor equal to the VAT rate.

²⁹⁴ The parameter results from an informed estimate which mediates among the following findings: (i) the tax differential between FMC and FCT was among the main drivers for the FCT market growth (+29%) that took place between 2008 and 2012; it is then considered that new consumers who have recently entered the FCT market did so mostly because of price reasons, and are thus more likely to return to FMC if the tax differential is lowered; (ii) a study on dual smokers estimates that 39% of FCT smokers also smoke FMC, and those are more likely to switch to FMC alone in case of tax increases; and (iii) in the OPC, FCT smokers were asked to select the most plausible effects of a tax alignment between FCT and FMC, and 28% responded that consumers would switch to FMC (other than resorting to cheaper products or smoking less and quitting smoking – cf Section 5.4.1.2 below, discounting respondents indicating 'continue smoking').

²⁹⁵ E.g., if 100 FCT sticks were lost because of the tax increase, this would correspond to an additional consumption of 35 FMC. But, if the price of FMC was twice the price of a FCT stick, the estimate would account for the price differential, and the additional demand would be estimated at $35/2=17.5$ FMC. The relative price is calculated for each MS, based on the WAP of FMC and FCT.

²⁹⁶ Part of these cheaper products, namely the licit ones, would also generate tax revenues. However, these tax revenue impacts are not accounted for in the subsequent quantification, due to the impossibility of estimating how the downtrading demand is likely to be split among the various categories. Impacts on the illicit market are discussed in Section 5.4.1.2 below.

Figure 41 - Analysis of market effects and impacts on tax revenues



Note: In blue, market impacts; in white, excise revenue impacts.

The impact analysis below is carried out at EU level, excluding Cyprus, Malta, and Luxembourg due to data limitations. FCT market size is retrieved from *Euromonitor*²⁹⁷, current level of taxations of FMC and FCT and WAP from the Excise Duty Tables (missing data for the WAP of FCT are filled based on *Euromonitor* data).

➤ **APPROXIMATION OF MINIMUM RATES OF FCT TO FMC**

Tables from **Table 44** to **Table 47** below provide results of the analysis of the six scenarios.

Table 44 - Market effects of approximation of minima – conversion rate: 1g per stick equivalent

Q ₀ FCT '000 tonnes	Approximation	Minimum excise	MS Affect-ed	Q ₁ FCT '000 tonnes	ΔQ FCT '000 tonnes	ΔQ FCT %	ΔQ FMC mn pcs	ΔQ FMC %
86.7	66% - €/kg 60	€/kg 60	3	85.0	-1.7	-2.0%	260.2	0.06%
	80% - €/kg 72	€/kg 72	9	81.6	-5.0	-5.8%	738.7	0.16%
	100% - €/kg 90	€/kg 90	15	71.5	-15.2	-17.6%	2530.7	0.54%

²⁹⁷ Euromonitor International: Passport Tobacco, 2016 Edition.

Table 45 – Tax revenue effects of approximation of minima – conversion rate: 1g per stick equivalent

TR ₀ FCT	Approximation	Minimum excise	Lost TR FCT	Additional TR FCT	Additional TR FMC	Net TR
mn €			mn €	mn €	mn €	mn €
8726.5	66%	€/kg 60	-73.3	74.2	33.4	34.4
	80%	€/kg 72	-244.2	256.9	115.1	127.7
	100%	€/kg 90	-886.3	805.6	435.5	354.8

Table 46 - Market effects of approximation of minima – conversion rate: 0.75 g per stick equivalent

Q ₀ FCT	Approximation	Minimum excise	MS Affect-ed	Q ₁ FCT	ΔQ FCT	ΔQ FCT	ΔQ FMC	ΔQ FMC
'000 tonnes				'000 tonnes	'000 tonnes	%	mn pcs	%
86.7	66%	€/kg 80	12	77.4	-9.3	-10.7%	1439.9	0.31%
	80%	€/kg 96	15	67.4	-19.3	-22.3%	3315.6	0.71%
	100%	€/kg 120	20	52.3	-34.4	-39.7%	6677.6	1.42%

Table 47 – Tax revenue effects of approximation of minima – conversion rate: 0.75 g per stick equivalent

TR ₀ FCT	Approximation	Minimum excise	Lost TR FCT	Additional TR FCT	Additional TR FMC	Net TR
mn €			mn €	mn €	mn €	mn €
8726.5	66% - €/kg 80	€/kg 80	-505.5	513.7	242.4	250.5
	80% - €/kg 96	€/kg 96	-1157.8	972.3	571.7	386.2
	100% - €/kg 120	€/kg 120	-2240.8	1392.6	1155.3	307.2

Source: see above. **Legend:** Q₀= current quantity; Q₁= new quantity; ΔQ=difference in quantity; TR=Tax Revenues

If a conversion rate of 1g per stick equivalent is maintained, the approximation of minima at 66% (the level currently envisaged by the Directive as of 2020) or 80% would not have major impacts in the market for FCT. In the former case, only 3 MS would be affected, and the overall EU market would decline by less than 2%, while the additional FMC consumed would amount to 260 mn pieces (less than 0.1% of the FMC consumption). Impacts on excise duty revenues would be marginal, but positive, also considering the revenues from the FCT market alone, and they would increase by €35 mn. At an approximation rate of 80%, the effects would be similar, though larger in magnitude: 9 MS would have to raise their current excise levels, a contraction of the FCT market of about 6% is expected, and an increase in excise duty revenues of about €130 mn is estimated. Finally, in case of full alignment (€/kg 90), some 15 MS would have to increase their current rates, triggering an estimated reduction of market size of more than 15%. Impacts on FMC would remain modest: the switch to FMC might amount to an increased 2.5 bn sticks annually, i.e. ca. 0.5% of the current consumption level. In terms of excise duties, revenues from FCT would decrease (-€60 mn), but the net effect would remain positive (+€350 mn), due to additional revenues from FMC, although modest as compared to the overall excise duties from manufactured tobacco (+0.4%).

With a conversion rate of 0.75g per stick equivalent, the expected market effects of approximating minimum rates of FCT and FMC would be greater. At the approximation rate of 66% the FCT market would decline by 11%, while the increase in FMC consumption would remain below 1%. The net impact on excise duty revenues would amount to an additional €250 mn annually, accounting for an increase of some +0.5%. At the highest minimum rate assessed, i.e. €/kg 120, the FCT market would likely collapse. The model estimates a sales drop of nearly -40%, with only eight MS not being touched, since they already apply higher rates. The aggregated excise duty revenues would decrease, only partly mitigated by a certain switch to FMC

(approximately + 1.4% of current consumption). The estimates for this scenario have to be taken with caution since the consequence of extreme changes are difficult to predict.

➤ **APPROXIMATION OF TOTAL TAX BURDEN ON FCT TO FMC**

In this section, the estimated effects of an alignment of the total tax burden (TTB) on FCT, rather than excise minima, are presented. However, as discussed in Section 4.4 above, the following analysis does not pertain to the assessment of EU policy options *stricto sensu*. In a nutshell, the analysis simulates the market and tax revenues effects (in this case, including VAT) should all MS decide to approximate the TTB on FCT and cigarettes, again at 66%, 80%, or 100% levels. Additionally, it is assumed that MS that already have a TTB higher than such levels would not reduce it. Unsurprisingly, impacts are of a much larger magnitude, and tax revenue impacts become negative much earlier. Net effects on tax revenues are positive only for the first scenario (conversion rate of 1g per stick equivalent and approximation rate of 66%); in all other cases, a revenue decline, up to -€2.1 bn, is expected. The market for FCT would drop from -26% in the first scenario, up to -90% in the most extreme scenario. As above, it is assumed that part of the lost demand for FCT shifts upward to FMC (35%), or downward cheaper products (the positive impacts of which on tax revenues are not accounted for). Under these scenarios, the impact on FMC consumption remains limited, at maximum 5% of the current levels.

Table 48 - Market effects of approximation of TTB – conversion rate 1 g per stick equivalent

Q ₀ FCT '000 tonnes	Approximation	MS Affected	Q ₁ FCT '000 tonnes	ΔQ FCT '000 tonnes	ΔQ FCT %	ΔQ FMC mn pcs	ΔQ FMC %
86.7	66%	7	64.1	-22.6	-26.1%	3473.3	0.74%
	80%	15	45.7	-41.0	-47.3%	7068.0	1.50%
	100%	22	22.8	-63.8	-73.7%	13562.3	2.89%

Table 49 - Tax revenue effects of approximation of TTB – conversion rate 1 g per stick equivalent

TR ₀ FCT mn €	Approximation	Lost TR FCT mn €	Additional TR FCT mn €	Additional TR FMC mn €	Net TR mn €
8726.5	66%	-1473.1	1128.2	660.5	315.5
	80%	-2914.0	1287.3	1340.3	-286.4
	100%	-5196.4	1234.0	2527.5	-1434.9

Table 50 - Market effects of approximation of TTB – conversion rate 0.75 g per stick equivalent

Q ₀ FCT '000 tonnes	Approximation	MS Affected	Q ₁ FCT '000 tonnes	ΔQ FCT '000 tonnes	ΔQ FCT %	ΔQ FMC mn pcs	ΔQ FMC %
86.7	66%	18	35.7	-51.0	-58.8%	9592.1	2.04%
	80%	23	19.6	-67.1	-77.4%	15734.2	3.35%
	100%	25	7.5	-79.2	-91.4%	24562.7	5.23%

Table 51 - Tax revenue effects of approximation of TTB – conversion rate 0.75 g per stick equivalent

TR ₀ FCT mn €	Approximation	Lost TR FCT mn €	Additional TR FCT mn €	Additional TR FMC mn €	Net TR mn €
8726.5	66%	-3879.3	1409.9	1802.0	-667.4
	80%	-5649.0	1314.2	2924.8	-1410.0
	100%	-7366.6	747.2	4539.6	-2079.7

Source: see above. **Legend:** Q_0 = current quantity; Q_1 = new quantity; ΔQ =difference in quantity; TR=Tax Revenues.

5.4.1.2 Other impacts

The other impacts – on SME, cross-border trade, tobacco control policies, and crime – are a second-order consequence, due to the decline of consumption of FCT and the more limited increase of FMC consumption. They can be assessed as follows.

➤ SME

The FCT market, and in particular the RYO segment, shows a higher population of SME compared to the FMC market; in the former, smaller companies, including SME, are reported to represent about one third of the market,²⁹⁸ while in the latter the share is lower than 5%. Any decline in the FCT market would thus more than proportionately affect smaller companies other than the big tobacco companies. This remains true even though it is reasonable to assume that the segments most affected by the approximation would be MYO and MYO-Volume - where SME presence is less significant - as their consumers are more price-sensitive compared to RYO smokers. Furthermore, these impacts would sum up with those triggered by the TPD2, which, according to some interviewees, imposes proportionately higher burden on SME, both in terms of administrative costs linked to the reporting of ingredients, and the track and trace system, and, most importantly, of compliance costs due to modification to the production process (e.g. to adjust to the new minimum size requirements).

