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EUROPEAN PARLIAMENT

# Working Documents

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3 November 1982

DOCUMENT 1-789/82

THIRD REPORT

drawn up on behalf of the  
Committee on Economic and Monetary Affairs

on the proposal from the Commission of the European  
Communities to the Council for a directive amending  
Directive 72/464/EEC on taxes other than turnover  
taxes which affect the consumption of manufactured  
tobacco (Doc. 1-328/80)

Rapporteur: Mr B. BEUMER

PE 78.796



By letter of 25 July 1980 the President of the Council of the European Communities requested the European Parliament to deliver an opinion on the proposal from the Commission of the European Communities to the Council for a directive amending Directive 72/464/EEC on taxes other than turnover taxes which affect the consumption of manufactured tobacco.

On 25 August 1980 this proposal was referred to the Committee on Economic and Monetary Affairs as the committee responsible and to the Committee on Budgets and the Committee on Agriculture for their opinions.

On 23 September 1980 the Committee on Economic and Monetary Affairs appointed Mr Beumer rapporteur.

It considered this Commission proposal at its meetings of 28 October 1980, 25 November 1980, 20 January and 30 January 1981 and at this last meeting adopted the motion for a resolution (Doc. 1-871/80)

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In the vote in plenary sitting the Commission's proposal for a directive failed to secure the majority of the votes cast. Pursuant to Rule 35(3) of the Rules of Procedure Parliament decided not to vote on the motion for a resolution and to refer the matter back to the Committee on Economic and Monetary Affairs.

The Committee on Economic and Monetary Affairs considered this item at its meetings of 13 and 14 May 1981, 21 and 22 May 1981 and 9 and 10 June 1981.

At the meeting of 21 and 22 May 1981, the Commission announced what amendments it would make to its proposal for a directive if Parliament adopted it.

At the meeting of 9 and 10 June 1981 the Committee on Economic and Monetary Affairs rejected this compromise proposal from the Commission and decided to maintain its rejection of the proposal for a directive and to keep the motion for a resolution unchanged (Doc. 1-871/80/II).

During the plenary sitting of 18 June 1981, the Commission stated that it was willing to make a study of the implications of continuing the harmonization of taxes other than turnover taxes which affect the consumption of manufactured tobacco. Pending the results of this inquiry the Commission proposal was referred back to the Committee on Economic and Monetary Affairs, pursuant to Rule 85 of the Rules of Procedure.

By letter of 4 March 1982 the Commission forwarded to Parliament a report on the implications of further harmonization of the excises on manufactured tobacco.

At its meetings of 28 May 1982 and 20 October 1982 the Committee on Economic and Monetary Affairs considered the Commission proposal further in the light of this report and at the latter meeting adopted the motion for a resolution and the explanatory statement by 10 votes in favour and 8 abstentions.

The following were present when the vote was taken:

Mr J. Moreau, chairman; Mr Beumer, rapporteur; Mr Beazley, Mr von Bismarck, Mr Bonaccini, Mr Caborn, Mr Desouches, Miss Forster, Mr Giavazzi, Mr Griffiths (deputizing for Mr Walter), Mr Herman, Mr Hopper, Mr Papantoniou, Mr Prag (deputizing for Mr de Ferranti), Mr Rogalla (deputizing for Mr Mihr), Mr Ruffolo, Mr Seal (deputizing for Mr Rogers), Mr van Rompuy, Mr Wedekind (deputizing for Mr Schnitker), Mr Welsh and Mr von Wogau.

The opinions of the Committee on Budgets and the Committee on Agriculture are attached to this report.

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The Committee on Economic and Monetary Affairs hereby submits to the European Parliament the following motion for a resolution together with explanatory statement:

MOTION FOR A RESOLUTION

closing the procedure for consultation of the European Parliament on the proposal from the Commission of the European Communities to the Council for a directive amending Directive 72/464/EEC on taxes other than turnover taxes which affect the consumption of manufactured tobacco.

The European Parliament

- having regard to the proposal from the Commission to the Council<sup>1</sup>,
  - having been consulted by the Council pursuant to Articles 99 and 100 of the EEC Treaty (Doc. 1-328/80)
  - having regard to the report from the Commission to the European Parliament on the implications of further harmonization of the excises on manufactured tobacco (COM(82) 61 final),
  - having regard to the third report of the Committee on Economic and Monetary Affairs and the opinions of the Committee on Budgets and the Committee on Agriculture (Doc 1-789/82),
  - having regard to the result of the vote on the proposal from the Commission,
1. Underlines the objective of harmonization of taxes on manufactured tobacco, namely that the taxes on the consumption of these products shall be levied in such a way that conditions of competition are not distorted and free movement of these products within the Community is not impeded.
  2. Stresses at the same time the basic principle of price formation in respect of manufactured tobacco laid down in the Council Directive of 1972<sup>2</sup>; calls on the Commission to ensure compliance with this principle of freely formed prices in the various Member States and to study closely the current national situation in this regard and to report on it to Parliament as soon as possible;
  3. Draws attention to the lengthy delays which have occurred in abolishing discriminatory practices by national manufactured tobacco monopolies within the meaning of Article 37(1) of the EEC Treaty; expresses its doubts as to the firmness of the Commission's action and calls on it to take immediate steps to ensure that any remaining instances of discrimination by these monopolies are abolished as soon as possible.

