

**WHO-Framework Convention on Tobacco Control ( FCTC).**

*“The Parties recognize that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons.”*

**A public health perspective for the review of the EU tax policy on tobacco products.**

**Luk Joossens, Advocacy Officer, Association of European Cancer Leagues, Brussels, June 2006.**

**Position paper endorsed by:**

Association of European Cancer Leagues (ECL) [www.europeancancerleagues.org](http://www.europeancancerleagues.org)

European Network for Smoking Prevention (ENSP) [www.ensp.org](http://www.ensp.org)

European Heart Network (EHN) [www.ehnheart.org](http://www.ehnheart.org)

European Respiratory Society (ERS) [www.ersnet.org](http://www.ersnet.org)

Action on Smoking and Health (ASH) [www.ash.org.uk](http://www.ash.org.uk)

Cancer Research UK (CRUK) [www.cancerresearchuk.org](http://www.cancerresearchuk.org)

Intstitut National du Cancer (INCA) [www.e-cancer.fr](http://www.e-cancer.fr)

**Executive Summary**

According to the World Bank, high taxes on tobacco are the single most effective intervention to prevent smoking. The European Community has a history of more than 30 years of regulating the taxes on tobacco products. On 12 February 2002 the Council of the European Union adopted Directive 2002/10/EC as regards the structure and rates of excise duty applied on manufactured tobacco. This Directive sets, amongst others, the required incidence of excise duty on the retail selling price of cigarettes at 57%, and also establishes that the overall minimum excise duty shall not be less than 64 € per 1000 cigarettes of the price category most in demand from 1 July 2006. Eight of the ten countries, which joined the European Community in May 2004, have obtained additional transition periods to obtain these rates.

Under the terms of the 2002 directive the European Commission is obliged to publish a review of the tobacco excise rules by the end of 2006.

This position paper, endorsed by the Association of European Cancer Leagues (ECL), European Network for Smoking Prevention (ENSP), European Heart Network (EHN), European Respiratory Society (ERS), Action on Smoking and Health (ASH), Cancer Research UK (CRUK), Institut National du Cancer (INCA), welcomes the review and supports higher taxes on all tobacco products in the European Union. However, whilst **there is evidence that higher taxes result in less consumption, the effect of tax increases on smoking prevalence has been weakened by the following six factors in the European Union:**

1. Minimum tax rates for cigarettes are too low and the tax rules too complex
2. Hand rolling tobacco is increasingly being used as a substitute for cigarettes
3. The increase of cross-border shopping in cheaper neighbouring countries
4. The launch of discount and low priced cigarette brands
5. Inventive pricing by tobacco companies
6. An increase of counterfeit cigarettes and the risk of smuggling

The signatories call upon the Commission and Member States to take the following actions in the field of tobacco taxation to improve public health in the European Union.

#### **1. Minimum tax rates for cigarettes are too low and the tax rules too complex**

##### **Recommendations:**

- Remove the concept of the most popular price category and apply tax rules to all price categories
- Remove the 55% maximum threshold for the weight of the specific tax component of the total tax.
- The required tax incidence (VAT and excise duties) on the retail selling price of cigarettes should be at 71% and the overall minimum tax (VAT and excise duties) shall not be less than 120 € per 1000 cigarettes from 1 January 2008. The required tax incidence (VAT and excise duties) on the retail selling price of cigarettes should be at 72% and the overall minimum tax shall not be less than 130 € per 1000 cigarettes from 1 January 2010.
- Where existing tax levels are significantly below these levels Member States should be allowed to transition to these new minimum excise duty levels. A suggested mechanism would be by using a cost of living index such as Eurostat's Comparative Price Levels of Final Consumption

## **2. Hand rolling tobacco as a substitute for cigarettes**

### **Recommendation:**

- Increase gradually the minimum tax for fine cut tobacco to same level as cigarettes by imposing the overall tax (excise duties and VAT) levied on fine-cut smoking tobacco intended for the rolling of cigarettes shall be at least equal to 60 % of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 60 € per 1kg from 1 January 2008, to 65 % of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 70 € per 1kg from 1 January 2010 and to 70% of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 80 € per 1kg from 1 January 2012.

## **3. The increase of cross-border shopping in cheaper neighbouring countries.**

### **Recommendations:**

- Reduce the indicative level for cigarettes for personal use when travelling between EU countries to 200 cigarettes.
- Establish a maximum of 40 cigarettes for import from outside the community for personal use.