➤ CROSS-BORDER APPROXIMATION

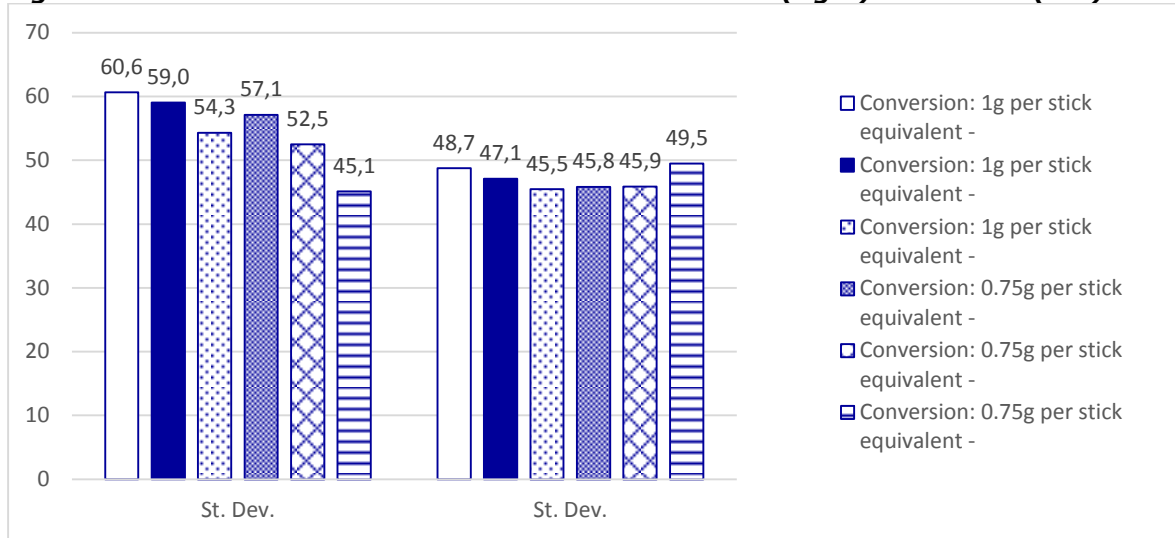
Raising the FCT minimum excise level would lead to an increase in excise duties in MS where tax rates are lower than the new floor. This would increase the nominal convergence of tax differentials, as low-excise MS would have to catch up with high-excise MS. The convergence of tax differentials is measured in **Figure 42** below (left) by means of standard deviation of excise duties, and declines linearly with the increase of the minimum level.

Further than nominal convergence, **Figure 42** (right) shows the excise convergence in Purchasing Power Parity (PPP),²⁹⁹ which provides a more accurate picture, also taking into account different affordability levels. Results are different in the latter case. First, the measure of divergence is smaller, meaning that, broadly speaking, MS with a higher purchasing power have a higher taxation. Secondly, any improvement in tax convergence is smaller, both in absolute and relative terms. Thirdly, and most importantly, small increases of the minimum level increase PPP excise convergence; however, larger increases (as in scenarios 5 and 6) cause a PPP excise divergence, meaning that the increase in taxation would be disproportionately impactful in MS with a lower purchasing power.

²⁹⁸ The Impact Assessment of the TPD2 (at p. 10) reports that the share of market covered by the Big Four in the RYO segment is estimated at 70%, and this was confirmed by industry estimates. Euromonitor data suggests a similar situation, though they do not allow to clearly identify whether a company other than the Big Four meets the EU definition of SME.

²⁹⁹ Source: Eurostat. PPP data refer to 2015 and are based on PPP GDP.

Figure 42 - Standard deviation of excise duties: nominal (right) and in PPP (left)



Source: Authors' own analysis based on *Euromonitor International: Passport Tobacco, 2016 Edition*, and EDT data (2016).

➤ **CRIME**

Economic operators, as well as several public authorities, claimed that FCT may act as a 'buffer' between FMC and the illicit trade,³⁰⁰ i.e. it may prevent consumers from turning to illicit cigarettes when the price of licit ones increases. This statement is generally questioned by public health stakeholders, who believe it is often used instrumentally to prevent tax increases. In particular, public health stakeholders may concede FCT can be an alternative to the black market, but some claim the magnitude of the problem is disputed, while others do not consider it as a valid argument not to increase taxes on FCT.

It is assumed here that some 10% of the FCT demand that would be lost following a tax increase would turn to illicit tobacco products. This parameter is in line with the estimated size of the illicit market for cigarettes discussed in Box 5 above; as such, this assumption implies that FCT consumers faced with a higher price will resort to illicit suppliers in line with the current trends.³⁰¹ The assumption is likely to be representative of small changes to the excise duty on FCT. Conversely, it may fail to fully capture the increase in illicit trade in case of strong and sudden increases of the minimum excise levels. In any case, in absolute terms, the magnitude of the problem would remain small, except in the most extreme scenario. The additional demand of illicit products, in millions of stick equivalents, is summarized in **Error! Reference source not found.**

Table 52 - Increased demand of illicit products due to the approximation of minima of FCT and FMC (mn stick equivalents and % of current illicit market for FMC)

Approximation	Conversion rate			
	1 g per stick equivalent		0.75 g per stick equivalent	
66%	174	0,4%	1,235	2.6%
80%	505	1,1%	2,572	5.5%
100%	1,523	3,2%	4,585	9.8%

³⁰⁰ This hypothesis is also used in the literature when estimating the substitution between FMC and FCT. Cf. Cornelsen L. and C. Normand, 2013, Is roll-your-own tobacco substitute for manufactured cigarettes: evidence from Ireland?, *Journal of Public Health*, Vol. 36, No. 1, pp. 65-71.

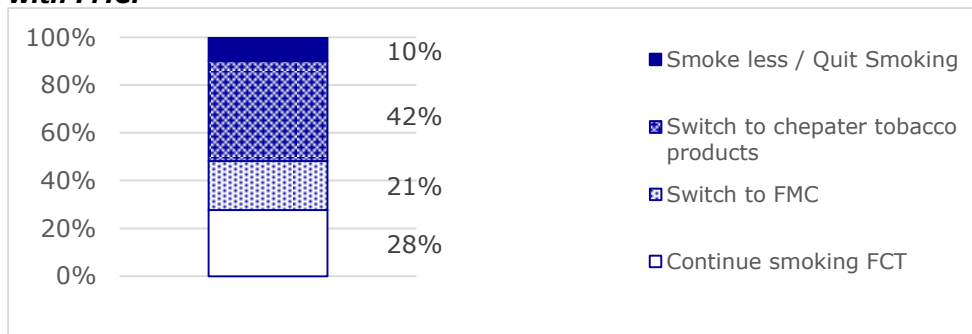
³⁰¹ Also in line with CASMEF – Luiss Guido Carli, "A preliminary analysis of the MYO market: the effect of a tax increase on government revenues in Europe", 2017, Study carried out for BAT Italia.

Source: Authors' own analysis based on *Euromonitor International: Passport Tobacco, 2016 Edition*, and EDT data (2016); cf. Box 5 for the sources on the illicit market.

➤ TOBACCO CONTROL POLICY

An increase in the taxation of FCT is expected to produce a positive effect on tobacco control as its consumption would decrease. In line with the methodology of this Study, this effect needs to be measured in terms of variation of smoking prevalence, i.e. the share of smokers over the total population. The market analysis carried out above assesses the reduction in the demand for FCT, but does not allow to determine whether this is due to a reduction in the average consumption per smoker, or in the number of smokers. To link the decrease in FCT consumption with the decrease in smoking prevalence, the results of the OPC are resorted to. In the OPC, respondents are asked to indicate the 'typical' FCT consumer reaction to an alignment of the tax rate of FCT with that of cigarettes among the following alternatives: (i) the consumer would continue smoking FCT in the same quantity; (ii) the consumer would switch to cigarettes; (iii) the consumer would switch to other cheaper tobacco products; and (iv) the consumer would smoke less or quit smoking. The responses provided by FCT smokers among the OPC respondents are presented below in **Figure 43**.³⁰²

Figure 43 – Perceived reaction of a typical FCT consumers to an alignment of tax rates with FMC.



Source: OPC results (only FCT consumers' replies are displayed).

Based on this finding, it is expected that 10% of current FCT consumers would smoke less or quit smoking in the event of an alignment. For FMC, estimates in the literature show that the impact of price increases is almost evenly split between a reduction of average consumption and a reduction in the number of smokers.³⁰³ If this assumption held true also for FCT, 5% of current FCT consumers would quit smoking.

According to Eurobarometer data, 24% of smokers are daily consumers of hand-rolled cigarettes; this corresponds to about 26.8 mn smokers.³⁰⁴ If 5% of daily FCT consumers quit smoking because of tax alignment, the overall number of smokers would decrease by 1.3 mn, that is 1.2% of the total. The smoking prevalence, currently at 26% of the EU population aged 15 or more, would in turn decrease by 0.3%, at 25.7%. This estimation refers to a 'full' alignment of tax rates, so the effects would be lower in case of partial alignment (the 66% and 80% scenarios analysed above).

³⁰² Respondents could select up to two options. 79 FCT smokers responded to this question. While tobacco consumers are likely to have a self-interest bias when assessing e.g. the desirability of tax increases, they can be considered as an informed source for estimating consumer reactions to policy changes. Given the relatively small sample, the results are purely illustrative and have no statistical significance.

³⁰³ Farrelly M.C., Bray J.W., Pechacek T., and T. Woollery, Response by adults to increases in cigarette prices by sociodemographic characteristics. *Southern Economics Journal*, Vol 68, No. 1, pp. 156-165, 2001.

³⁰⁴ Considering a smoking prevalence of 26% (source: Eurobarometer) and a EU28 population aged 15+ of 429.2 mn individuals.

Box 10 – From reducing smoking prevalence to health impacts

In accordance with the scope and the methodology of the Study, the analysis focused on the key indicator of tobacco control policy, which is the 'smoking prevalence', i.e. the proportion of individuals aged 15 or more who are daily smokers. The objective was to compare smoking trends with policy targets with a view to establish, in a mostly qualitative manner, whether the various policy scenarios could contribute to or hamper the achievement of such targets. The assessment carried out in the Report showed that a 100% approximation of FCT rates with FMC rates may contribute to a tangible reduction of the overall smoking prevalence. In other words, a small but non-negligible number of FCT smokers may eventually decide to quit in the event of a major tax-induced increase of FCT price. This has been estimated as approximately 1.3 mn smokers or 1.2% of the total.