<sup>1</sup>OJ No C 264, 11.10.1980, p 6

<sup>2</sup>OJ No L 303 of 31.12.1972

4. Stresses that under no circumstances should competition in countries with a national monopoly be distorted by subsidization of the production of national monopolies, a practice which runs counter to Article 37(1) of the EEC Treaty, and wonders whether, in view of the heavy losses made and very low prices in these countries, this principle is in fact being observed; wishes to be informed as soon as possible of the results of the Commission's investigation into the price determination policy of these national manufacturing monopolies; acknowledges that as a result of this investigation the matter of price fixing policy in France has already been brought before the Court of Justice and trusts that serious consideration will be given to the question of whether similar action is necessary in the case of Italy.
5. Takes the view that in order to gain a true picture of the financial situation of the state monopoly, Directive 80/723/EEC on transparency in financial relations between Member States and public undertakings is necessary; emphasizes once again in this regard the urgent need to implement this directive as rapidly as possible;
6. Notes that the interpenetration of national markets overall is in many cases still relatively weak and that there are significant differences in the tax-exclusive prices of cigarettes in different markets, but does not believe that the volume of intra-Community trade alone is a good indicator of the effects of the first two stages of harmonization, if only because manufacturers wishing to establish trade in another Member State are free to set up local manufacturing facilities and have often done so (except where manufacturing is reserved to a state monopoly);
7. Disagrees with the proposals for a third stage of harmonization and considers that there is now no alternative to a prolongation of the second stage pending the submission of final proposals that take into account all aspects of this harmonization issue, including the rules governing collection of excise duty;
8. Believes, however, that the Commission's report to the European Parliament does not adequately provide a basis on which it is possible to judge what the relationship between the specific and the proportional elements of total taxation should be at the final stage; stresses that this relationship is ultimately determined by the multiplier and the tax burden and points out that especially in the current climate of increasing rates of tax a specific component higher than the 20% proposed by the Commission would be desirable for the final stage; stresses that the decisive criterion in establishing the final stage must be that the tax system should as far as possible permit undistorted competition, irrespective of whether this requires comparable efforts from the various Member States;

9. Believes that the Commission's proposal does not take proper account of this latter consideration; and emphasises the difficulty of achieving progress on tobacco harmonization whilst not all Member States have complied fully with the provisions of the first and second stages, particularly in view of Article 1.4 of Council Directive 72/464/EEC;
10. Considers that the proposal for reducing the minimum excise duty is premature.
11. Considers also that the alternative approach to harmonization, namely to harmonize the ad valorem elements of tax as a proportion of the retail selling price, is likely to be more effective than the present approach in providing uniform competitive conditions and calls on the Commission to reconsider this approach when preparing any subsequent proposal;
12. Notes that, according to the Commission, use has not yet been made of the possibility of excluding customs duties from the basis of assessment of ad valorem excise duty on cigarettes so that removal of this option can have no major repercussions: agrees therefore with the proposal that inclusion of customs duties in the basis of assessment of excise duties on cigarettes should be obligatory;
13. Points out that the calculation of the financial implications for the Community budget is incomplete and based on static assumptions;
14. Invites the Commission, after consulting the parties concerned, to put forward a proposal on harmonization of the method of collection at the same time as the proposal on the final phase of the harmonization of taxation.

EXPLANATORY STATEMENTI. Introduction

1. The Committee on Economic and Monetary Affairs has had a number of detailed discussions on the proposal from the Commission of the European Communities to the Council concerning the third stage of harmonization of excise duties on manufactured tobacco (Doc. 1-328/80). During these discussions quite a number of members asked for further information on possible alternative approaches and arguments demonstrating that the approach proposed by the Commission was the most suitable. Since the Commission was unable to present convincing arguments, the Committee on Economic and Monetary Affairs finally adopted a motion for a resolution rejecting the proposal for a third stage of harmonization and which, in paragraph 6, called on the Commission to carry out a study. This paragraph was worded as follows:  
  
