

# TOBACCO TAXATION IN THE EUROPEAN UNION

An Overview

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EUROPEAN COMMISSION



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## Abstract

The European Union has a long experience in tobacco tax harmonization, which provides useful lessons learned. In the European Union, tobacco tax harmonization took place in stages, and currently all Member States have agreed upon definitions, tax base, and minimum excise duty rates for all product categories of manufactured tobacco. Tobacco tax harmonization pursues several different objectives, among which some might appear contradictory at first sight. This is the case in the European Union, where ensuring collection of revenues and ensuring a high level of health protection are, among others, objectives of tobacco tax harmonization. Reaching the objective to ensure a high level of health protection implies a declining consumption and thus declining revenues. It therefore seems impossible to reach both objectives with the same legal provisions. However, experience in the European Union proves otherwise. Lower tobacco consumption and the decrease in revenue this would otherwise generate have been compensated by increased rates, thereby reaching both objectives.

## Tobacco Taxation in the European Union<sup>1</sup>

The first efforts to harmonize tobacco taxation among European Member States started as early as in the 1970s. With over 40 years of experience, the European Union has the longest experience in tobacco tax harmonization in the world. Over four decades, these harmonization provisions have been enhanced, expanded and improved. This section describes the beginning and objectives of tobacco tax harmonization in the European Union (hereafter: EU). The focus will thereafter be on the current provisions applicable to manufactured tobacco products in the EU and its Member States.

### 1. Beginning of the European Union

In 2017 the EU celebrates its 60th birthday. In 1957 six countries signed a treaty and created the European Economic Community, launching a process that has given rise to the EU as we know it today.<sup>2</sup> During the following years, the foundation of the EU was established and strengthened. The freedom of movement of goods, people, services, and money within the borders of the EU is considered as the concrete outcome of this cooperation. To achieve a properly functioning single market, new treaties were signed, and legislation was adopted and improved. Among others, the Schengen agreement was signed to allow people to travel freely in the Schengen area, regardless of their nationality.<sup>3</sup> With the treaty of Maastricht, the idea to develop a single currency was formalized, and the name “European Union” replaced European Community.<sup>4</sup> More countries joined; on 1 July 2013, with the accession of Croatia, the EU encompassed a total of 28 Member States with a population of 510 million people. Becoming an EU Member State is a lengthy process. First the conditions for membership need to be fulfilled, and all EU legislation must be implemented. There are currently five candidate countries: Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, and Turkey. In addition, the EU has association agreements with countries that are in the process of bringing their legislation in line with the EU acquis.

1. By Annerie Bouw, European Commission, April 2017. The content of this paper does not reflect the official opinion of the European Union. Responsibility for the information and views expressed in this paper lies entirely with the author. Reproduction is authorised provided the source is acknowledged.

2. Treaty Establishing the European Economic Community, Rome Treaty, 25 March 1957  
Parties: Belgium, France, Germany, Italy, Luxemburg and the Netherlands

3. Convention Implementing the Schengen Agreement of 14 June 1985 between the Governments of the States of the Benelux Economic Union, the Federal Republic of Germany and the French Republic, on the Gradual Abolition of Checks at their Common Borders (Schengen Implementation Agreement), 19 June 1990

4. Treaty on European Union (Consolidated Version), Treaty of Maastricht, 7 February 1992, Official Journal of the European Communities C 325/5; 24 December 2002