Estimating and quantifying in monetary terms the public health effects, and the broader socio-economic implications, of a reduction in the smoking prevalence fall outside of the scope of the Study, however the impact assessment accompanying Directive 2014/40 may provide useful benchmarks in this respect.³⁰⁵

According to the IA on the TPD2 (and the underlying GHK Study³⁰⁶), the burden of smoking in the EU can be estimated at €544 bn per year, divided as follows:

- (i) Direct costs to the healthcare system, from both smoking and environmental tobacco, amounting to €26 bn per year;
- (ii) Productivity losses to the EU economy, amounting to €7 bn per year; and
- (iii) Premature mortality, amounting to €517 bn per year.

Based on these estimates, a reduction of the smoking prevalence by 0.3% may translate into a reduced burden in the three dimensions above, with the following order of magnitude:

- (i) Direct costs to the healthcare system: €312 mn;
- (ii) Productivity losses to the EU economy: €84 mn;
- (iii) Premature mortality: €6.2 bn.

As discussed in the Report, it is important to underline that these savings would materialise in the event of a theoretical but largely unrealistic scenario consisting of doubling the FCT minimum rates and an ensuing market collapse.

5.4.1.3 The public view on the proposed policy options

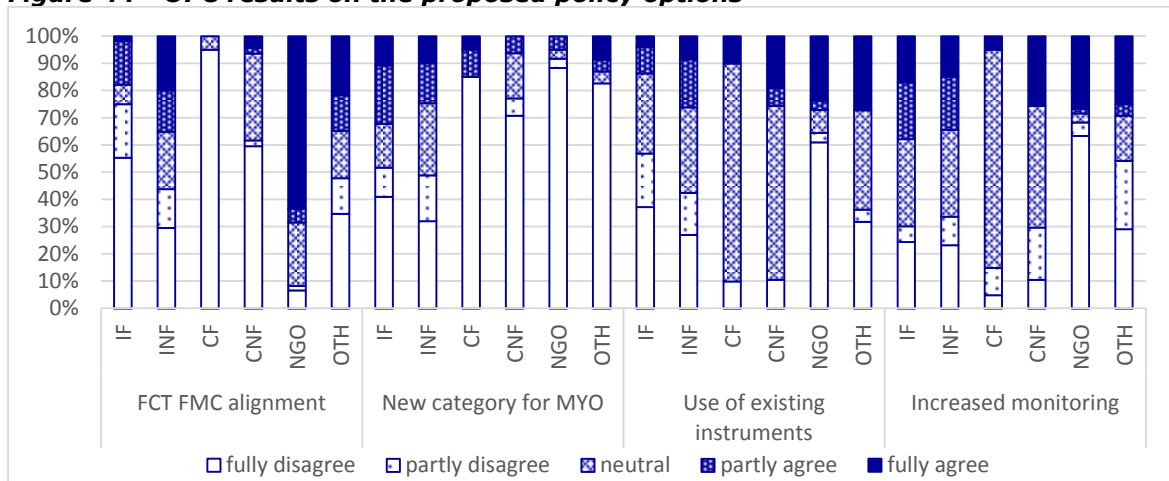
Four options were submitted to the open public consultation, of which two regulatory revisions of the Directive and two 'soft' policy options. As outlined in Section 4.4, only the two regulatory options – namely the alignment of FCT and FMC rates and the introduction of a new category for MYO – were eventually retained for the present assessment. It is nonetheless useful to analyse the OPC results in order to understand the different stakeholders' views on the issue. More specifically:

- i) Unsurprisingly, FCT manufacturers and FCT consumers oppose an alignment of FCT and FMC rates, while NGOs are strongly in favour.
- ii) All categories of respondents are against the creation of a new category for MYO.
- iii) With the exception of NGOs, all categories – and notably FCT manufacturers – are fairly neutral towards the non-regulatory options (i.e. encouraging MS to use the instruments already provided in the Directive to address possible distortions caused by MYO, and to increase the monitoring of the MYO market at both MS and EU-level)

³⁰⁵ Commission Staff Working Document 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

³⁰⁶ GHK (2012).

Figure 44 - OPC results on the proposed policy options



Legend: IF: Individual consumer of FCT, INF: Individual non-consumer of FCT; CF: FCT manufacturer; CNF: non-FCT manufacturing company; NGO: Non-governmental organisation; OTH: Other.

Note: The total number of respondent varies across questions.

Source: OPC.

5.4.2 Comparison of Policy Options

Table 53 below provides the multi-criteria analysis for the policy option considered, i.e. the approximation of minima of FCT with those of FMC. Importantly, when multiple scores are assigned, this depends on the parameters chosen, i.e. the approximation and conversion rates. The dynamic baseline, which corresponds to the stage approximation of minima to 66% with a conversion rate of 1, and the policy change are compared with respect to the various impact areas analysed in Section 5.4.1 above. For every impact area, a summary judgment is provided including (i) a rating of the positive or negative effect expected (between -2 and +2); and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be summed or aggregated.

Table 53 – Approximation of minimum excise levels on FCT and FMC – Comparison of Options

Impact area and target groups	No change	Approximation
Market effects (for economic operators)	0 Slight contraction / stagnation of the FCT market (in absolute value)	-1 / -2 Moderate to significant contraction of the FCT market (-5% to -40%).
Tax revenues (for tax administrations)	0 No significant change in tax receipts.	+1 Moderate positive impact (+100 to +400 € mn).
SME competitiveness	0 Very modest reduction of FCT market, unlikely to generate substantial impacts.	-1 / -2 Contraction of the FCT would impact more than proportionately smaller companies, including SME, which have a higher presence in this segment. Magnitude depends on the contraction of the FCT market
Single Market Functioning (for economic operators)	+1 Small reduction of excise divergence	-1 / +1 Lower approximation rates reduce tax divergence; higher approximation rates increase tax divergence.
Tobacco control (for public)	0 Marginal reduction in smoking prevalence.	0 / +1 Reduction in smoking prevalence up to 0.3% in case of alignment.

Impact area and target groups	No change		Approximation	
health stakeholders)				
Crime (for economic operators and public authorities)	0	Small increase in the demand for illicit products	0 / -1	Small increase in the demand for illicit products (+0.4% to +10% of current illicit market)

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- There is a tax-induced substitution between FCT and FMC, and this is driven by (i) changes in the FMC tax rate and affordability; (ii) larger or smaller tax differentials between FMC and FCT. However, the EU FCT market has now stabilised, following a steep growth in the 2006-2012 period. MS can already adjust national excise rates to address the substitution, whenever they consider that the tobacco market is excessively distorted.
- Any increase of the current minimum excise level on FCT – be it achieved by raising the current ratio, reducing the conversion rate, or both – would reduce its demand. The market effects would happen in a limited number of MS, i.e. those in which excise levels are currently below the new proposed minima; the affected MS range from 3 in the dynamic baseline scenario, to 20 if the minimum is set at 120 €/kg. The magnitude of this impact increases the higher the taxation rate and the lower the conversion rate, from slight (-2% of the FCT market) to significant (-15% if the minimum is set at the current level of FMC). Market effects on the consumption of FMC, which is going to increase because part of the consumers would switch to them, remain marginal, are estimated at less than 1% of the current consumption in the most feasible scenarios.
- Market impacts would fall disproportionately on smaller companies, including SME, which have a higher share in the FCT than in the FMC market. Also, higher approximation rates would increase cross-border tax divergence in purchasing power parity.
- Impacts on excise revenues are positive and reach, at maximum, € 390 mn, which is a small fraction (0.5%) of the EU revenues from tobacco taxation. Impacts at national level may be very different, and depend on the current excise duties on FCT: where excise duties are very low, a very high minimum may cause a collapse of the market, with a negative impact on tax revenues.
- Impacts on tobacco control policies are positive, because the decreased demand for FCT is only partly compensated by consumers shifting to FMC and illicit products. In case of alignment, it is estimated that the overall smoking prevalence among EU population would decrease by 0.3%, i.e. about 1.2% of the current smokers may quit.
- The same reasoning goes for impacts on crime, namely on the demand for illicit tobacco products caused by an increase of FCT taxation. In the most likely scenarios, the additional demand for illicit product is estimated at about 0.4 – 3% of the current market for illicit cigarettes.

- In conclusion, the market and tax revenue impacts from the approximation of minima of FCT and FMC are not large, when measured at EU level. Only in the most extreme scenarios, the FCT market is subject to a large drop, but, even in this case, net revenues and impacts on tobacco control policies remain limited, in relative terms. Hence, this policy option, and namely the exact value of the new minima, should be considered as a tool for reducing market distortions, rather than for achieving fiscal or tobacco control objectives. However, while impacts at EU level may not be very large under the various scenarios, they may be severe in those MS where the FCT market is sizeable and the tax differential with FMC is large.
- The current Directive seems in line with its objective of bringing taxation of FCT closer to that of FMC. This is even more true considering that the flows of consumers between the FMC and FCT markets have largely stopped at a macro-level: from 2012 onwards, consumption of FMC has declined, while FCT has remained stable in absolute terms, thus increasing in terms of market share. On top of that, not all the staged increases provided for the FCT minimum excise have taken place, since two additional steps will take place in 2018 and 2020. The Directive has been designed in a period in which FCT represented a lower share of the tobacco market, and in which the FCT market itself did not display the current product diversification – including the growth of the MYO and MYO-volume segments. Nevertheless, there is no evidence that the current legal framework may hamper MS to pursue their objectives of budget stability and tobacco control.

5.5 Water-pipe Tobacco

5.5.1 Impact from introducing a separate tax category for WPT

5.5.1.1 Market monitoring and illicit trade

The main rationale behind a possible change in the tax regime for WPT at EU level, is the estimated significant tax evasion that characterises this market and the risk it may further increase in the near future, thanks to the popularity this product is gaining in various MS and especially among young people. The overall share of non-duty paid WPT (smuggled, bootlegged, purchased online) can be estimated at some two-third of the overall 5,000 tonnes possibly consumed in the EU, in 2016. Evidence from fieldwork showed that in some MS only a marginal quantity of WPT is sold through the authorised channels, and this is especially true where the tax burden is particularly heavy. For instance, the excise duty on WPT in Sweden is about € 200 per kg, i.e. some 20 times the import price before taxes, and 4-5 times the black market price.

Although significant in proportional terms, WPT remains a niche product in absolute terms as compared to cigarettes, possibly yielding some € 100 mn of excise receipts / year EU-wide. In this sense, for tax and customs authorities the tax fraud on cigarettes remain the main priority, and comparatively lower efforts are placed on combating illicit trade of WPT. An incomplete estimate of the overall seizure of WPT in the EU suggests it may account for much below 10% (possibly 1-2%) of the total non-duty-paid consumption.