## **4. The launch of discount and low priced cigarette brands.**

### **Recommendations:**

- Favour specific taxation instead of proportional taxation (remove the upper limit for specific taxes) and introduce overall minimum taxation levels (for instance 120 euros per 1000 cigarettes).
- Commission research on the impact of tobacco companies on tax policy in Europe and the consequences of the break-up of Altria and the spin-off of PMI on tax and price policy in EU-countries.

## **5. Inventive pricing by tobacco companies**

### **Recommendation:**

- Ban all cigarette packs which contain less than 19 cigarettes

## **6. An increase of counterfeit cigarettes and the risk of smuggling.**

### **Recommendation:**

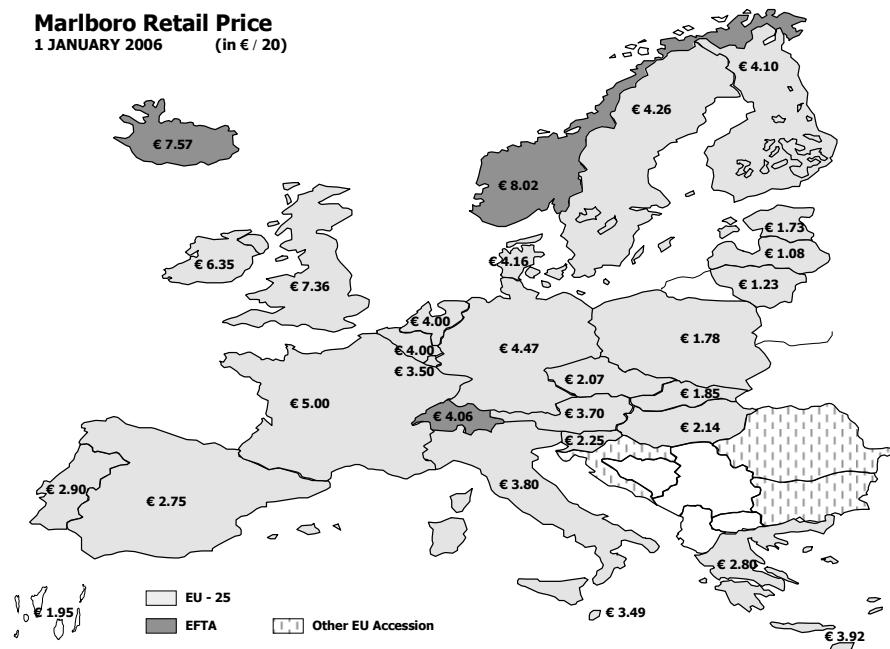
- Article 15 of the WHO FCTC contains obligations for the countries to reduce the illegal tobacco trade, but is not detailed and specific enough to be fully effective. What is needed is a protocol which controls the illegal trade of tobacco products. This should be based on similar conventions such as the Protocol against the Illicit Manufacturing of and Trafficking in Firearms, Their Parts and Components and Ammunition, supplementing the United Nations Convention against Transnational Organized Crime. The EU should support the development of such a WHO-FCTC protocol to effectively control the worldwide trade in both “normal smuggled cigarettes” and counterfeit.

## Introduction

The European Community has a history of more than 30 years of regulating the taxes on tobacco products. On 12 February 2002 the Council of the European Union adopted Directive 2002/10/EC as regards the structure and rates of excise duty applied on manufactured tobacco. This Directive sets, amongst others, the required incidence of excise duty on the retail selling price of cigarettes at 57%, and also establishes that the overall minimum excise duty shall not be less than 64 € per 1000 cigarettes of the price category most in demand from 1 July 2006. Eight of the ten countries, which joined the European Community in May 2004, have obtained additional transition periods to obtain these rates. While progress has been made in harmonising tobacco taxation at EU level, the big concern remains that the price of and the taxes on tobacco products varies greatly in the European Union.

For instance,

- The price a pack of cigarettes of Marlboro in January 2006 varies from 1,08 euro in Latvia to 7,36 euro in the United Kingdom.
- The price a pack of cigarettes of the most popular price category in January 2006 varies from 60 cent in Latvia to 7,40 euro in the United Kingdom
- The percentage of all taxes on cigarettes for the most popular price category in January 2006 varies from 60,90% of the retail price in Lithuania to 80,39% in France.
- The excise yield per 1000 cigarettes for the most popular price category in January 2006 varies from 16 euro in Latvia to around 232 euro in the United Kingdom.