## 2. Why Harmonize Excise Duties on Tobacco Products?

In order to ensure the functioning of the internal market, a certain degree of harmonization of tax policies was considered necessary, including excise duties applied on manufactured tobacco.<sup>5</sup> National legislation discriminating against foreign products was not compatible with the freedom of movement of goods, one of the requirements for the functioning of the internal market. Only excise duties on energy products, alcoholic beverages, and manufactured tobacco products are harmonized in the EU. The first legal act in the area of tobacco taxation was adopted in 1972.<sup>6</sup> At the time, the establishment of an economic union was the main priority. The objective of tax harmonization was therefore to create a framework which would not distort competition or hinder the free movement of goods within the internal market. The legislation harmonizing the taxes on consumption of manufactured tobacco has been amended several times since. The damaging effects of smoking were acknowledged by including the objective to protect the health of the citizens of the EU in the recitals of the legal act.<sup>7</sup> Member States also agreed that the harmonized taxation should assure them of the collection of revenue of excise duties. Although some of these objectives may seem to be contradictory, the paragraphs below describe the objectives and the effects of many years of tobacco tax harmonization in the EU, including the current trends.

### 2.1. Functioning of the Internal Market and Competition

A proper functioning internal market implies the presence of competition, requiring the free setting of prices. Therefore it was agreed that importers or manufacturers of tobacco products should not be restricted in setting a maximum retail selling price.<sup>8</sup> This has resulted in different price levels across the EU. However, one should not forget that the geographical locations and economic situations of Member States also vary, as therefore does the affordability of products. The current legislation does not interfere in the prices of manufactured tobacco directly. However, depending on its level, taxation can have a major indirect influence on price. In particular in the EU, where tax burdens on cigarettes range from 70 to 85 percent, taxation

5. Article 99 of the Treaty Establishing the European Community (Consolidated Version), Rome Treaty, 25 March 1957

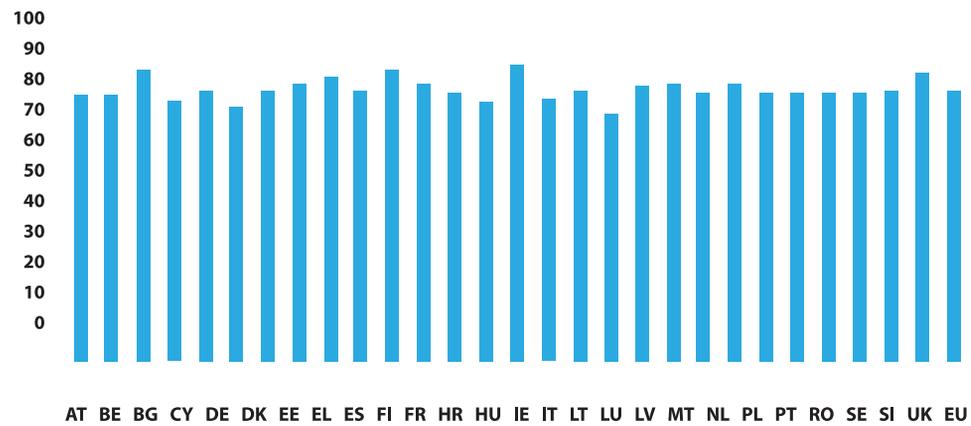
6. Directive 72/464/EEC, 19 December 1972 on taxes other than turnover taxes which affect the consumption of manufactured tobacco

7. Recital 7 of Council Directive 2002/10/EC of 12 February 2002 amending Directive 92/79/EEC and 95/59/EC as regards the structure and rates of excise duty applies on manufactured tobacco

8. Article 15 of Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco, PbEU 176/24

has a major indirect effect on prices. In line with the objectives of avoiding distortion of competition and ensuring a high level of health protection, it was decided that the tax burden on manufactured tobacco should be similar in each Member State. As shown in Figure 1 below, despite varying prices, a degree of convergence of tax burdens on cigarettes has been achieved across the EU.