The lack of strong monitoring data on market development and consumption patterns contributes to a general limited awareness of the phenomenon and its implications, not only in terms of excise losses, but also as concerns the related VAT fraud, and the broader societal and public health issues. In this sense, the first step towards a more consistent tax treatment of WPT should pass through an increased knowledge and monitoring of market trends. Two improvements in this respect are worth mentioning, i.e.: (i) the revision of the Harmonised System and related CN system with the introduction of an *ad hoc* code for WPT, which helps monitoring transnational movements; and (ii) the traceability provisions introduced by the TPD2 (Art. 15), although for WPT they will enter into force no earlier than 2024.

The introduction of a separate tax category for WPT and a dedicated EMCS coding may further contribute to market monitoring and a more precise assessment of the tax gap. In fact, at present, WPT is classified as 'other smoking tobacco' along with pipe tobacco and – pending a Directive revision – new tobacco products like Heat-not-Burn tobacco. While consumption of pipe tobacco is predictable as it is steadily declining since many years, the novel tobacco products are on the rise and having them in the same tax category of WPT will not help appreciating the market development for none of the two products.

Better and more granular monitoring data may eventually be used by enforcement authorities for more effective contrast to the illicit trade, in the same way the introduction of EMCS facilitated and reduced the costs of controlling movements, exchanging information, and tackle fraud for cigarettes. Concrete impact in this respect are in any case difficult to anticipate, and they should be in any case supported by other national measures such as, for instance, the obligation of use of sealed packages by shisha bars.

5.5.1.2 Market functioning and tax revenue effects

The proposed option is not expected to directly influence market development, since the proposed new tax category would not necessarily modify the current tax treatment of WPT. However, it can be expected that national tax authorities may take advantage

of a separate tax category to modulate their current tax regimes in a way that may reduce the incentive for the black market and re-direct consumers to the licit one, without significantly affecting the demand. **Table 54** below provides a simple simulation in the case of a significant reduction of the excise duty for WPT in the UK. The current end-price of one kg of duty-paid WPT is ca. € 220, of which the total tax component is € 180 (including VAT). On the black market, the price of one kg of WPT is less than € 50, which makes that some 90% of the total market (200 tonnes / year) is illicit. According to industry stakeholders it would be sufficient to apply taxation to the tobacco component only of WPT (i.e. 20%) to reduce end-price to a level where illicit trade is no longer convenient and the tax revenue would increase. The figures provided in the simulation are purely indicative but may help understanding the magnitude of impact that can be expected.

Table 54 – Effects from a hypothetical reduction of tax burden of WPT in the UK

Scenarios	Market volume	Total tax per kg	RSP per kg	Est. evasion	Tax revenue
Current	200 tonnes	€ 180	€ 230	90%	€ 3.6 mn
Hypothetical	200 tonnes	€ 36	€ 85	20%	€ 5.8 mn

In addition to tax revenue impact, the reduction of the illicit trade would evidently have profound beneficial effects in redressing the distortion of competition and the disadvantages that legitimate players are facing in certain geographical markets.

5.5.1.3 Legal and administrative impact

Since the consumption of WPT is not even across MS, it is important that any Directive revision would have a minimal impact for MS tax policies. In this sense, the new WPT category may maintain the same tax treatment it currently has under the 'other smoking tobacco', so that legal and administrative changes are minimised, and MS remain free to decide whether or not to modify the tax regime of WPT. The administrative impact for legitimate economic operators will also be marginal and would essentially consist in a minimal update of their trade and logistic systems.

On the other hand it should be noted that any creation of new tax categories may unintentionally create opportunities for the development of 'borderline' products designed to take advantage of ambiguities and regulatory loopholes. The definitions of WPT provided either under the TPD2 and in the HS³⁰⁷ offer a good starting point, but both make reference to intended use via a water-pipe, which call into question how to define for tax purposes a water-pipe, and how to distinguish it from other devices that can be used to smoke a mix of tobacco, glycerol and other ingredients. Similarly, there is no standard on the percentage of tobacco contained in WPT mixture, and it is not clear if the lack of specifications may create incentives for product with a higher content of tobacco.

In practical terms, the creation of a tax incentive for 'borderline' product would occur only in the event the tax rate applied to the new category is significantly lower than the current ones, but in the case of modest variations it is unlikely that 'borderline' product would appear.

5.5.1.4 The public view on the proposed policy options

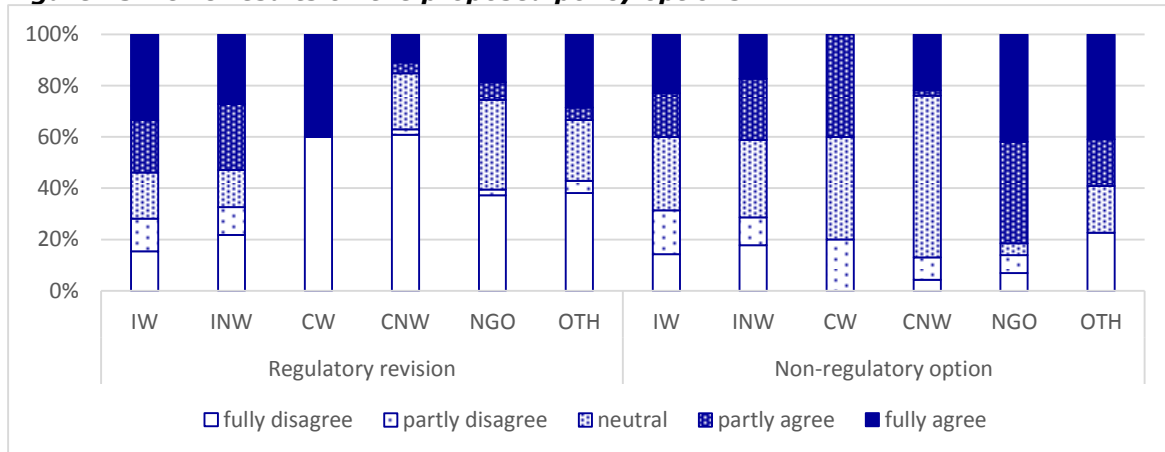
Figure 45 below presents the OPC results with respect to two proposed policy options, namely: (i) a possible revision of the Directive creating a separate tax category for WPT, and (ii) the non-regulatory possibility of increasing the monitoring of WPT market trends and informal consumption. As mentioned in the previous Sections, WPT

³⁰⁷ Specifically under Note 1 of Subheading 2203.11.

manufacturing in the EU is modest, and only 5 WTP manufacturers took part in the survey. The following results can be noted:

- While the majority of private individuals, including those who do not primarily consume WPT, are in favour of the regulatory option, the other categories of respondents tend to disagree with it.
- All categories– especially NGOs – tend to agree with the non-regulatory option (i.e. increasing monitoring of WPT markets), although large shares of respondents expressed a neutral stance.

Figure 45 - OPC results on the proposed policy options



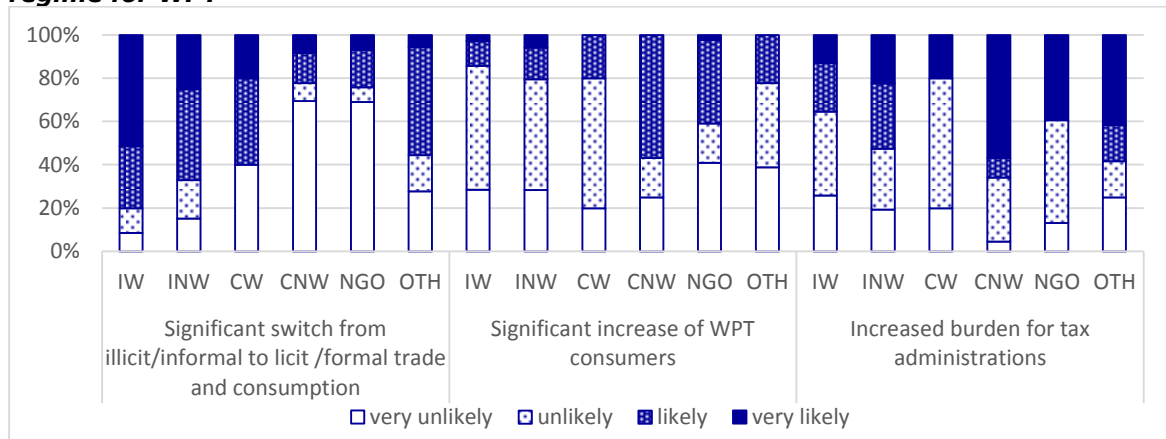
Legend: IW: Individual consumer of WPT, INW: Individual non-consumer of WPT; CW: WTP manufacturer; CNW: non-WTP manufacturing company; NGO: Non-governmental organisation; OTH: Other.

Note: The total number of respondent varies across questions. Only 5 respondents in the CW category. 'Don't know' answers not displayed.

Source: OPC results.

OPC respondents were also asked to express their views on the possible consequences of a separate category for WPT with a relatively lower tax rate that is more proportionate to the actual tobacco content of WPT. Individual consumers (of both WPT and other tobacco products), WTP manufacturers and public authorities (included in the 'other' group of respondents) tend to agree that such a measure would translate into a significant switch from illicit/informal to licit/formal trade and consumption. To the contrary, manufacturers of tobacco products other than WPT and NGOs consider it highly unlikely. Almost all categories – the only exception being the manufacturers of tobacco products other than WPT – consider unlikely or very unlikely that WPT consumption is going to increase. Finally, the majority of manufacturers of tobacco products other than WPT and of public authorities flagged the possibility of increased administrative burden for tax administrations.

Figure 46 - OPC results on the consequences of a separate and more proportionate tax regime for WPT



Legend: IW: Individual consumer of WPT, INW: Individual non-consumer of WPT; CW: WTP manufacturer; CNW: non-WTP manufacturing company; NGO: Non-governmental organisation; OTH: Other.
Note: The total number of respondent varies across questions. Only 5 respondents in the CW category. 'Don't know' answers not displayed.
Source: OPC results.

5.5.2 Comparison of Policy Options

Table 55 below summarises the expect impact of introducing a separate tax category for WPT, in comparison with the current situation. The option does not indicate a specific tax treatment for this new category since the absence of a solid market data basis to determine what would be the most suitable approach. It is implicitly assumed that the new category would be established in a way that reduce the current differential between retail selling price and the black market price levels. It is also assumed that the revised tax treatment of WPT would not make it more affordable to consumers.