According to the World Bank, **price increases** are the most effective and cost effective deterrent – especially for young people and others with low incomes, who must, of necessity, be highly price responsive. A price rise of 10% decreases consumption by about 4% in high-income countries. Price affects both smoking initiation and smoking cessation. Particularly for current smokers, the effect of a permanent increase in price will be greater in the long run than in the short-run, because it takes longer for a person addicted to nicotine to change his/her behaviour.<sup>1</sup>

The price of cigarettes has sharply increased in several European countries, such as France, Germany and the Netherlands, in 2003 to 2005. Stock analysts from Citigroup Smith Barney described the tax increases in some European countries in 2004 as the “perfect storm”: “Cigarette sales volumes plunged by 10%-25% in many countries in Continental Europe as result of sharp tax rises (Netherlands, Germany, France), increased smuggling (Austria) and more intense regulation (Ireland). For the first time there were general earnings downgrades in the sector (...).<sup>2</sup>

**While there is evidence that higher taxes result in less consumption, the effect of tax increases on smoking prevalence has been weakened by the following factors:**

<sup>1</sup> Jha P, Chaloupka F. Curbing the epidemic. Governments and the economics of tobacco control. Washington DC, The World Bank, 1999

## **1 Minimum tax rates for cigarettes are too low and the tax rules too complex.**

Taxation rules on tobacco products in the EU are complex. Like most goods, cigarettes are liable to Value Added Tax or VAT. Unlike other excise taxable items, however, they are subject to a mix of two types of excise duty - specific and ad valorem. Fixed or specific excise duties are imposed as a fixed amount per 1,000 pieces or per 1,000 grams. Ad valorem excise duties are proportional to the final retail price. Ad valorem taxation and VAT have a "multiplier effect". This means that price differences at production level are multiplied with the addition of tax which leads to greater price differences between cheaper brands (which pay proportionately less tax), and more expensive brands. Specific duties do not have a multiplier effect, as the same tax is applied whatever the production cost. This means that price differences between cheaper and more expensive brands are reduced. It also means that manufacturers can increase prices without this having too high an impact on the final retail selling price.

In 1992, in view of the approaching Single European Market, the EU adopted a set of common directives to ensure a level of harmonization of tobacco tax levels across its member states. It represented a compromise between the ad valorem and the specific taxation proponents. The directives established an overall excise incidence (specific and ad valorem combined) of at least 57% of the retail price of the most popular price category (MPPC). Taken with the minimum specified VAT rate set at 13.04 percent, the minimum overall level of taxation on cigarettes was 70 percent. Countries were free to set the balance between ad valorem and specific taxation—on the condition that the latter falls in the range of 5 to 55 percent of the total tax including VAT. Although they did lead to price increases in a number of countries, these directives did not eliminate the large differences in price and tax levels that characterized the EU market.<sup>3</sup>

The problems with the tobacco tax rules are the following:

- EU tax rules apply only to the most popular price category which represents a minor part of the overall cigarette market (only one third of the cigarette market, according to commission sources).
- Minimum tax rules should apply to overall taxes (VAT and Excise duties) and not specifically to excise duties (the 57% rule) or to the minimum specified VAT rate (set at 13.04 percent).

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<sup>2</sup> Citigroup Smith Barney. Tobacco, Industry report, After the storm, December 2004, page 37

<sup>3</sup> Gilmore A, McKee M. Tobacco-control policy in the European Union: the legal, ethical and policy debates. In: Tobacco Control and the Liberal State: The Legal, Ethical and Policy Debates. Feldman E, Bayer R (eds). Harvard University Press

- The upper limit of the specific excise duty can not be justified. According to EU legislation, specific taxation cannot be higher than 55 percent of the total tax including VAT. Specific taxes eliminate large price differentials and should be encouraged.

The Aspect Consortium report “Tobacco or health in the European Union. Past, present and future” which was financed by and prepared for the use of the European Commission, recommended in 2004 that “tax differences should be harmonised on the basis of specific rates as opposed to ad valorem”.<sup>4</sup>

The health objectives of reduced tobacco consumption should be taken more seriously by the European Community. Article 6 of the WHO Framework Convention on Tobacco Control (FCTC), which was adopted unanimously by 192 countries in May 2003, signed by 168 countries and ratified by 131 countries, say very clearly : “The Parties recognize that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons.”