'6. Requests the Commission therefore to investigate as soon as possible whether as regards the final stage it would not be more neutral from the point of view of competition to determine the effects of proportional taxation on retail prices than to fix the relationship between the specific and proportional components on duty;'
2. During its sitting of 13 February 1981, Parliament rejected the proposal for a directive and pursuant to Rule 35 of the Rules of Procedure, referred the motion for a resolution back to the Committee on Economic and Monetary Affairs, as the Commission had not withdrawn its proposal.
3. At its meetings of 21 and 22 May and 9 and 10 June 1981, the Committee on Economic and Monetary Affairs had talks with Mr TUGENDHAT, Member of the Commission. At that stage the Commission was prepared to amend its proposal, provided Parliament approved the proposal for a directive subject to the following amendments:  
  
- to restrict harmonization provisionally to the second phase of the third stage originally proposed, namely that as from 1 January 1982 the amount of the specific excise duty levied was to be not less than 7.5% and not more than 42.5% of the total tax burden;  
  
- in the meantime the Commission would carry out the investigation requested by Parliament.

4. The Committee on Economic and Monetary Affairs rejected the compromise proposal and upheld its motion for a resolution.

During Parliament's June 1981 part-session, Mr TUGENDAHT stated that the Commission was nevertheless prepared to meet Parliament's request and carry out the study it had asked for. Parliament would thus be able to deliver an opinion on the proposal on the basis of the study's findings. The Commission's proposal was not to be withdrawn but consideration of it in the Council was to be suspended pending the outcome of the study. The report was therefore referred back to the Committee on Economic and Monetary Affairs pursuant to Rule 85 of the Rules of Procedure.

5. The next section contains additional comments prompted by the Commission's study (COM(82) 61 final) which has now been made available. There is no need here to analyse the whole Commission proposal again, since this has already been done in the explanatory statement to the first report (Doc. 1-871/80/II) to which the reader is referred.

## II. Basic principles for the harmonization of excise duties on cigarettes laid down in the first Council directive of 19 December 1972<sup>1</sup>

6. The recitals to the directive clearly define the conditions which the system of taxation on the consumption of manufactured tobacco must satisfy in order to be in conformity with the Treaty. The first recital of the directive reads as follows:

'Whereas the objective of the Treaty is to establish an economic union within which there is healthy competition and whose characteristics are similar to those of a domestic market; and, as regards manufactured tobacco, achievement of this aim presupposes that the application in the Member States of taxes affecting the consumption of products in this sector does not distort conditions of competition and does not impede their free movement within the Community;'

Another recital reads as follows:

'Whereas, as far as excise duties are concerned, harmonization of structures must, among other things, result in competition in the different categories of manufactured tobacco belonging to the same group not being distorted by the effects of the charging of the tax and, consequently, in the opening of the national markets of the Member States;'

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<sup>1</sup>OJ No L 303 of 3.12.1972

This shows clearly that the primary aim of harmonizing the taxation of manufactured tobacco is to establish a system which is neutral from the point of view of competition and which enables the free movement of these goods without any distortion of competition.

Article 4(3) of the directive lays down the arrangements for the final stage of harmonization so as to comply with this requirement of neutrality from the point of view of competition:

'At the final stage of harmonization of structures, the same ratio shall be established for cigarettes in all Member States between the proportional excise duty and the specific excise duty, in such a way that the range of retail selling prices reflects fairly the difference in the manufacturers' delivery prices'.

7. The recitals also contain another important basic principle, namely the freedom to fix prices,

'Whereas the imperative needs of competition imply a system of freely formed prices for all group of manufactured tobacco.'

This principle is clarified further in Article 5 of the directive which reads as follows:

'Manufacturers and importers shall be free to determine the maximum retail selling price for each of their products. This provision may not, however, hinder implementation of the national systems of legislation regarding the control of price levels or the observance of imposed prices.'

In order to attain this objective of free movement of manufactured tobacco within the Common Market, free from distortions of competition, the directive opts for a tax structure which combines a proportional excise duty with a specific excise duty. The ratio between the specific component and the proportional component of excise duty on cigarettes in the most popular price category is to be gradually harmonized until, in the final stage, it is supposed to be identical in all Member States.

### III. Progress towards the objectives achieved by this approach to harmonization

8. This section examines the extent to which the objectives, in particular the free movement of manufactured tobacco within the Common Market, free from distortions of competition, and the creation of a genuinely common market for manufactured tobacco, have actually been achieved through harmonization.

After the completion of the first two stages of harmonization, interpenetration between the various national markets has remained extremely limited and the relative volume of trade between the various Member States has remained low (see Table VII/4 on page 47 of the Commission's study (COM(82) 61 final)). It should be pointed out in this connection that various brands of cigarette are produced in other Member States of the Community under licence, a fact which is not reflected in the statistics on trade between the Member States of the Community. The Commission provides no information on this point in its study. As stated above, in order to achieve free trade the taxation system must be neutral from the point of view of competition. The question is: Can this be guaranteed under the present approach to harmonization? Another important factor in this context is the attainment of free price determination.

