

Study on Financial Structure in

Presentation to the European Commission
Brussels, 9th July 2015

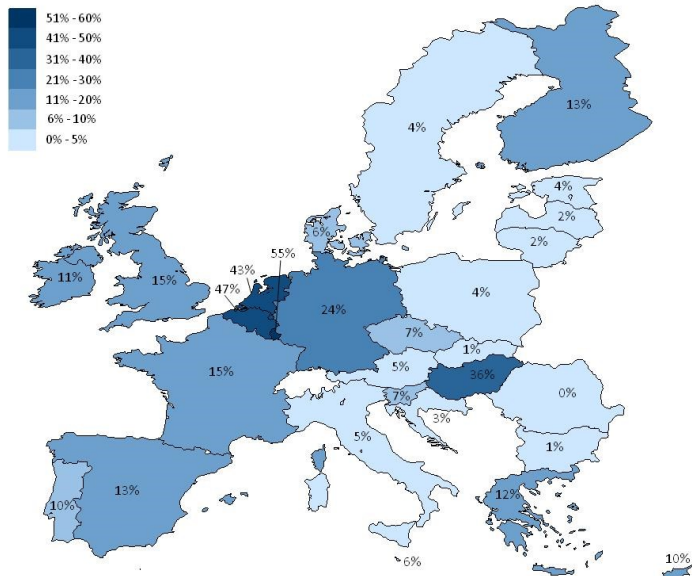


Objectives of study

- The fundamental objective of the study, commissioned by the European Smoking Tobacco Association, ESTA, is to consider some of the **economics** behind the taxation of Fine Cut Tobacco
 - The **buffer function** of Fine Cut Tobacco
 - The **cross price elasticity of demand** with respect to the price of substitutes
 - **Maintaining the tax-base** through predictable duty increases (**own price elasticity**)
- Specifically, using the most **robust data sources available**, we try and demonstrate a number of outcomes associated with tobacco taxation policy
 - The relationship between excise duties, illicit trade and the ‘tax gap’
 - The concept of a **market**: the influence of tobacco taxation policy neighbouring countries and the need for flexibility
 - The impact of long term and consistent FCT tobacco taxation policy
- We achieve this , as well as demonstrating a number of unintended consequences, using extracts from case studies for the **United Kingdom**, the **Netherlands** and **Germany**.

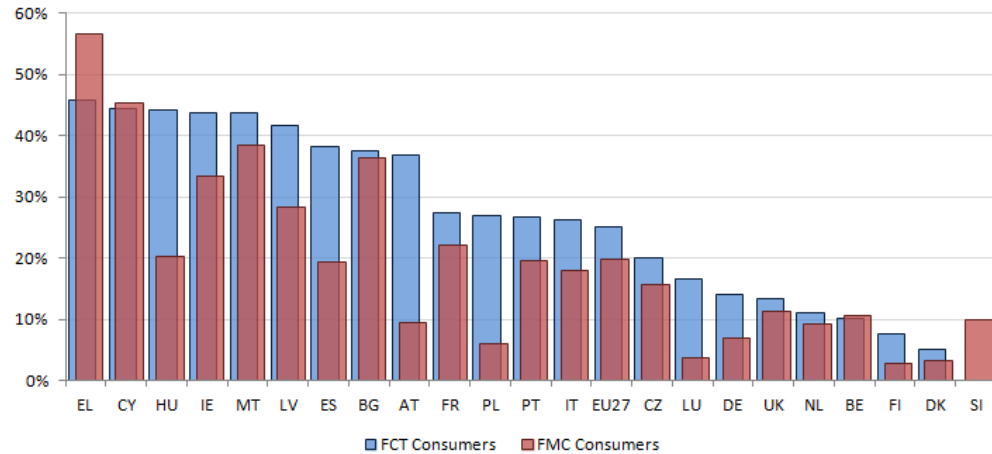
Wide variation in FCT markets and consumers

FCT annual consumption as a proportion of total FCT and FMC consumption



LE analysis of EC DG Taxud data (2002-2013) relating to FMC and FCT volumes released for consumption ([here](#)). Note that we assume 1kg FCT = 1,000 FMC sticks