**Recommendations:**

- **Remove the concept of the most popular price category and apply tax rules to all price categories**
- **Remove the 55% maximum threshold for the weight of the specific tax component of the total tax.**
- **The required tax incidence (VAT and excise duties) on the retail selling price of cigarettes should be at 71% and the overall minimum tax (VAT and excise duties) shall not be less than 120 € per 1000 cigarettes from 1 January 2008. The required tax incidence (VAT and excise duties) on the retail selling price of cigarettes should be at 72% and the overall minimum tax shall not be less than 130 € per 1000 cigarettes from 1 January 2010.**
- **Where existing tax levels are significantly below these levels Member States should be allowed to transition to these new minimum excise duty levels. A suggested mechanism would be by using a cost of living index such as Eurostat’s Comparative Price Levels of Final Consumption<sup>5</sup>.**

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<sup>4</sup> The ASPECT consortium. Tobacco or health in the European Union. Past, present and future. Luxembourg, European Commission, 2004.

<sup>5</sup> Ángel López Nicolás , Public health and the taxation of cigarettes in the European Union: A proposal for reform, Action on Smoking and Health, London, 2006

## **2. Hand rolling tobacco as a substitute for cigarettes.**

Minimum tax rates for fine cut tobacco at EU level are set at much lower level than for manufactured cigarettes: the overall excise duty levied on fine-cut smoking tobacco intended for the rolling of cigarettes shall be at least equal to 36 % of the retail selling price inclusive of all taxes, or EUR 32 per kilogram from 1 January 2004. As a consequence, hand rolling tobacco is taxed at a much lower rate than cigarettes in most countries of the EU. An increase of the price of cigarettes may result in a switch from cigarettes to hand rolling tobacco. Sales of roll-your-own tobacco, for instance, increased by 13% in 2004 in France. Even among youngsters hand rolling tobacco may become popular. One out of two young smokers smokes roll-your-own tobacco in France. The tax rate on roll-your-own tobacco should be made equal to the tax rate on one cigarette to prevent substitution towards this form of tobacco products. In this context, the Commission, upon request of a number of Member States, made the following statement to the Council minutes of 12 February 2002 : "The Commission states that, in its next review report provided for under Article 4 of Directive 92/79/EEC and Directive 92/80/EEC, it will present sufficient elements in order to proceed to an overall review of the possibility to bring the structure of excise duties for fine-cut smoking tobacco into line with the structure of excise duties for cigarettes'.

The Aspect Consortium report "Tobacco or health in the European Union. Past, present and future" recommended in 2004 that "tax on roll your own cigarettes should be raised to prevent substitution towards this form of tobacco products."

### **Recommendation:**

**Increase gradually the minimum tax for fine cut tobacco to same level as cigarettes by imposing the overall tax (excise duties and VAT) levied on fine-cut smoking tobacco intended for the rolling of cigarettes shall be at least equal to 60 % of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 60 € per 1kg from 1 January 2008, to 65 % of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 70 € per 1kg from 1 January 2010 and to 70% of the retail selling price inclusive of all taxes and the overall minimum tax shall not be less than 80 € per 1kg from 1 January 2012.**

## **3. The increase of cross-border shopping in cheaper neighbouring countries.**

The number of cigarettes that can be imported for personal consumption when travelling between EU countries is restricted, but its level remains high. Directive 92/12/EEC sets an indicative level to establish whether tobacco products are for personal purposes (< 800

cigarettes). Member States may lay down guide levels, solely as a form of evidence. The effect of price increases may be weakened by intensified cross border shopping in neighbouring countries. Cross-border shopping in Finland for instance takes mainly place with Estonia. It has been calculated that 2.5 million trips are made annually from Finland to Estonia for cross-border shopping. Luxembourg has consistently pursued a policy to keep tobacco prices at least 25% lower than in neighbouring countries to make cross-border shopping attractive. Sales in Luxembourg (population around 450,000 persons) increased as a result of tax increases in neighbouring countries (from 4.8 billion cigarettes in 2003 to 5.3 billion cigarettes sold in 2004). A survey among smokers in Belgium in 2001 found out that 25% of the people living in one of the two provinces closer to the border with Luxembourg had packs with Luxembourg stamps, whereas the percentage goes down to 4% for the rest of the country.<sup>6</sup> This shows that legal cross-border trade mainly takes place within a range of 50 to 100 km from the border: the probability of people travelling to buy cheaper cigarettes will decrease with the distance and increase with the price differential.