**Figure 1. Tax burden cigarettes, in % of the Weighted Average Price**

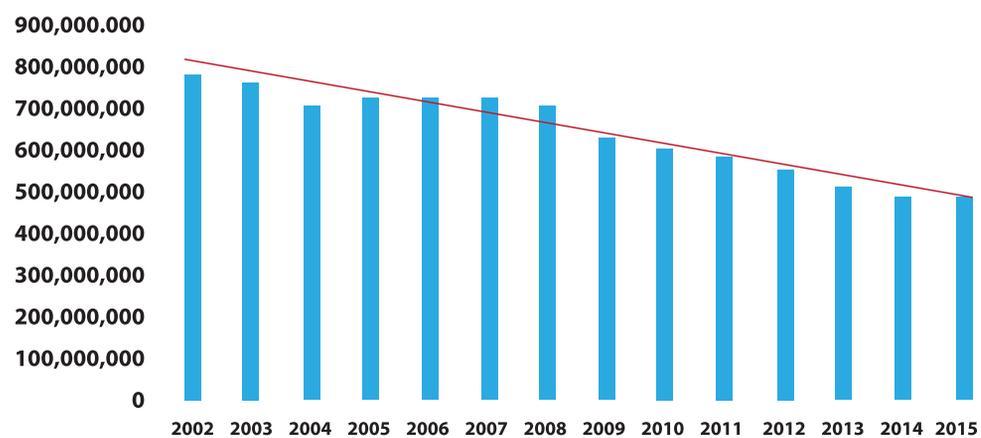


SOURCE: European Commission 2016

## 2.2. Contributing to a high level of health protection

The consumption of cigarettes has been declining over the years. However, smoking and its consequences remain a major burden on the health of citizens and health care systems in the EU. The decline is also reflected in the amount of cigarettes released for consumption between 2002 and 2015, as shown in Figure 2 below. Consumption has declined from almost 800 billion pieces in 2002 to just below 500 billion pieces in 2015.

**Figure 2. Releases for consumption of cigarettes 2002-2015, in 1000 pieces**



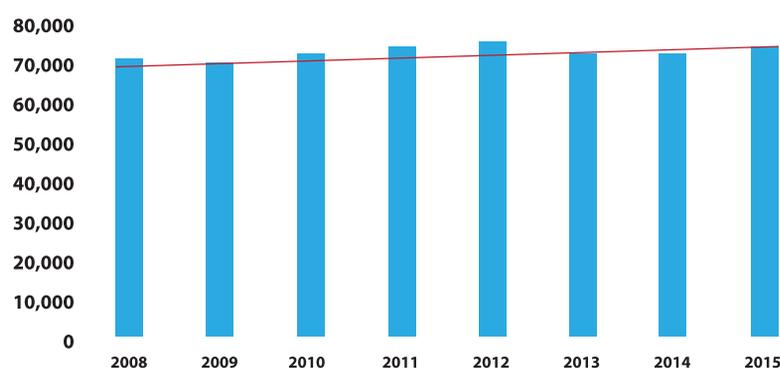
SOURCE: European Commission 2016

It is worth noting that concerns have been expressed about consumers' switching to other tobacco products, such as fine-cut tobacco for the rolling of cigarettes, which have remained cheaper than manufactured cigarettes due to a lower taxation level. This phenomenon is also called "tax-induced" substitution and is monitored at EU level. In 2010 the EU stated its desire to bring the minimum tax requirements for fine-cut tobacco closer to the minimum levels applied to cigarettes, to take better account of the degree of competition between the products, which are seen as equally harmful to health.<sup>9</sup> Gradual increases in the minimum tax requirements for fine-cut tobacco took place in 2013 and 2015, and further increases are foreseen for 2018 and 2020. Despite these efforts, an increase in the consumption of fine-cut tobacco was indeed observed from 2002 to 2012, although the market seems to have stabilized between 2012 and 2015. Moreover, fine-cut tobacco still represents a comparatively small portion of the market (about 20 percent last year). In preparation for a future review of the legislation, the European Commission has included tax-induced substitution on the list of subjects to look into as part of a possible next revision.<sup>10</sup>

### 2.3. Ensuring revenue for Member States

The objective of ensuring revenue from excise duties applied to manufactured tobacco may seem to be contradictory to the objective mentioned above of protecting the health of citizens. This is partly true. However, it does seem possible to reach both objectives. As shown in Figure 3, the total revenue of excise duties on cigarettes was more or less stable between 2008 and 2015.