Proportion of everyday FCT and FMC smokers indicating financial constraints limiting ability to pay their bills

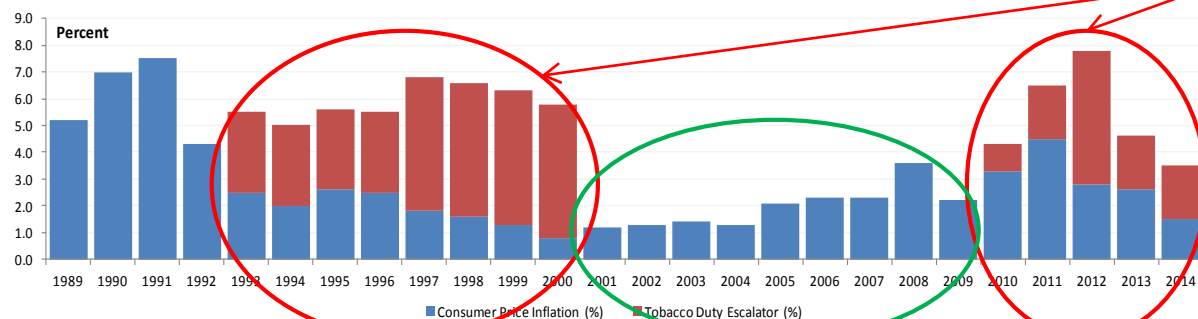


LE analysis of Eurobarometer 385 (2012) data ([here](#)). Proportion of everyday smokers indicating that they have difficulties paying their bills most of the time. Note: Sample sizes for FCT users in Estonia, Lithuania, Romania, Sweden and Slovakia were small (below 10) and are not shown above. In some cases, individuals may be FCT and FMC smokers and hence, observations are not unique.

- There is a **significant variation** in the maturity of the FCT market across the European Union. In some Member States, FCT accounts for more than **40%** of total consumption (the **Netherlands, Belgium and Luxembourg**), while in other countries, FCT consumption is more moderate
- Furthermore, FCT consumers have different demographic (age, gender, etc) and socioeconomic characteristics **across country** and **within country** (i.e. compared to FMC consumers) – for instance in relation to financial position

The relationship between excise duties, illicit trade and the 'tax gap' in the United Kingdom

- Through the 'so called' tobacco duty escalator, the United Kingdom imposes the highest duties on FCT in the European Union



Periods where tobacco escalator operated

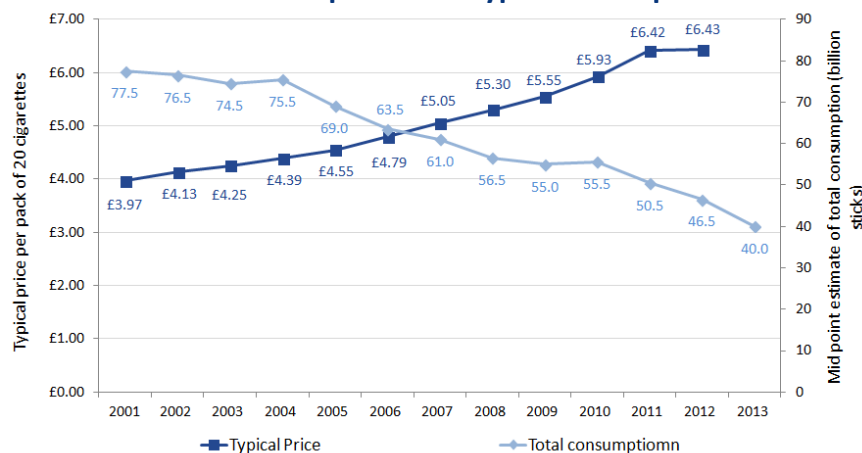
Period where tobacco escalator was suspended

LE analysis of ONS/ House of Commons data

What happened as a result?

- After the real terms price increases, FMC consumption declined year on year (as might be expected)
- However, some of this decline was as a result individuals substituting to cheaper products, including FCT, non-UK tax paid cigarettes (i.e. cross border) as well as the purchase of illicit contraband and counterfeit cigarettes and FCT.