For every impact area a summary judgment is provided including (i) a rating of the positive or negative effect expected; and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process so the ratings provided cannot be aggregated straightforwardly.

Table 55 – Water-pipe tobacco, comparison of options

Impact area and target groups	A) No Change		B) Introducing a separate tax category	
Monitoring and control (for public authorities)	-1	As the market grows the problem may become more acute.	+1	More granular monitoring may contribute also to better enforcement.
Market functioning (for economic operators)	-2	Market profoundly distorted by illicit trade.	0	MS may modulate policies so as to reduce incentives for illicit trade.
Tax revenues (for tax administrations)	-2	About 2/3 of the market is non-duty paid.	-1 to +1	Effects depend on how MS apply the new category.
Legal and administrative certainty (for tax administrations)	0	No change.	-1	Modest administrative costs, but possible risk of unintended effects.

Legend:
+2 major positive effect expected,
+1 moderate positive effect expected,
0 no effect or neutral impact expected,
-1 moderate negative effect expected,
-2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- The current tax treatment of WPT as 'other smoking tobacco' in some MS have translated into a heavy excise burden and created economic incentives for the development of illicit trade, which in many MS seemingly account for the majority or so of the market.
- At the same time, WPT is poorly monitored and control and little information is available to administrations and authorities to assess market trends and dynamics. TPD2 envisages a better traceability, but it won't be in place before 2024.
- With the growing popularity of WPT, especially among young people, it seems important to ensure a better control over this market and apply appropriate policies to curb illicit trade. This would also redress the profound distortion of competition that legitimate players have to endure.
- In a first step, the solution may be represented by the introduction of a separate tax category for WPT. Since the magnitude of the problem differs across countries, no mandatory change of the minimum excise level seems necessary. MS would be able to modulate their tax policy balancing the need to eliminate the economic rationale for illicit trade with the need to avoid more favourable rates translate into greater consumption or the development of 'borderline' products.

5.6 Minimum Excise Duty on Cigarettes

5.6.1 Impact Analysis of a clarification of the nature of the MED by means of a legislative revision

This section discusses the possible effects of (i) clarifying that a MED set above the excise yield on WAP is not *per se* in conflict with the mixed structure requirements and (ii) clarifying, conversely, that the MED should not exceed 100% of the excise yield on WAP. These approaches involve two direct impacts - market and tax revenue effects - and one indirect impact on tobacco control policy goals. Most of the impacts are concentrated in, but not limited to, MS in which the MED is currently higher than the excise yield on WAP. Impacts on tax revenues are assessed quantitatively for two of these MS, in which additional fieldwork was carried out.

5.6.1.1 Market effects

Under the policy change scenario (constraining MED to 100% of the excise yield on WAP), five MS would have to reduce their MED, and this could trigger immediate effects on the cigarette market structure. In addition, the cap of the MED could also produce impacts in countries where the MED is used as a credible threat to guide the entry price.

A reduction of the MED would cause the following static effects:³⁰⁸

1. A decrease of the price of cigarettes below the MED threshold. This would increase demand for low-cost cigarettes, and, as a consequence, the overall demand for cigarettes.
2. An increase of price differential between low-cost, mid, and premium cigarettes. This may in turn encourage consumers to switch to cheaper brands, which become more convenient in relative terms.
3. A decrease of consumption of fine-cut tobacco due to cross-price elasticity: in a nutshell, part of the consumers which had down traded to fine-cut tobacco for price reasons may return to the now cheaper low-end of the cigarette market.

Given that the relative difference between the MED and the excise yield on WAP is limited (the maximum being 5.8% in Finland), these market effects are expected to be of limited magnitude. Also, it is fair to assume that tax authorities would react to the reduction of the MED by increasing the excise rate, in order to limit impacts on tax revenues and the cigarette market structure. This would compensate the market effects #1 and #3 listed above; in particular, the cigarette consumption could remain stable if the excise increase were sufficiently large. However, given the mixed structure requirements, any reaction would be insufficient to fully prevent the increase of price differentials in the cigarette market, and thus a possible down trade from premium to low-cost brands.

From a dynamic perspective, a reduction of the MED could change the incentives for economic operators to enter into a price competition, because the gains from it would be higher, and this could change the market behaviour of manufacturers. This may happen in the short-term in the MS which have to reduce the MED, but also, in the long-term, in the MS where MED could not be raised further than the limit. It is hard to predict whether price wars would actually take place in case of MED reduction, because there have been no recent examples in the MS visited during fieldwork. However, certainly, payoffs from and incentives to price competition would become higher.

³⁰⁸ During this study, a pass-on factor of 1 is assumed for any tax increase. To assess impacts of the MED, this assumption is maintained also for a tax cut, even though producers may be tempted to increase their margins. Obviously, if there is no pass-on of the tax reduction to consumers, no market effects would be triggered.

Finally, a cap would have an indirect market effect also in France, where the possibility of a sudden MED increase works as a credible threat for economic operators intending to market low-cost cigarettes. The cap would not affect the MED in France, which is set at 97% of the excise yield on WAP, but would affect the magnitude of its possible increase.

Under the no change scenario - or in the case of a substantial confirmation of the *status quo* - MS would remain free to set the level of the MED above the excise yield on WAP. Hence, there would be no MED reduction and, consequently, no immediate market effects. However, if the revision were just to clarify that there is no conflict between a MED higher than WAP and the mixed structure requirements, this could lead to unintended market configurations and to a MED so high that the whole market falls below it. This would run contrary to the spirit of the Directive, and to the duty of the MS to respect the mixed structure. Such a situation would lead to an excessive compression of competition in the cigarette market - compared with what is considered appropriate under the current provisions on mixed structure - and to the risk of cross-border price divergences with MS where the taxation is mostly based on the *ad valorem* component.³⁰⁹ For this reason, it remains crucial that any revision clarifies also the conditions at which MED shall be considered incompatible with the mixed structure requirements, based on e.g. an absolute or relative level of MED, or the share of the market which remains subject to the mixed structure.

5.6.1.2 Tax revenues

Should the clarification lead to the reintroduction of a limit to the MED, this would have two impacts on tax revenues for the MS in which the MED is higher than the limit:

- 1) Immediate reduction of tax revenues - both excises and VAT;
- 2) Negative impacts on revenue stability.

With respect to the immediate reduction of tax revenues, this can be calculated based on the market share below the MED:

- In Portugal, cigarettes below the MED represents 88% of the total consumption (7.7 bn sticks, based on *Euromonitor* data). Cigarettes taxed at the MED are estimated to generate about € 900 mn in excise revenues.³¹⁰ Should the MED be reduced from 104.3% to 100% of the excise yield on WAP, excise losses would amount to €41.2 mn, or 3.7% of cigarette excise revenues; on top, a VAT loss of € 9.5 mn would be incurred, for a total of €51 mn
- In Finland, cigarettes below the MED represents 65% of the market (estimated, based on *Euromonitor* data, at 4.0 bn sticks). Cigarettes taxed at the MED are assessed to generate about € 520 mn of excise revenues. Should the MED be reduced from 105.8% to 100% of the excise yield on WAP, excise losses would amount to €30.2 mn, or 3.9% of cigarette revenues; additionally, lost VAT would amount to € 7.2 mn, resulting in total of about €37.5.

It is fair to assume that MS would minimise any impact on tax revenues by raising overall taxation (via the specific or the *ad valorem* component), to ensure budget neutrality. However, even keeping total tax collection constant, the income from cigarettes taxed at the MED and their share over total excises would be lowered, thus

³⁰⁹ The Impact Assessment of Directive 2011/64 considers that a mixed structure shall be maintained to prevent cross-border diversion of premium brands (from specific to *ad valorem* MS) and of low-cost cigarettes (from *ad valorem* to specific MS). Cf. pp. 35 and ff.

³¹⁰ Portugal has a MTT system and cigarettes below the MED generates € 1.2 mn of total revenues. The impacts estimated above consider that (i) Portugal keeps the MTT system; and (ii) the excise component of the MTT system is reduced by 4.3%.

reducing stability and predictability of tax revenues. This impact concerns, again, MS that have already opted for a MED higher than the excise yield on WAP.

Under the dynamic baseline scenario, i.e. if the clarification would eliminate any possible conflict between the MED and the mixed structure requirements, MS would remain free to opt for a MED higher than the excise duty on WAP, and there would be no impacts on tax revenues.

5.6.1.3 Tobacco control policy goals

Effects on tobacco control policy goals are second-order impacts, which depend on the extent to which market effects occur. As discussed in Section 5.6.1.1 above, MS are expected to compensate for the reduction of the MED with higher excise rates; hence, impacts on the total consumption of tobacco products are expected to be negligible. However, the increase in price differentials may spur tobacco consumption in the least affluent segments of the population – which is more likely to smoke low-cost brands – and among more price-sensitive categories, such as young adults.

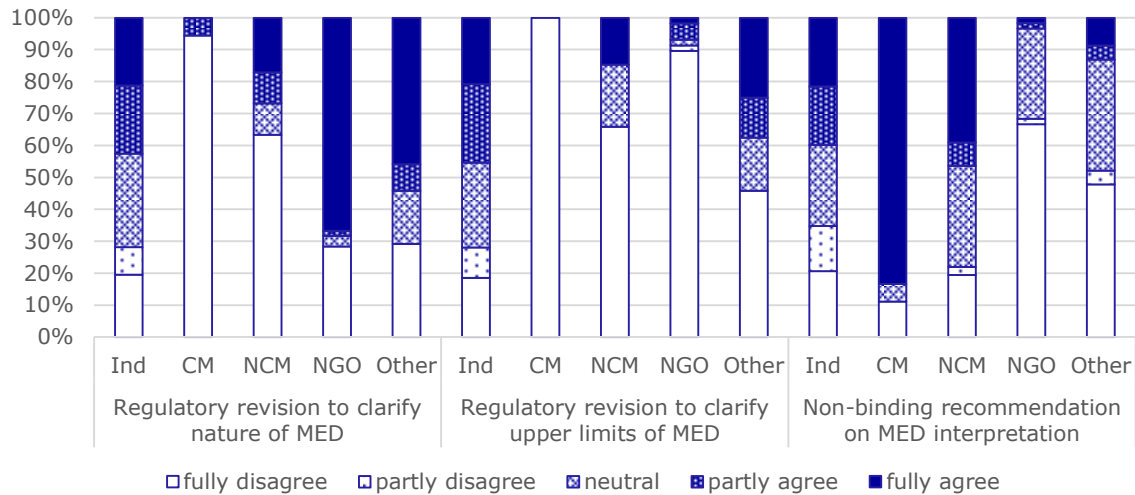
In a dynamic perspective, tobacco control policy goals would be undermined if price competition starts in the low-end of the market or if new brands are marketed at a price lower than the current entry level. Either of these effects could undermine short-term and long-term tobacco control policy goals, by increasing current consumption and the entry rate in the tobacco market.