**Recommendations:**

- ❑ **Reduce the indicative level for cigarettes for personal use when travelling between EU countries to 200 cigarettes.**
- ❑ **Establish a maximum of 40 cigarettes for import from outside the community for personal use.**

**4. The launch of discount and low priced cigarette brands.**

Discount brands makes cigarettes more affordable and may lead to price competition. The competition of the discount brands in 2005 resulted in a decrease of the price of major international cigarette brands in Hungary and Belgium. Discount brands are not only a public health concern, but cause problems for finance ministers – because lower priced pay less taxes- and threatens the dominant position of the major international tobacco companies, which loses market share. Several EU countries, such as Ireland, Italy, France, Belgium and Austria have adopted recently minimum price laws to tackle the problem of the discount brands. They received the support of Philip Morris International, the cigarette market leader in Europe, which observes in the Altria Annual Report, 2004, that PMI “is encouraged by minimum reference laws passed during 2004 in France and Italy”.<sup>7</sup> However, such laws are an infringement of European legislation. In a press release, the European Commission announced on 10 April 2006 that it will take action against Member States that impose

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<sup>6</sup> Ligue Nationale contre le Cancer. Seminar on Tobacco Taxation and Prices in Europe, 28 January 2005, Paris, 2005.

<sup>7</sup> Altria, Annual Report 2004, page 15

minimum retail selling prices on cigarettes. The Commission takes the view that such minimum prices infringe Community law, distort competition and just benefit manufacturers by safeguarding their profit margins. To achieve the objective of reducing tobacco consumption, the Commission advocates an increase of the excise duties on cheap cigarettes.<sup>8</sup> In this respect, the view of the European Court of Justice is rather clear. The court has already stated on two occasions (against France and Greece) that minimum prices are not in line with European treaty obligations and that:

- imposing a minimum price is incompatible with the current legal framework (Directive 95/59/EC), since the setting of a minimum price by public authorities inevitably has the effect of limiting the freedom of producers and importers to determine their selling price (see also case C-302/00, Commission/France)
- minimum prices are not necessary, since the health objectives may be attained by increased taxation of tobacco products. (Case C-216/98, Commission/Greece). We quote: "it must be observed that the objective of protecting public health may be adequately attained by increased taxation of manufactured tobacco products, which would safeguard the principle of free formation of prices."

The impact of tobacco companies on the taxation policy of governments in Europe is a big concern. According to PMI, a minimum price is consistent with EU law<sup>9</sup>, where this is clearly not the case. Philip Morris International has already an important position in the European cigarette market (an EU market share of 39%), which may increase after a possible break up of the mother company Altria, which is expected to happen in the coming years. A spin-off could even take place by the end of the year. Stock analysts believe that "an Altria break-up - the spin-off of Kraft and Philip Morris International - will be a very significant event for the global tobacco industry. PMI could become more inclined to increase prices in the EU. PMI made 50% of its 2005 operating income in the EU and once listed will need to generate steady profit growth from these markets." "Because the company's overall portfolio structure leaves it more exposed to suffering negative mix - life for Marlboro is getting tougher - we think PMI may need to increase prices to achieve profit growth." "There will be some important implications for European Tobacco stocks because (a) either Altria tobacco business might acquire assets in Europe, and (b) a spin-off could change PMI's pricing behaviour."<sup>10</sup> The prospect of a break-up of Altria that would split Philip Morris USA and Philip Morris International into separate companies raises significant concerns about how an

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<sup>8</sup>European Commission, Excise duties/cigarettes: The European Commission alerts Member States on minimum retail selling prices, press release, 10 April 2006, Brussels.

<sup>9</sup> Huub Stavelkous, Director Fiscal & Economic Affairs PMI, Government Objectives & Fiscal policy, EU Tobacco Tax Seminar, Bucharest, April 4 2006.

independent Philip Morris and may lead to a more aggressive on taxation and prices in the European region.