**Figure 3. Total Revenue from Excise Duties on Cigarettes, Millions of Euros**



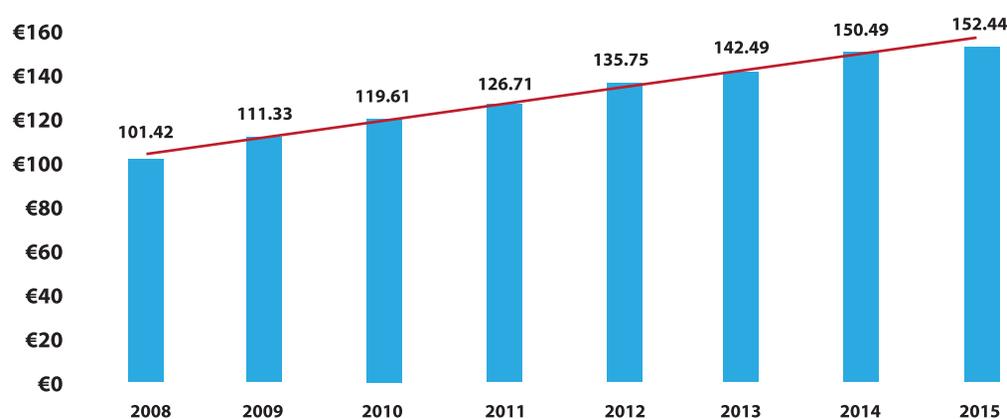
**SOURCE:** European Commission 2016

9. Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco, PbEU 176/24

10. Inception Impact Assessment on the possible revision of Directive 2011/64/EU on the rates and structure of excise duty applied on manufactured tobacco, 16 June 2016

Stable revenues with declining consumption can only be explained in one way: an increase in rates must have taken place, in order to maintain the same level of revenue. This has indeed been the case, as shown in Figure 4 below. The average tax revenue per 1000 cigarettes has been increasing over the years. In other words, the lower consumption and the decrease in revenue this would otherwise generate have been compensated by increased rates.

**Figure 4. Average Revenue from Excise Duties on Cigarettes, Euros per 1000 Cigarettes**



SOURCE: European Commission 2016

### 3. Current excise duties on tobacco products in the EU

#### 3.1. Tobacco market in the EU

According to the latest available figures, during 2015, 493 billion cigarette sticks were released for consumption, equivalent to almost 25 billion packs a year.<sup>11</sup> Moreover, although it represents a much smaller market share, an estimated 88 000 tons of smoking tobacco were also released for consumption during 2015. Smoking tobacco mainly includes fine-cut tobacco used for hand rolling of cigarettes. The revenue generated from excise duties on cigarettes and smoking tobacco was €75 billion and €9 billion, respectively, in 2015. This revenue is collected by Member States and goes entirely to their national budgets.

11. Assuming a pack of cigarette contains 20 pieces.

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## **3.2. Tobacco taxation policy in the EU and decision procedure**

Legal acts in the EU, also called Directives, are adopted by the Council of the EU. The Council is composed of Government ministers from each EU Member State. The decision-making procedure in the Council begins once a proposal from the European Commission is tabled. The Commission has the right of initiative and may table a proposal to amend existing legislation or to adopt new legislation. Most legal acts are adopted if a qualified majority of Member States in the Council agrees. However, Member States consider that some matters are too sensitive, and for legislative acts in these areas the Council must make decisions by unanimity.<sup>12</sup> Harmonization of indirect taxation, such as tobacco taxation, is an example of this. One advantage of this decision-making procedure is that any adopted or amended act will have the full support of all Member States, as no member can be overruled. The disadvantage is that, in practice, it can be very difficult to find a compromise agreement with so many diverging views and differences between the Member States.