5.6.1.4 The public view on the proposed policy options

In the OPC, the general public was asked about the policy options for revising the MED provisions – by clarifying its nature and implementation, or, more specifically, the introduction of an upper limit) and for providing non-binding guidelines about its interpretation. About 850 respondents answered this question (out of the about 7,500 participants).

Manufacturers of both cigarettes and other products are strongly against the review of the MED provisions, including the establishment of an upper limit; to the contrary, they are mostly in favour of the publication of non-binding guidelines. NGO would like to see a legislative clarification of MED, but are opposed to the introduction of an upper limit and the provision of non-binding guidelines. View of other respondents was mostly in line with the opinion expressed by the NGO. The views of individuals are more mixed, with most of them supporting the two options for legislative revision and, to a more limited extent, the publication of non-binding clarifications.

Figure 47 - OPC results on the proposed policy options



Legend: Ind: Individuals; CM: Cigarette Manufacturers; NCM: Manufacturers of products other than cigarettes; NGO: Non-Governmental Organisations; Other: any other respondent (including public authorities).

Source: OPC results.

5.6.2 Comparison of Policy Options

Table 56 below provides the multi-criteria analysis for the policy option considered, i.e. the clarification of the MED, in particular with respect to its relations with the mixed structure. The dynamic baseline scenario corresponds to the status quo in which MS are free to set a MED higher than the excise yield on WAP, while the policy change scenario corresponds to a clarification which implies that the MED is capped at 100% of the excise duty on WAP. These options are compared with respect to the various impact areas analysed in Section 5.6.1 above. For every impact area, a synthetic judgment is provided including (i) a rating of the positive or negative effect expected (between -2 and +2); and (ii) the main motivations underlying the rating. Needless to say, impact areas may have a different importance for the policy-making process, so the ratings provided cannot be summed or aggregated.

Table 56 – Clarifications of the MED, comparison of options

Impact area and target groups	No change		Clarification (cap at 100% of the excise yield on WAP)	
Market effects (for economic operators)	-1	No immediate changes to the market structure of cigarettes. MS could raise MED to levels which are incompatible with the mixed structure requirements.	-1	Change in the market structure of MS in which the MED > 100% of excise yield on WAP: increase of price differentials between low-cost and premium cigarettes; higher risk of price competition. Potential impacts in all MS: higher risk of price competition.
Tax revenues (for tax administrations)	0	Tax revenues and budget stability will not be affected.	-1	Reduction of tax revenues in countries in which the MED > 100% of excise yield on WAP (3-4% of current excise revenues from cigarettes). Reduced capacity to use the MED to ensure budget stability.
Tobacco control policy (for public health stakeholders)	0	No expected changes in the price and consumption of both cigarettes and low-cost cigarettes.	-1	Reduction of entry price of cigarettes could increase cigarette demand in the short-term and increase tobacco entry rates in the long-term.

Legend:

- +2 major positive effect expected,
- +1 moderate positive effect expected,
- 0 no effect or neutral impact expected,
- 1 moderate negative effect expected,
- 2 major negative effect expected.

➤ **SUMMARY OF KEY FINDINGS**

- Though the MED provisions in the current Directive may result in a certain degree of legal uncertainty, this is not perceived as generating costs for public authorities and economic operators. The latter are confronted with national implementation measures, not with the EU text, and report no significant problems with respect to their application. The former, conversely, acknowledge the legal uncertainty, but are not opposed to it, because it enhances the flexibility of the MED framework *vis-à-vis* national tobacco policy objectives.
- A clarification of the MED provisions by means of a revision of the Directive could go in opposite directions. On one side, it could consolidate the *status quo* by confirming that a MED higher than the excise duty on cigarettes priced at WAP is not *per se* breaching to the mixed structure requirements (and also clarifying when a breach occurs). On the other side, it could specify that the MED shall be considered as equivalent to a specific form of taxation, and hence it should be limited to 100% of the excise duty on WAP.
- Impacts of the policy change scenario would be concentrated in, but not limited to, the MS in which the MED is currently higher than WAP. In these MS, the reduction of the MED would lower tax revenues (-3% to -4% of current revenues on cigarettes in Portugal and Finland), and diminish revenue stability. Also, it would increase price differentials in the cigarette market and the risk of price competition. Finally, in terms of tobacco control policy goals, a limit on the MED could increase demand for low-cost cigarettes and tobacco entry rates in the long-term.
- Under the no change scenario, no immediate market effects are expected. However, stating that a MED higher than the excise yield on WAP is acceptable without a clarifications of when the MED is in breach of the mixed structure could lead to situation in which most or all of the cigarette market is taxed at the MED. This would run contrary to the spirit of the Directive and the mixed structure requirements.
- If the Commission intends to provide a clarification, it could state that the MED shall not be considered a form of specific taxation, in line with the current interpretation. At the moment, such interpretation does not create any problem at national level with respect to tobacco control policy goals and budget stability. However, the clarification should be complemented by a definition of when MED shall be considered breaching the mixed structure requirements, otherwise MS would be free to set it at a level which covers the whole market. To the contrary, an upper limit, as it was in place before the approval of Directive 2010/12/EU, would hamper some of the purposes currently pursued at national level by means of the MED.

6 CONCLUSIONS

6.1 Key Findings and Recommendations

6.1.1 New Products

➤ **BASELINE ASSESSMENT**

There is limited information on the market and consumption trends of new products, like e-cigarettes and heated tobacco products. Combining different sources it has been possible to estimate at approximately nine million the number of e-cigarettes regular users in the EU, and at less than half a million the users of heated tobacco products. The e-cigarette market has grown significantly over the past 3-4 years and in 2016 it was worth an estimated € 3.5 billion (including both hardware and consumables). A certain slow-down is expected in the near future, partly due to the uncertain effects of Directive 2014/40. After a few 'pilot' experiments, a large scale commercialisation of heated tobacco in the EU started only in 2016. It is therefore too early to draw conclusions on its possible evolution, but initial indications suggest it may rapidly develop.

New products are not explicitly covered by Directive 2011/64. Various Member States have therefore introduced non-harmonised national taxes on both e-cigarettes and heated tobacco consumable components, with a view to regulate the marketing of such products and possibly offset the effects of substitution on tax receipts. According to the Study's results, the hypothetical excise duty loss caused by substitution between ordinary cigarettes and new products may account for less than 2.5% of the total revenue, i.e. less than € 2.0 billion. The tax yield of new products in 2016 (not including VAT) was likely below € 100 million. The revenue argument underlying new product taxation is largely controversial in the light of the claimed reduced risk carried by non-combustible products and their potential support to smoking cessation. On this point, national and international public health authorities and experts have views that largely diverge.

The result of the various national regulations is a fragmented picture with negative repercussions on the functioning of the Single Market. In particular, national frameworks create obstacles to market integration, affect the competitiveness of domestic operators, and create incentives for tax avoidance practices. In the case of heated tobacco products, the lack of a harmonised approach also hampers their commercialisation in certain geographical markets.

➤ **ASSESSMENT OF POSSIBLE POLICY OPTIONS**

As concerns e-cigarettes, this Study examined primarily the possibility of introducing a harmonised tax structure for e-liquids, with either no minimum rate or a positive minimum rate. The overall outcome returned a mixed picture with the various options having different effects in different areas and for different stakeholders.

- The 'no change' option would likely help the market to develop and recover from the effects of Directive 2014/40 but has the major downside that, in the absence of common rules, more Member States may opt for national frameworks, thus deepening fragmentation and possible legal issues. A 'no change' option may be also justified by the current scarcity of robust data on market and consumption as well as on the health risk and benefits of non-combustible products. Detailed data on e-cigarettes are expected from the monitoring mechanisms envisaged under Directive 2014/40.

- A light harmonisation, i.e. without imposing a minimum tax, would minimise tax-induced market shocks and improve the level playing field for operators in MS that currently have a national tax on e-liquids. Administrative and substantive compliance costs would likely be moderate but not negligible, especially for SMEs (i.e. about € 15,000 / year per operator).
- A positive tax may modestly contribute to MS tax revenues. In the scenarios considered, the overall excise yield at EU-level would amount to approximately €0.3 - € 0.5 billion, i.e. only a fraction of the possible 'tax gap' induced by substitution. The experience of some MS is that higher tax rates would bring the market to a collapse and/or to a massive recourse to illicit products, since the movement of e-liquids is very difficult to control.

As regards heated tobacco products, a harmonised classification under a revised Directive 2011/64 would be effective in redressing the current legal and administrative uncertainties and constraints, which affect the commercialisation of these products in the Single Market. Legal certainty would be provided only by an explicit categorisation, but defining heated tobacco could be complex especially with respect to its intended use for inhaling and not smoking. Any weak or vague definition may easily create new loopholes for 'borderline' products. Alternatively, heated tobacco may be classified under an expanded 'other smoking tobacco' category (as various MS are currently doing). However, this solution would also have downsides: (i) it would be necessary to reconsider the reference to 'smoke' in the smoking tobacco definition; (ii) it implies avoiding any consideration on the possible reduced risk offered by non-combustible products; and (iii) any tax policy adopted for these product would unintentionally affect also other products that share the same category (e.g. pipe tobacco).

The current *ad hoc* arrangements or the use of a soft approach (non-binding guidelines) may be considered as temporary solutions, to provide tax regulators with the time to better assess market trends and develop a suitable and future-proof definition for these novel products. However, as the variety and the market penetration of these products increase, a non-binding policy approach would not only become poorly effective but it may also contribute to legal uncertainty and disputes.

➤ **RECOMMENDATIONS**

Against the above framework, any radical intervention would be controversial under one of the various perspectives considered, therefore a light-touch and flexible approach seems in any case preferable at this stage. In the case of e-cigarettes tax regulators may therefore consider to adopt a multi-staged path towards a possible tax harmonisation of e-cigarettes. This would involve at first collecting and pooling accurate data on markets and consumption (including under Directive 2014/40), then adopting a harmonised and future-proof definition and tax category (taking into account the overall evolution of novel non-combustible products, as well as the ongoing standardisation processes). A parallel modification of the customs classification would be desirable, to ensure consistency and facilitate enforcement. The final step would be the adoption of positive taxes, but this should be ideally left to each MS to decide based on actual market conditions and country policy goals.

As regards heated tobacco, there is less margin for a further procrastination of its harmonisation under the Directive. The recourse to Commission guidelines may help, but the expected market growth and possible proliferation of new products suggest an appropriate tax categorisation may be soon needed.