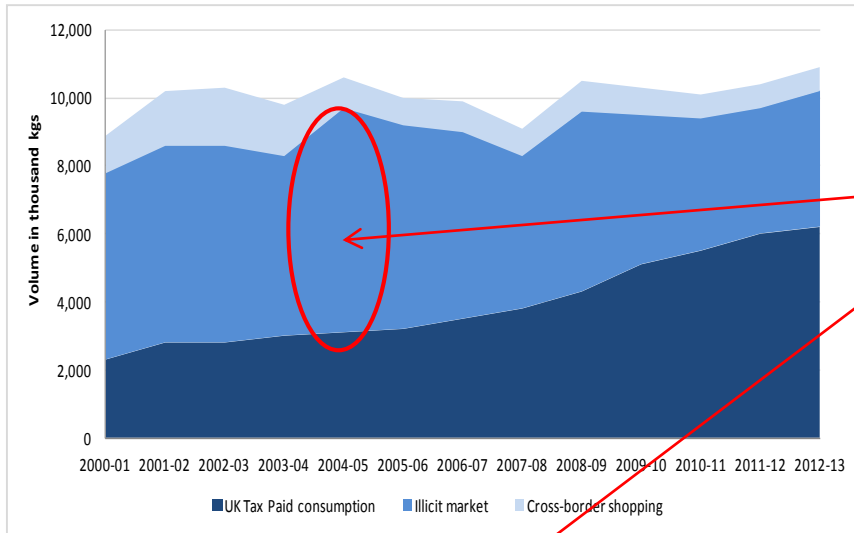
FMC annual consumption and 'typical' retail price



London Economics' analysis of HMRC data

What else happened in the UK?

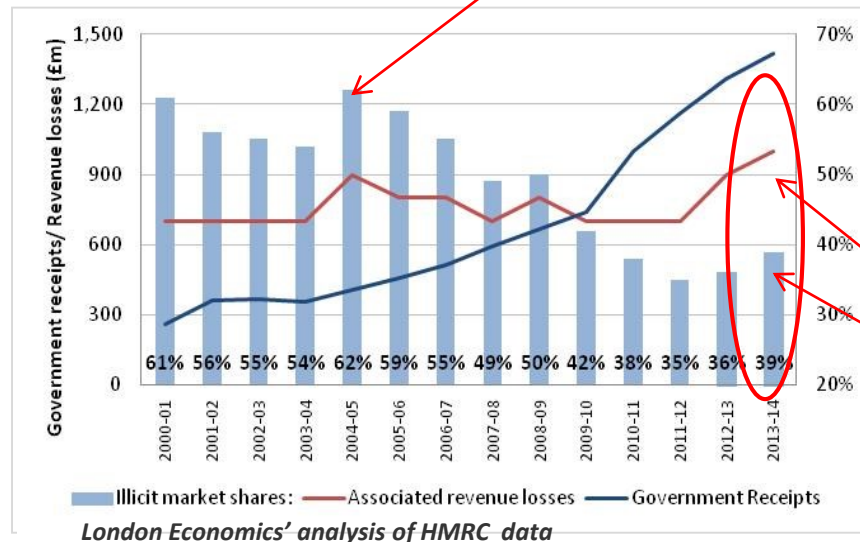
Total FCT consumption in the UK over time



- There was some substitution into UK duty paid FCT; however, the increase in duties resulted in a significant increase in the market share of **illicit FCT** – reaching **62%** of total market share in 2004-05 (with a further **12%** accounted for by cross border trade)

- The suspension of the tobacco duty escalator, as well as enhanced enforcement techniques, did result in a **reduction** in the *share* of total FCT consumption accounted for by illicit trade (to approximately **35%** (3,700 tonnes) in 2011-12). The tax gap associated with this level of illicit trade remained stubbornly high at **£700m** (because of the increased tonnage in total).