## **3.3. How are excise duties harmonized in the EU?**

At the time the first act affecting the taxes on the consumption on tobacco products was adopted, it was considered too ambitious to immediately seek the same tax base, structure, and rate in all countries. The European Economic Community, as the predecessor of the EU was called at that time, decided that harmonization should take place in stages.<sup>13</sup> During the first stage, only the structure and tax base were harmonized. During the second phase, Member States agreed upon the different categories of manufactured tobacco products and the tax structure for each category. The adoption of minimum excise duty levels for each category of tobacco products took place during the third stage, in order to achieve a greater convergence between the tax levels applied in the Member States.

12. Article 113 of Consolidated version of the Treaty on the Functioning of the European Union, 13 December 2007, 2008/C 115/01.

13. Directive 72/464/EEC, 19 December 1972 on taxes other than turnover taxes which affect the consumption of manufactured tobacco.

### 3.3.1. General rules for excise duties

Without legislation governing the collection of tax and the enforcement activities of the competent authorities in the Member States, it would be impossible to put an effective tax system in place. The general rules applicable to all excise goods such as energy products, alcoholic beverages, and manufactured tobacco, are also harmonized in the EU and laid down in a separate legal act.<sup>14</sup> This general excise duty directive contains provisions about the production, storage, and movement of excise goods. Until the excise duty is paid, a system called the Excise Movement and Control System (EMCS) monitors the movement of alcohol, tobacco, and energy products in the EU. In addition, the time and place where excise duties are due and who is liable to pay the excise duty are included in this directive.

### 3.3.2 Tax structure

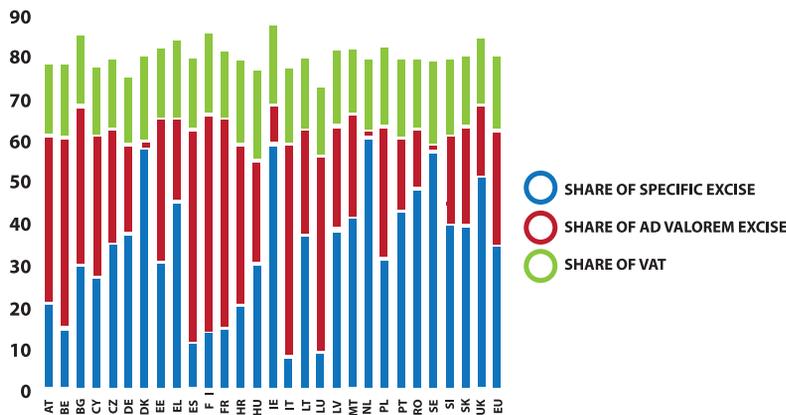
As mentioned above, Member States agreed in the early 1970s that the tax structure should be harmonized to eliminate factors that are likely to hinder free movement and distort competition. Already in the first legal act affecting the taxes on consumption of tobacco products, it was required that the excise duty for cigarettes should consist of two components, also known as the “mixed structure.” This mixed structure was at the time a compromise between southern Member States (themselves producers of raw tobacco), which favored an ad valorem system, and northern Member States (not producers of raw tobacco), which preferred a specific excise duty. The current legal act, Council Directive 2011/64/EU (hereafter: tobacco excise duty directive), requires that the excise duty on cigarettes must consist of:

- A specific component of between 7.5 percent and 76.5 percent of the total tax burden (TTB) - expressed as a fixed amount per 1000 cigarettes;
- An ad valorem component - expressed as a percentage of the maximum retail selling price.

14. Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC.

As shown in Figure 5, the percentage of each component varies from country to country. However, in each Member State, a specific component, ad valorem component, and value added tax are applied to cigarettes.