6.1.2 Raw Tobacco and Intermediate Products

➤ **BASELINE ASSESSMENT**

Directive 2011/64 does not apply to raw tobacco and to intermediate tobacco products (e.g. tobacco refuse and reconstituted tobacco), unless they are in a 'smokeable' form. However, the definitions set out in the Directive contain some subjective elements, which might cause classification uncertainties between excisable and non-excisable products and related disputes. In the past few years, 'bulk' tobacco and refuse tobacco not subject to the excise duty but capable of being smoked after minor treatment has appeared on the market in a few MS. These products exploited regulatory loopholes and ambiguities, so in some of the MS where the problem appeared specific measures to either ban it or bring it under the scope of excise goods have been adopted. Very few classification disputes leading to judicial cases have also been reported.

A second, more significant issue is that raw tobacco and tobacco refuse can be diverted to the illicit manufacturing of smoking products, taking advantage of the fact that the EMCS and the other monitoring tools envisaged in the EU excise system to prevent and fight tax fraud cannot be applied. Illicit trade of raw tobacco is estimated at approximately 10,000 tonnes per year, i.e. around 1.0% of the EU raw tobacco market (including EU production and net imports). Once transformed into illicit cigarettes, this amount of tobacco may cause a tax evasion between € 1.2 and 2.0 billion, that is 1.6% to 2.7% of the current revenues from cigarettes. The extent of the possible diversion of tobacco refuse to illicit manufacturing seems comparatively much lower, since it is an output of first processing, and the controls over the value chain at this level are stricter in all MS.

➤ **ASSESSMENT OF POSSIBLE POLICY OPTIONS**

The option of including raw tobacco among excise goods, with a view to enhance control and prevent diversion, requires to carefully balance the expected benefits with the intended and unintended costs. Extending the EMCS and the other requirements of the EU excise system may indeed enhance the monitoring of movements and make illicit trade more difficult, but it may not eradicate the problem, since strong economic incentives for illicit activities would remain and a minute monitoring at tobacco field level would remain complex and burdensome. On the other hand, this approach may impose administrative and compliance costs for all legitimate growers and first processors, which have been estimated at some 8% of the total market value of raw tobacco in the EU. These substantive compliance and administrative costs may cause a price increase of up to 35% and an ensuing loss of competitiveness of the EU-grown tobacco against imported tobacco. Tobacco growers are prevalently micro and small undertakings, therefore the social impact should be carefully considered.

An alternative approach may consist in the reintroduction of a common administrative regulation of tobacco in the EU, building upon the various national experiences in this area. This approach, consisting of a registration of value-chain operators and recordkeeping obligations, may provide similar benefits in terms of control but at a lower costs for operators, especially since it is already in place in most of tobacco-growing MS.

As far as raw tobacco put up for retail sale is concerned, the current definition of smoking tobacco seems appropriate, and introducing more stringent criteria may actually result in unintended consequences. For this reason, the provision of non-binding guidelines on the excisability of raw tobacco put up for retail sale, based on national best practices, seems a more effective option.

With respect to tobacco refuse, the issue of proportionality in the intervention seems even more acute, given the relatively small magnitude of the problem in terms of both volume of product traded, and especially market value. Extending the excisability to all tobacco refuse, and not only to the product put up for retail sale, may eventually affect primarily and excessively legitimate players. Conversely, a more effective approach would be to revise the definition of tobacco refuse for retail to make it more operational, so as to reduce uncertainties.

➤ **RECOMMENDATIONS**

Introducing in the EU excise system new tax categories for raw tobacco and other intermediate products like tobacco refuse (not for retail sale) may contribute to enhance the control over the value chain and eventually help fighting illegal manufacturing. However, the benefits of this approach do not seemingly outweigh its administrative and compliance costs and the adverse effect it may have on the competitiveness of tobacco growing and first processing activities in the EU. In line with the approach adopted in various MS, the reintroduction of a common administrative regulation of the tobacco market in the EU may bring similar benefits at a lower cost.

The issue of non-excised raw tobacco directly sold to consumers seemingly does not justify a revision of the definition of smoking tobacco laid down in the Directive. The problem appears marginal and MS already have instruments to tackle it effectively. Instead, a more operational and weight-based distinction between tobacco refuse sold in bulk or for retail sale may be beneficial. In this respect, a two-threshold system can be envisaged, since a single clear-cut threshold may generate 'borderline' cases.

6.1.3 'Borderline' cigarillos

➤ **BASELINE ASSESSMENT**

In some EU countries, so-called 'borderline' cigarillos (or 'eco-cigarillos') have appeared on the market since the early 2000s. These products have some characteristics similar to cigarettes (e.g. dimension, filter, packaging, etc.), but can be sold at a much lower price, thanks to the more favourable tax treatment applied to the overall category of cigars and cigarillos. This has raised concerns about the risk that these product may distort competition, affect tax revenues and undermine tobacco control targets. The baseline assessment showed that the issue of tax-induced substitution of cigarettes with 'borderline' cigarillos has been largely and effectively addressed over the past few years with the adoption of a revised product definition (and the end of derogations for DE and HU), and with the adoption by MS of appropriate tax structures and rates reducing the incentives for low price products. With few minor exceptions, the market of these products is declining in all MS and there are no signs this trend is going to reverse soon, although the comparatively softer rules that the Directive 2011/64 imposes on these products may provide them a small advantage. The Study has estimated an overall 3.7 billion pieces have been placed on the EU market in 2015 (including some low-price products not necessarily 'borderline'), and the number of regular smokers is about 0.5 million.

Germany accounts for nearly half of the market, followed by Spain. Assuming a complete substitution (which is an extreme scenario, given the characteristics of these products), the reduction in the excise duty revenue caused by these low price cigarillos can be estimated as lower than € 400 million.

There are differences in the definition of cigars and cigarillos used in the excise and customs classifications, which makes it possible for certain products to be classified as cigarettes for customs purposes and as cigarillos for tax purposes. This is a possible

source of legal uncertainty, generating (rare) disputes and inconsistencies in the EMCS system.

➤ **ASSESSMENT OF POSSIBLE POLICY OPTIONS**

MS may adopt tax measure to prevent or discourage the placing on the market of low-price cigarillos that may induce the substitution of cigarettes, such as introducing or increasing a specific tax component (per weight or number of pieces) and/or establishing a minimum excise duty (MED). Most of the MS where low price cigarillos are marketed have done this in the past few years, therefore imposing at EU level a specific or mixed tax structure seems disproportionate and of limited relevance. To further tackle substitution, an alignment of the minimum excise of cigarillos with that of cigarettes can instead be considered. A hypothetical mandatory MED should aim at minimising the price differential between low-price cigarillos and cigarettes, taking into account the lower tax bearing capacity of cigarillos. The Study showed that this approach may be effective in reducing the consumption of 'borderline' products by half, but it would inevitably affect also non-target products (other low-price brands), including those commercialised by SMEs. Because of the market drop, the positive effect on tax revenues would be modest, and only some 15% of the tax gap attributable to 'borderline' cigarillos would be recovered. The proportionality of the intervention seems therefore dubious.

With respect to classification disparities, legal disputes and other major issues are exceptional. Most of the problem lays in the unnecessary administrative burden to cope with the dual classification. An alignment of definitions would likely prompt the industry to modify products so as they can still be classified as cigarillos, so minor indirect compliance costs can be expected.

➤ **RECOMMENDATIONS**

The tax-induced substitution between 'borderline' cigarillos and cigarettes has significantly reduced in recent year, thanks to the full implementation of the new definition of cigarillos that requires a natural tobacco wrapper, and the end of derogations in Germany and Hungary. Furthermore, the Directive already provides MS with effective instruments to address the problem where necessary. All in all, there seems to be little rationale for introducing additional regulatory measures. It is however important to monitor the development of this market, in the light of the effects of the new Tobacco Products Directive. An alignment of the definitions used for excise and customs purposes may remove some administrative issues. A pragmatic alternative solution, whose technical feasibility is subject to verification, may consist in adapting EMCS to allow uncoupled coding.

6.1.4 Fine-cut tobacco

➤ **BASELINE ASSESSMENT**

At EU level, the market for fine-cut tobacco (FCT) has seen a considerable growth in the period 2006-2012, with year-on-year growth rates exceeding 5%. This was followed by a relative stabilisation in the 2013-2016 period, with sales fluctuating between 87-88 mn tonnes what leads to an increasing share of FCT on the total tobacco consumption. At EU level, FCT currently accounts for nearly 20% of the total tobacco consumption, but its market share varies significantly across MS from almost nil up to about 50% of total consumption. FCT is to a large extent a substitute of cigarettes and its penetration is mostly driven by a more favourable tax treatment and greater affordability than cigarettes. While specific consumer preferences vary from country to country, in most of the cases analysed a price shock in cigarettes can be associated to an increase in the consumption of FCT (unless a parallel FCT price

increase takes place). Overtime, MS have adjusted their tax policies to reduce the tax incentives for substitution and this, combined with a certain market saturation, has led to the current market stabilisation.

The FCT can be further segmented in sub-classes of products with different characteristics, namely: (i) the traditional roll-your-own tobacco intended for hand-rolling; (ii) the so-called 'make-your-own', which has a wider cut a lower humidity and is intended for machine-rolling; and the (iii) 'volume tobacco' that is FCT typically intended for machine-rolling, which contains a certain percentage of expanded tobacco. Where the taxation is prevalently per weight, 'volume tobacco' may offer a greater value-for-money to consumers and enhance substitution.

➤ **ASSESSMENT OF POSSIBLE POLICY OPTIONS**

The Study assessed the possible impact of increasing the current minimum excise level on FCT in order to approximate it to the minimum excise of cigarettes, thus mitigating the incentive for substitution. Various scenarios have been considered to this end, ranging from a partial to a full approximation of minimum rates, applying different conversion rates, and estimating the effects of a hypothetical approximation of the actual tax burden. Depending on the scenarios the results differ from a very limited effect, perceivable only in a few MS, to more profound market effects with a possible decline down to -40%. Impacts would vary significantly between MS: where excise duties are currently low, a steep increase of the minimum rate may cause a collapse of the market. Importantly, impacts would be more pronounced on SMEs, which have a higher share in the FCT than in the cigarette market. Tax revenues effects would follow the market trend. In the best case scenario, the net increase would be of € 390 mn, which is still a small fraction (0.5%) of the current revenues from tobacco taxation in the EU. The reduction of smoking prevalence is estimated at 0.3% in case of full alignment. Some stakeholders concur that a large share of FCT consumption would probably shift to other licit or illicit tobacco products.

The possibility of separating the tax regimes of roll-you-own tobacco, make-your-own and volume tobacco has been taken into consideration, but discarded for a lack of solid justification compounded by practical difficulties. Moreover, this option received only a very limited support among stakeholders.