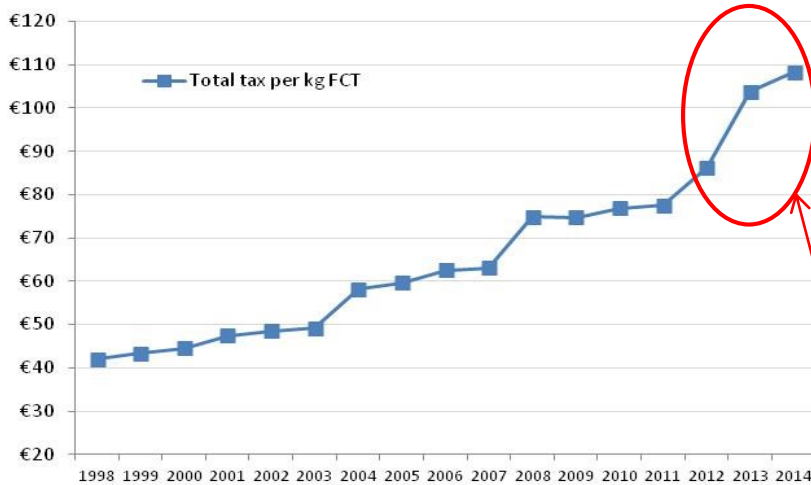
Incidence of illicit trade in FCT and associated revenue losses



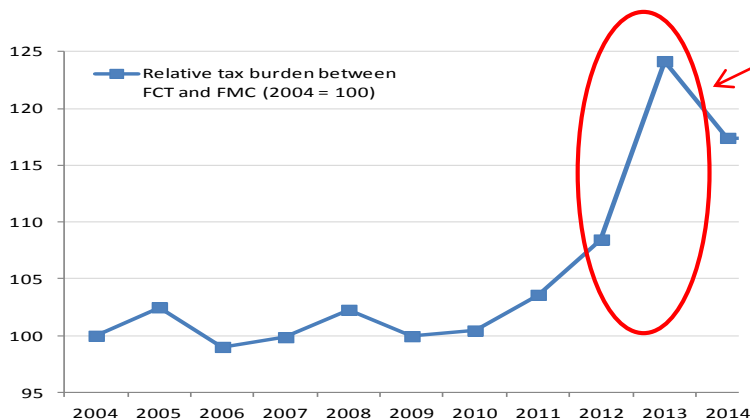
- The long term decline in illicit as a proportion of total consumption has **reversed** since the re-introduction of the duty escalator, and now stands at **39%**. This corresponds to a tax gap of **£1.0billion** in 2013-14.

How the effects of one country's decision depends on the tax regime in surrounding countries: An example from the Netherlands

Evolution of the tax burden of FCT - 1998 - 2014



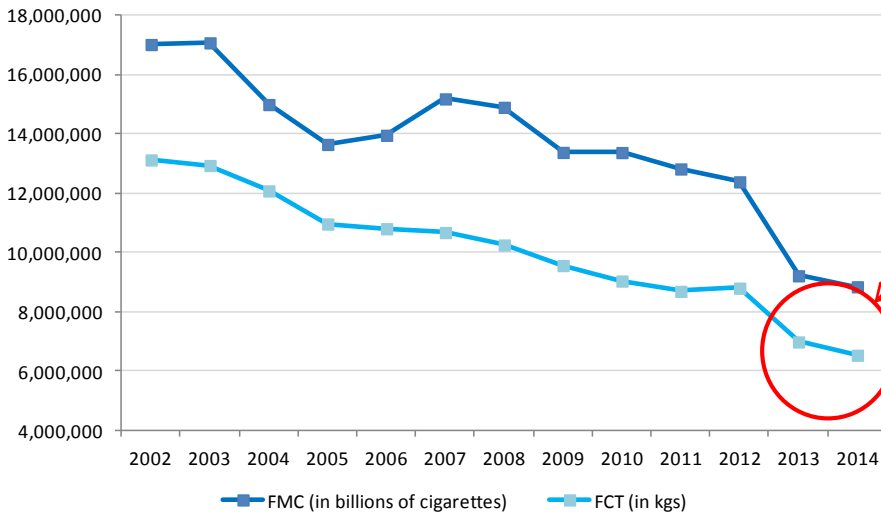
Relative tax burden in the Netherlands (FCT versus FMC) 1998 – 2014



- Recent developments in the Netherlands clearly demonstrate that, when setting duty rate on tobacco products, national authorities need to take account of the prevailing duty rates in neighbouring countries.
- With recent large increases in excise duties on tobacco products (from 2013), the tax burden on FCT has increased to a significantly greater extent than FMC
- The relative tax burden on FCT in the Netherlands has increased sharply compared to neighbouring countries
- Did consumers **change behaviour**, and what was the result on **government revenues**?