**Figure 5. Structures of Excise Duties on Cigarettes, by Percentage of Retail Selling Price**



### 3.3.3. Minimum rates

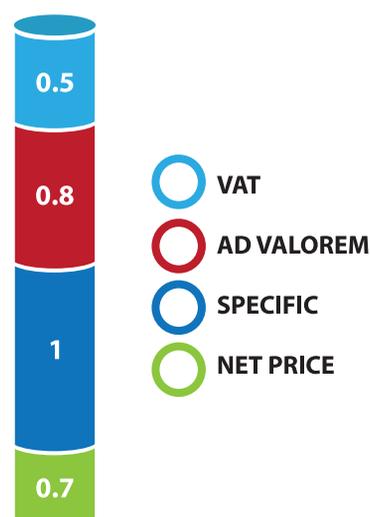
To achieve a greater approximation of rates, the EU Member States decided to introduce minimum rates in 1992, in order assist in establishing the internal market. The tobacco excise duty directive requires Member States to levy a minimum overall excise duty on cigarettes.

Product Category	Minimum Rate
Cigarettes	At least €90 per 1000 cigarettes and At least 60% of the weighted average retail selling price

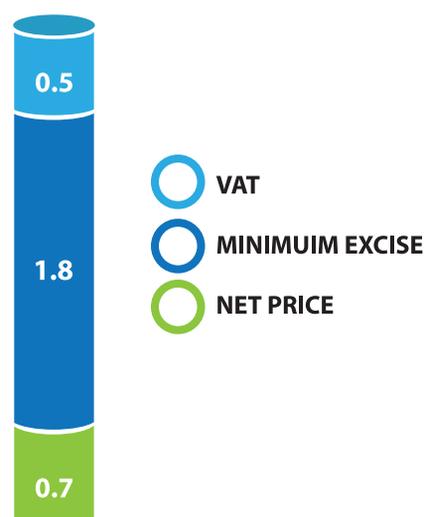
Member States that apply an excise duty of €115 or more, however, do not need to comply with the 60 percent criterion above.

Figure 6 shows how a Member State could comply with these minimum requirements.

**Figure 6. Example of a Tax Structure for a Package of Cigarettes Costing 3 Euros**



**Figure 7. Example of the Tax Floor on a Package of Cigarettes Costing 3 Euros**



The fact that the minimum tax consists of an ad valorem component, which is related to the price, could be an incentive to market products at a low(er) price since it would lead to a lower ad valorem tax. This could in turn undermine tobacco control policies and cause erosion of the tax base. This weakness could be compensated by a higher specific component of the tax. However, the tobacco excise duty directive foresees yet another mechanism to overcome this problem. The Member States also have the possibility to set a tax floor which applies regardless of the price of a product. Figure 7 shows the effect of such a tax floor.

Unlike in the example in Figure 6, there is no possibility to reduce the ad valorem component of the tax. If a product had a lower price, the tax burden would increase, because the tax floor is expressed in a fixed amount per unit, while with the mixed system a lower amount of ad valorem tax would be due.

The tobacco excise duty directive also lays down minimum excise duty rates for manufactured tobacco products other than cigarettes. The structure for taxing these products is slightly different (and simpler) than that used for cigarettes. Member States can choose between applying a specific component or an ad valorem component, or if they wish, they may apply a mixture of the two. Minimum rates are set out for three separate categories.

<b>Product Category</b>	<b>Minimum Rate</b>
<b>Fine-cut smoking tobacco</b>	46% of the weighted average retail selling price Or €54 per kilogram
<b>Cigars and Cigarillos</b>	5% of the retail selling price Or €12 per 1000 or per kilogram
<b>Other smoking tobaccos</b>	20% of the retail selling price Or €22 per kilogram

**Note:** The minimum rates for fine-cut smoking tobacco will gradually be increased up to 50% and 60 Euro per kilogram in 2020.<sup>15</sup>