➤ **RECOMMENDATIONS**

The current text of the Directive already envisages a staged increase of the minimum excise on FCT until 2020, which would bring the minimum rate closer to that of cigarettes. In reality, most MS already go beyond the minimum rate laid down in the Directive, and in a few cases rates are already aligned. In this sense, an intervention on the minimum rates would have little effect on the current tax policies of MS. More profound impacts on consumption levels and tax revenues could be achieved if MS actually 'pegged' the tax treatment of FCT to cigarettes, but this is an option that MS may already adopt, and it would be disproportionate to impose in the Directive since for no tobacco products the Directive goes beyond the harmonisation of minima. The risk of creating incentives for illicit trade (e.g. of bulk tobacco) should be carefully considered. Any attempt to distinguish for tax purposes between sub-classes of FCT may inevitably open the door to 'borderline' products, not counterbalanced by strong fiscal or market functioning benefits.

6.1.5 Water-pipe Tobacco

➤ **BASELINE ASSESSMENT**

There is a notable scarcity of data on the trade and consumption of water-pipe tobacco (WPT) in the EU. The information collected is unsystematic and largely anecdotal, also due to the fact the value-chain of WPT is largely separated from conventional tobacco products and that WPT is mostly an imported product. More importantly, this sector seems characterised by a high level of informal and illicit trade. Overall consumption in the EU can be estimated at some 5,000 tonnes per year, of which an estimated two-thirds non-duty paid (including both smuggling and 'bootlegging' of small quantities for own consumption). There is a strong economic incentive for tax evasion due to the relatively high tax burden on WPT. This is caused by its classification as 'other smoking tobacco' despite being much heavier than other products in the same category (such as pipe tobacco). The amount of tax evaded is roughly estimated at € 200 million. In absolute terms, the size of the problem is modest, but all data sources concur WPT is growing in popularity, especially among young people, and enhancing control seems therefore necessary.

➤ **ASSESSMENT OF POSSIBLE POLICY OPTIONS**

The policy option analysed in this Study consists of the creation of a new, separate excise category specifically for WPT. This solution may allow a more effective monitoring of the WPT market, addressing the current information needs. Moreover, it may allow MS to modulate the WPT tax rate as deemed necessary to remove the incentives for illicit trade, while avoiding that a tax reduction may translate into a greater consumption. It has been calculated that at the current level of evasion even a major tax cut may in fact translate into a greater tax revenue, by simply shifting consumption from the black market to the licit one. The creation of a new category may in principle generate administrative costs for national competent authorities and operators, but since the product is already under the excise system, these can be assumed as marginal.

At the same time, however, there is a risk that a separate tax category may create unintended incentives for 'borderline' products, aiming at exploiting eventual classificatory loopholes. The existing definition seems not enough robust, since it makes reference to its intended use through a water-pipe, which calls into question how to define a water-pipe for tax purposes. Similarly, there is no standard on the percentage of tobacco contained in WPT mixtures, and it is not clear if the lack of specifications may create incentives for products with a higher content of tobacco.

➤ **RECOMMENDATIONS**

The data currently available on WPT are too scarce and unreliable to support a major tax reform on this basis, and there is a general need to step up monitoring of this market and its value-chain. As concerns Directive 2011/64, a first step may consist of introducing a separate tax category for WPT. Since the magnitude of the problem differs across countries, no mandatory change on the minimum excise level seems necessary. MS would be able to modulate their tax policy balancing the need to eliminate the economic rationale for illicit trade with the need to avoid that more favourable rates translate into greater consumption or the development of 'borderline' products.

6.1.6 Minimum Excise Duty on Cigarettes

➤ BASELINE ASSESSMENT

Directive 2011/64 requires that cigarettes be taxed according to a mixed structure, including an *ad valorem* excise duty and a specific excise duty respecting certain proportions. The Directive also allows MS to levy a Minimum Excise Duty (MED), i.e. a minimum tax floor, provided that the mixed structure is respected. The provision leaves ample room of interpretation on the actual rules and limits of application of the MED, some of which have been dismissed by ECJ rulings. The MED is used in nearly all MS as a tool to discourage downtrading and prevent price wars, and to ensure stability and predictability of tax revenues. In this respect, the lack of implementation details or guidelines is not considered problematic, since it enhances the flexibility in the application of the MED and its adaptation to country's needs.

➤ ASSESSMENT OF POSSIBLE POLICY OPTIONS

A possible clarification may either confirm the *status quo*, or establish that the MED is equivalent to a specific excise and therefore, in order to respect the mixed structure, it should not exceed the excise duty applied at the level of the weighted average price (WAP). At present a few MS apply a MED that is higher than the excise duty at WAP level (by maximum six percentage points), and these would be the only markets where the effects of a stricter interpretation of the MED may produce some impacts. The regulatory revision would require these MS to reduce their MED, with inevitable negative effects on tax revenues (estimated at maximum -4%), and the risk of more instability at the bottom of the market. In all likelihood, the affected MS would adjust their tax regime to offset tax losses, and may opt for increasing the specific excise duty to prevent price reductions. This way, they may also prevent that cigarettes become more affordable, in order not to undermine tobacco control policies.

➤ RECOMMENDATIONS

The MED is reportedly functioning well in all MS analysed, and there is no demand for a revision of the current rules from both tax authorities and economic operators. If any, a clarification of the MED may aim at confirming the current flexibility, and explaining if and under which conditions a MED set above the amount of excise duty applicable at WAP level may still respect the mixed structure.

6.2 Summary of Impacts by Typology

This final Section summarises the impacts – actual and expected - that have been analysed in this Study, based on their nature and typology. **Table 57** below provides a cross-cutting overview of the most relevant impacts that have been identified in relation to the issues at stake, and their estimated drivers and magnitude.

Table 57 – Overview of most relevant impacts

Impact Area	Conclusions
Single Market Functioning	<ul style="list-style-type: none"> As regards conventional tobacco products no significant market distortion or competition issues have been observed. The tax-induced substitution attributed to 'borderline' cigarillos and FCT has been partially addressed at MS level, and both segments are stable or declining. The application of MED across MS is uneven, but there is limited demand for a revision in a stricter sense. In the case of e-cigarettes, the fragmentation caused by the introduction of national taxes is affecting the level playing field, and may somehow hamper the Single Market integration. The lack of a harmonised approach to heated tobacco product

Impact Area	Conclusions
	<p>creates obstacles to its commercialisation and movement across the EU.</p> <ul style="list-style-type: none"> • Where the share of illicit trade is high (e.g. water-pipe tobacco) legitimate players are penalised. In some countries legal operators have virtually disappeared.
SME competitiveness	<ul style="list-style-type: none"> • The presence of big brands in segments where the population of SMEs is larger (cigars/cigarillos, FCT) may induce regulators to increase taxation. However, there is a risk of disproportionate effects on small operators, due to their lower tax bearing capacity. • Extending the excise system to raw tobacco and tobacco refuse may hamper the competitiveness of small EU tobacco growers and first processors. • Extending the excise system to e-cigarettes would affect small players (recently 'hit' by the TPD2) more significantly than big ones.
Legal certainty	<ul style="list-style-type: none"> • The current scenario does not present critical situations. Various regulatory 'loopholes' with conventional tobacco products have been closed, and very limited disputes are reported. • Clarifications may remain necessary in the case of tobacco refuse put up for retail sale and, possibly, with respect to the conditions of application of the MED above a certain threshold. • The tax treatment of e-cigarettes is increasingly controversial and in some MS has also caused judicial cases. In the absence of a clear framework, the expected growth in the new products segment may exacerbate uncertainties.
Regulatory costs (substantive compliance and administrative costs)	<ul style="list-style-type: none"> • The dual classification of products for tax and excise purposes is not creating unnecessary burden. The only exception are certain cigarillos classified as cigarettes according to the CN definition. This may require aligning definitions or adjusting the EMCS. • Significant substantive compliance and administrative costs may be caused by the introduction of a tax category for raw tobacco and intermediate products, as well as in the case of a tax category for e-cigarettes.
Tax revenues	<ul style="list-style-type: none"> • The possible tax 'gaps' caused by substitution is low in the case of cigarillos, more marked in the case of FCT, but the tax increases adopted in the past few years have partly redressed the situation. • New products are not causing major tax losses at present, but, in perspective, they may induce an increasing share of smokers to switch from combustible to non-combustible products. If and how they can be excised should be carefully weighed against their possible impact on smoking-related harm. • The MED generally works well and help MS to stabilise the bottom of the market and the tax revenues. • The tax evasion caused by illicit manufacturing of cigarettes is non-negligible and may suggest the need to improve the regulation of the tobacco value chain.
Market development and demand trends	<ul style="list-style-type: none"> • The consumption of conventional tobacco products is generally declining, in particular cigarettes, cigars/cigarillos (with few exceptions), and pipe tobacco. • The FCT is mostly stable in absolute terms, with the sub-class of 'volume' tobacco gaining shares at the expenses of ordinary FCT in a few geographical markets. • Water-pipe tobacco seems growing at a fast pace, including among young people, but data are scarce given the limited monitoring. • Also new products are poorly monitored at present. The evidence available indicates they have been growing rapidly, but in the case of e-cigarettes a certain slow-down is expected as a consequence of the TPD2.

Impact Area	Conclusions
Tobacco control targets	<ul style="list-style-type: none"> • In line with market development trends, the smoking prevalence is declining.³¹¹ Positive effects can be expected to a certain degree resulting from the implementation of the TPD2. • Evidence shows that price is one of the main prevalence determinants. The threats posed by affordable tobacco have been partially tackled, since in the past few years tax levels have increased for all categories of products. In some MS the price of FCT may still encourage substitution, even if MS would have the instruments to solve the issue nationally. • Although modest in absolute terms, some niche products require a certain monitoring to prevent they become popular especially among young people i.e. water-pipe tobacco, 'bulk' tobacco, and flavoured cigarillos.
Illicit trade and cross-border shopping	<ul style="list-style-type: none"> • In response to the non-harmonised taxation of e-cigarettes in some MS, a significant share of consumptions has shifted to the informal (online, bootlegging) or illicit trade. Enforcement is particularly difficult for this category of products. • The diversion of raw tobacco and tobacco refuse to the illicit manufacturing of tobacco products requires an increase of control mechanisms at both MS and EU level. • Water-pipe tobacco consumed in the EU is to a large extent non-duty paid, i.e. smuggled or bootlegged. In absolute terms the impact is small, but it nurtures a ramified illegal value-chain.

³¹¹ Source: WHO global report on trends in prevalence of tobacco smoking 2015. http://apps.who.int/iris/bitstream/10665/156262/1/9789241564922_eng.pdf

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