How did consumers react, and what was the impact on government revenues?

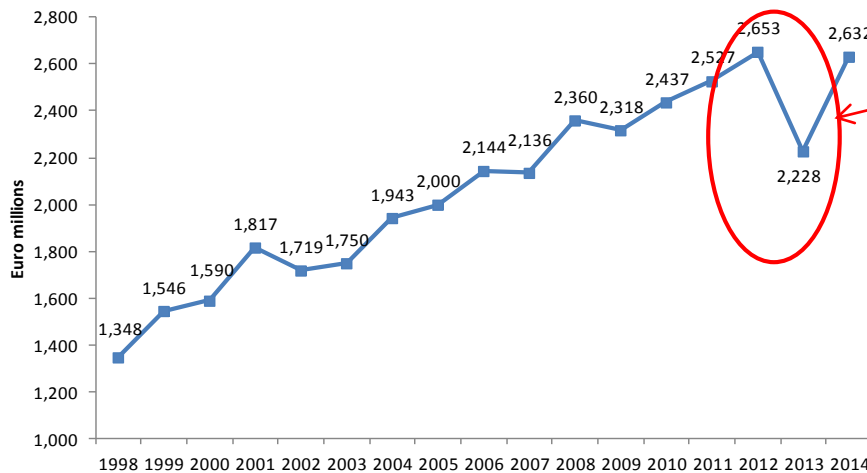
FCT and FMC releases for consumption in the Netherlands



- Given the increase in the Duty paid FCT consumption declined by **21%** in 2013 and a further **6.5%** in 2014 (compared to 33% over the 2002-2012 period) with many consumers switching to cross border purchases (and illicit FCT), as well as some FMC consumers switching to FCT

LE analysis of EC DG TAXUD data

Government tax revenues from tobacco products 1998 - 2014 (€m)

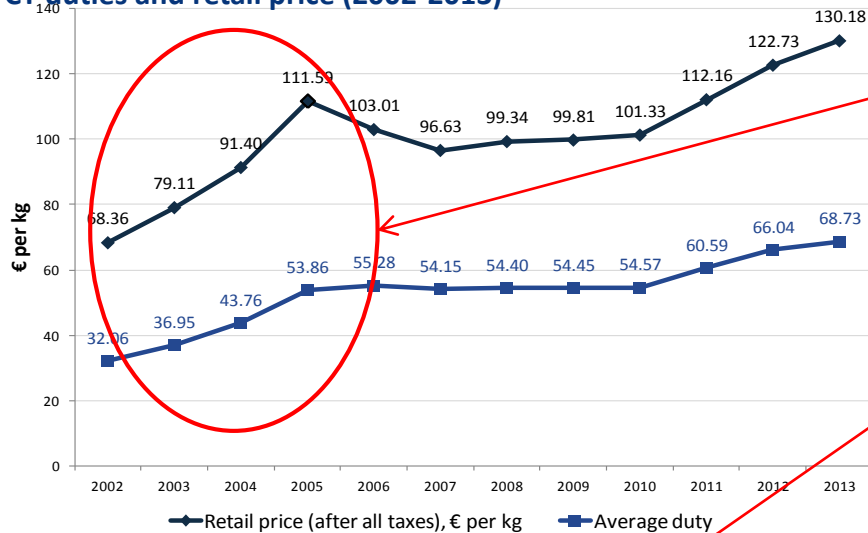


- Following the substantial increase in the tobacco tax burden and the opening of a large differential in tax burden between the Netherlands and Belgium, government tobacco tax revenues fell by 16% in 2013 (corresponding to approximately **€440 million**).