#### 4. Lessons learned

One of the lessons learned relates to the decision-making procedure in the EU and reaching agreement on the level of the minimum rates. Experience in the EU in the area of excise duties has shown that agreeing on relatively high minimum rates with transitional periods for some Member States gives better results than agreeing on lower minimum rates with the aim of constantly revising them over short periods of time. Although in the first situation not all members reach the minimum at the beginning of the process, having a deadline in a legal act obliging them to do so has proven to be a strong incentive to start with increases even before the transitional period ends. In contrast, in the second situation, negotiations to increase minima could well prove difficult, with the result that the “old” legislation and rates would remain in place. For example, in both the areas of energy taxation and alcohol taxation, no agreement on new minima has been reached despite several attempts to amend the legislation.<sup>16</sup> Obviously, Member States in such a situation are still free to decide individually to increase rates above the minimum. However, greater divergence between the highest and lowest rates is more likely to occur, and an agreement on new minima would be preferable.

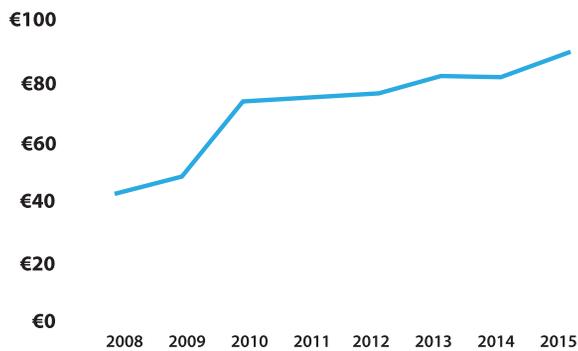
15. According to Article 14 of Directive 2011/64/EU.

16. COM (2006) 486, Proposal for a Council Directive amending Directive 92/84/EEC on the approximation of the rates of excise duty on alcohol and alcoholic beverages.

COM (2011) 169, Proposal for a Council Directive amending Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity.

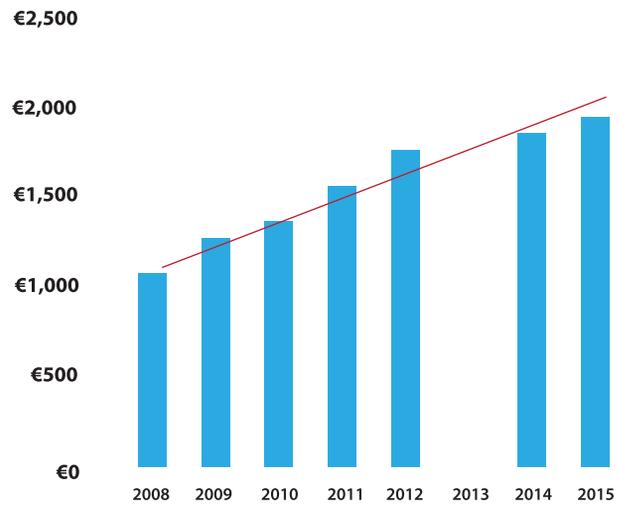
In the tobacco excise duty directive, an increase in the minimum rates for cigarettes from €64 to €90 per 1000 pieces was foreseen on 1 January 2014. Of the 28 Member States, nine were granted a transitional period until 31 December 2017.<sup>17</sup> However, even though this period has not ended, four out of nine Member States have already reached the minima. The remaining five are very close and seem to be up to speed to comply before the end of this year. A long-term tobacco tax policy, including gradual increases, seems to be the success factor to align rates to the EU minima in new Member States. Figures 8 - 11 show the developments of rates and revenues in Romania and Croatia, two of the nine Member States with a transitional period.