The tax policy of the commission is also a concern. Governments have been advised to raise specific excise duties in stead of introducing minimum price laws. Ireland is not able to follow this advice as specific taxes in Ireland have almost reached the European upper limit (55 percent of the total tax including VAT). The upper limit of the specific excise duty cannot be justified.

**Recommendations:**

- **Favour specific taxation instead of proportional taxation (remove the upper limit for specific taxes) and introduce overall minimum taxation levels (for instance 120 euros per 1000 cigarettes).**
- **Commission research on the impact of tobacco companies on tax policy in Europe and the consequences of the break-up of Altria and the spin-off of PMI on tax and price policy in EU-countries.**

**5. Inventive pricing by tobacco companies.**

In order to avoid a third increase of a pack of cigarettes in a period of 18 months in Germany, the market leader in Germany decreased in September 2005 the number of cigarettes in a pack from 19 to 17 cigarettes. Despite the tax increase of 10%, the price for a pack decreased from 4 euro (19 cigarettes) to 3.85 euro (17 cigarettes), which gave the false impression to smokers that price had hardly changed.

**Recommendation:**

**Ban all cigarette packs which contain less than 19 cigarettes.**

**6. An increase of counterfeit cigarettes and the risk of smuggling.**

A new phenomenon in Europe is the counterfeit cigarettes. In the UK, counterfeit cigarettes represent about one quarter of the illicit cigarette market.<sup>11</sup> Counterfeit cigarettes are often produced in China and the control of counterfeit cigarettes is even more difficult than the control of the “normal smuggled cigarettes”. An estimate of counterfeit trade is difficult to make, but it is certain that the market share of counterfeit cigarettes is rising in some countries. The recognition of counterfeit cigarettes at time of seizure is an additional problem. Most counterfeit cigarettes have health warnings or tax stamps on the pack and are not

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<sup>10</sup> Morgan Stanley, Tobacco. Altria break-up has positive implications for European tobacco, March 7, 2006.

recognised as fake by smokers. In most countries customs authorities rely on the tobacco industry to determine whether a product is genuine or counterfeit, which can take considerable time and impedes effective control of counterfeit trade. The need for independent identification of counterfeit cigarettes is self evident. California, Malaysia and Brazil for instance require markings on the pack which allow enforcement officials to detect easily counterfeit cigarettes. While smuggling has been strongly reduced in countries such as Spain and Italy, the risk for smuggling remains and should be tackled at EU and at international level, for instance through the WHO Framework Convention on Tobacco Control.

**Recommendation:**

**Article 15 of the WHO FCTC contains obligations for the countries to reduce the illegal tobacco trade, but is not detailed and specific enough to be fully effective. What is needed is a protocol which controls the illegal trade of tobacco products. This should be based on similar conventions such as the Protocol against the Illicit Manufacturing of and Trafficking in Firearms, Their Parts and Components and Ammunition, supplementing the United Nations Convention against Transnational Organized Crime. The EU should support the development of such a WHO-FCTC protocol to effectively control the worldwide trade in both “normal smuggled cigarettes” and counterfeit.**

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<sup>11</sup> House of Commons. Committee of Public Accounts, HM Customs and Excise: Standard Report 2004-05, London ,2006.

**Annexes:**

<b>Table 1: Cigarette taxation in EU countries : 1 January 2006</b>			
Member State	Excise duties as % of the retail price, all taxes included	VAT as % of the retail price, all taxes included	Total Tax as % of the retail price, all taxes included
BE	57,63	17,36	74,99
CZ	51,27	15,97	67,24
DK	54,68	20,00	74,68
DE	62,29	13,79	76,08
EE	54,05	15,25	69,30
EL	57,50	15,97	73,47
ES	64,29	13,79	78,08
FR	64,00	16,39	80,39
IE	60,33	17,36	77,69
IT	58,49	16,67	75,16
CY	59,05	13,04	72,09
LV	49,35	15,25	64,60
LT	40,33	15,25	55,59
LU	57,02	13,04	70,06
HU	58,27	16,67	74,94
MT	60,82	15,25	76,07
NL	57,09	15,97	73,05
AT	58,70	16,67	75,37
PL	56,98	18,03	75,01
PT	61,04	17,36	78,40
SI	57,55	16,67	74,22
SK	54,43	15,97	70,39
FI	57,38	18,03	75,41
SE	49,20	20,00	69,20
UK	62,89	14,89	77,79