LE analysis of Centraal Bureau voor de Statistiek (CBS) data Note that the information from CBS is 'actual' between 1998 and 2012. Information from 2013 and 2014 is provision and subject to revision (6, 12 and 30 months) after the calendar year in question. Note also that there are some differences in the CBS and EC DG TAXUD ([here](#)) estimates in 2013 and 2014.

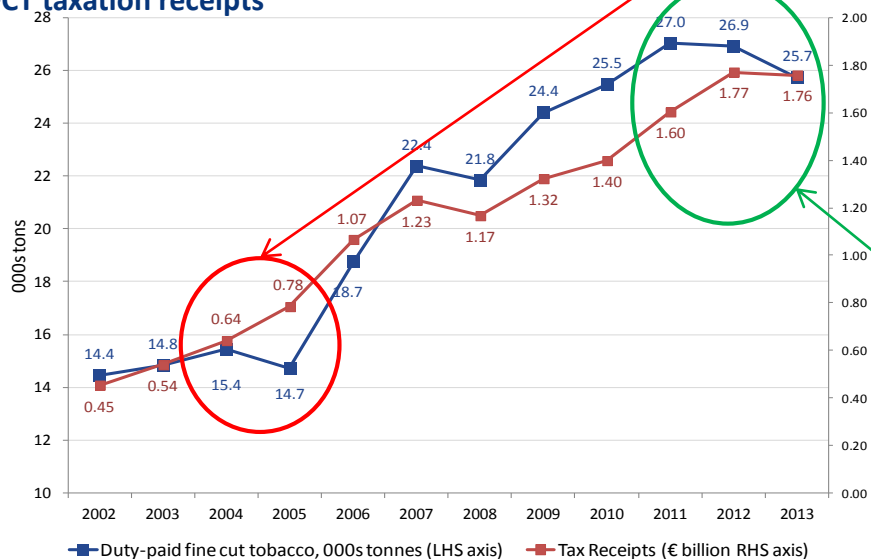
Are there alternative approaches? An example from Germany

FCT duties and retail price (2002-2013)





- Germany also introduced significant increases in duties on FCT between 2002 and 2005, which resulted in a sharp increase in retail price
- As a result of this sharp increase in duties
 - There was a significant (18-fold) shift in consumer behaviour towards pre-portioned tobacco which acted as a buffer function between FMC and 'classical' FCT
 - There was a big jump in cross border and illicit trade
 - The level of 'classical' FCT duty-paid consumption decreased
 - Across FMC and FCT, government tobacco duty revenues declined between 2002 and 2004

FCT duty-paid consumption (excluding pre-portioned tobacco) and FCT taxation receipts



- Following a period of relative duty stability between 2006 and 2010, the German government implemented the **Tobacco Duty Model** in 2011 – aimed at introducing **moderate duty increases over a five year period**.
- The result of the 2% increase in duty levels has been to **stabilise the level of illicit and cross border trade** (although still at levels higher than in 2005); **reduce consumption levels** by approximately 3% per annum; however, simultaneously **increase government tobacco taxation revenues**

Conclusions

- There are significant differences **between** countries in relation to the incidence of FCT consumption. Furthermore, **within** countries, the characteristics of FCT consumers are different from FMC consumers.
- Within each country, there is a **balance** or **equilibrium** between the level of tobacco excise duty, duty-paid consumption, the level of illicit trade and government taxation receipts. Sudden changes to factors such as the level of tobacco excise duty may result in an **imbalance** or **disequilibrium** in other outcomes (such as the level of illicit trade).
- Where countries have initiated sharp increases in FCT excise duties, without due consideration of the wider marketplace, there have been both **direct effects** with **unintended consequences** (increased illicit trade and cross border purchases). This has resulted in an erosion of the tax base and a deterioration in the public finances 
- Where countries have adopted a **transparent, long term** and **systematic** approach to FCT tobacco taxation, this has resulted in a stable market-place, which has generated an ongoing source of taxation revenue for the public purse. 

Mr Patrice Muller

Senior Partner

London Economics

T: +44 20 3701 7702

pmuller@londoneconomics.co.uk

Dr Gavan Conlon

Partner

London Economics

T: +44 20 3701 7703

gconlon@londoneconomics.co.uk