**Figure 8. Romania, Excise Duty per 1000 Cigarettes, Euros**



SOURCE: European Commission 2016

**Figure 9. Revenue from Excise Duties on Cigarettes, Million Euros**

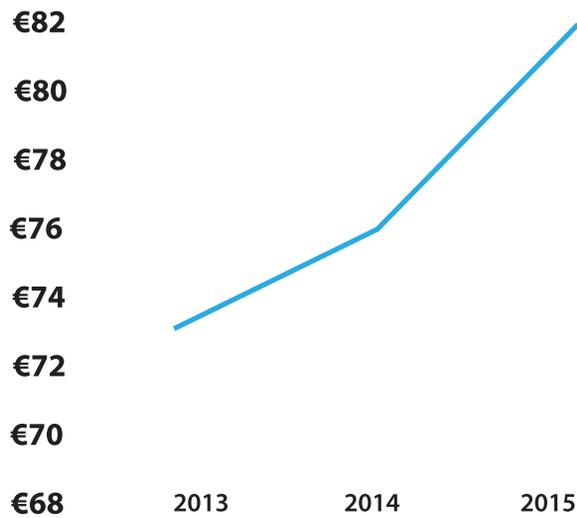


SOURCE: European Commission 2016

Romania successfully doubled its rates and revenues and has reached the minimum rates already.

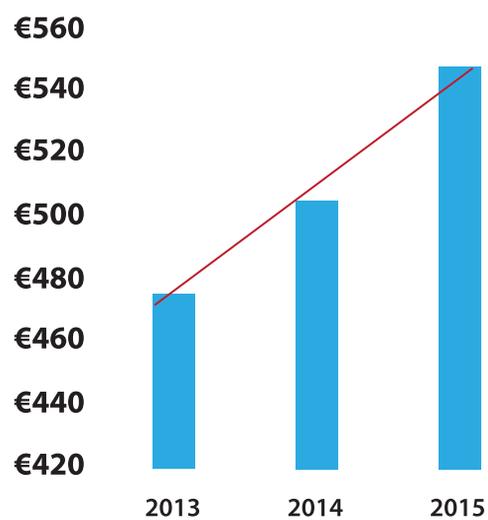
17. Bulgaria, Estonia, Greece, Latvia, Lithuania, Hungary, Poland, Romania, and Croatia.

**Figure 10. Croatia, Excise Duty per 1000 Cigarettes, Euro**



SOURCE: European Commission 2016

**Figure 11. Revenue from Excise Duties on Cigarettes, Million Euros**



SOURCE: European Commission 2016

Although Croatia's experience began much more recently, the situation appears similar; both rates and revenues have increased.

These experiences are in line with the overall developments in the EU, namely: increase or stable revenues from excise duties on cigarettes, and declines in consumption which are achieved by increasing rates resulting in a higher average excise duty collected per 1000 cigarettes.

## 5. Conclusion

The experience of the EU shows that both the establishment of economic and political cooperation and the harmonization of tobacco taxation are lengthy processes that require improvements and updates over time. Both processes took place in stages in the EU. Finding agreements among members of a cooperative group is sometimes challenging, and it has proven worthwhile to think ahead and aim to agree upon legislation that is as “future-proof” as possible. Currently, the definitions, the tax base, and the structure of tobacco taxes on consumption are harmonized within the EU. Member States have to respect minimum overall excise duty rates for all product categories of manufactured tobacco. The experience of the EU also confirms that different – and perhaps at first glance contradictory – objectives can be reached with harmonization of tobacco taxation. During the first stage of harmonization of tobacco taxation in the EU, the objective was to create a framework which ensured the proper functioning of the internal market. Distortion of competition and hindering the free movement of goods had therefore to be avoided. To achieve this, it was decided that the tax burden on manufactured tobacco should be similar in each Member State, which also supports the objective of ensuring a high level of health protection. Another objective of the harmonized tobacco tax was to ensure the collection of revenues for the Member States. Experiences in the EU have proven that it is possible to achieve these different objectives: a properly functioning internal market, a declining tobacco consumption trend, and stable revenues. The lower consumption has been compensated by increased rates. Achieving these objectives is also within reach of new Member States, where establishing a long-term tax policy with gradual increases to reach the EU requirements has been a success factor in aligning their rates to the EU minima.