#### (a) The principle of free price formation

9. This, as stated above, is one of the basic principles laid down in the 1972 directive. An argument which is constantly being advanced is that free price formation is not possible in a taxation system which contains a high ad valorem component. Cigarette prices consist largely of tax, 70% on average; the remaining 30% is made up of roughly 20% production costs and 10% distributor's margin. Hence, in a predominantly ad valorem taxation system, any increase or reduction in price entails an increase or decrease in government tax revenue which is greater than the increase or decrease in producer's income. Hence the frequent remark that the government has too big a stake in the fixing of cigarette prices to allow them to be determined freely by the producer. The fact remains that under a high ad valorem taxation system the difference in ex-factory prices is multiplied many times

in the final retail selling price. Consequently, if cost prices fall, the drop in government revenue is greater than the drop in the producer's revenue, so that the producer has a strong incentive to lower his prices. There are those who argue, therefore, that these price reductions would be emulated by other manufacturers, leading to a fall in prices across the board. In that event, the government would be obliged to raise the rate of taxation if it wished to maintain the level of tax revenue.

10. Certain national professional associations repeatedly claim that a high multiplier would lead to a price war, resulting in a downwards price spiral and a fall in tax revenue - a situation which could only be avoided by strict government price controls. At present, despite the fact that the multiplier is high in a number of Member States, there is no sign of such a downwards price spiral. Is this cut-throat price war avoided by producers forming cartels or by strict government price control? This would run counter to the Council directive which stipulates that prices must be freely determined. Certain representatives of the tobacco industry maintain that the price controls in some Member States do in fact infringe the Council directive of 1972. The Commission has very little to say in its study on the subject of the price control measures in force in the various Member States. Here, one must distinguish between the two Member States which have a national commercial monopoly for manufactured tobacco, namely France and Italy, and the other Member States. The situation in the two former countries will be examined separately under (b).

11. Article 5 of the Council directive of 1972 stipulates that manufacturers and importers shall freely determine the maximum retail selling prices of their products. It goes on to say, however, that this provision must not constitute an obstacle to the implementation of national legislation on price controls or the observance of imposed prices. In the current economic situation, with its problems of inflation, every Member State enforces price controls of one kind or another. Naturally, cigarettes, which are included in the retail price index, are also subject to these controls. When applications are made

for rises in cigarette prices the conflicting interests of the Ministry of Economic Affairs and the Ministry of Finance have to be weighed one against the other. The prime concern of the Ministry of Economic Affairs is naturally to curb inflation, and therefore applications for price increases are subject to critical examination. The Ministry of Finance on the other hand, where a high ad valorem tax is imposed on manufactured tobacco, has no objection to an increase in manufactured tobacco prices because it means an increase in tax revenue. Given that the government has a greater interest in price increases in cigarettes than in other products, price controls on cigarettes are unlikely to be stricter than for other products; on the contrary, a price increase is likely to be approved more easily for manufactured tobacco than for other goods.

12. The argument put forward again and again by the industry however concerns price reductions. However, in the current economic situation, price reductions are extremely rare. With inflation and the attendant increases in cost prices, price movements are always up and never down. Admittedly under normal national price control arrangements there is nothing to stop price reductions. It would be interesting, however, to hear from the Commission of any examples of genuine reductions in price or of applications to reduce prices which have been turned down by price control authorities in particular Member States. In this connection it is worth recalling Article 10 of the first directive of 1972 on the harmonization of taxes on manufactured tobacco, which stipulates that Member States may levy on cigarettes a minimum excise duty, the amount of which may not exceed 90% of the aggregate amount of the proportional excise duty and the specific excise duty which they levy on cigarettes in the most popular price category. This provision also appears in the second directive and five Member States have already incorporated it in their national legislation. As at 1 January 1980 the situation in these countries was as follows: Belgium, Bfrs 0.968 per cigarette = 90% of the normal excise duty; Luxembourg, Lfrs 0.42 per cigarette = 59% of the normal excise duty; Netherlands, Hfl 0.03948 per cigarette = 58% of the normal excise duty;

France, FF 0.030 per cigarette = 60% of the normal excise duty; Germany, DM 0.075 per cigarette = 89% of the normal excise duty. This provision is particularly useful in the cases where the proportional component of the excise duty is very high. The above countries which have incorporated this provision into their national legislation are all countries, with the exception of the Federal Republic of Germany, which have a high ad valorem excise duty. Fixing this minimum excise duty artificially restricts the price range of cigarettes and makes it possible to avoid a cut-throat price war with a downwards price spiral. This applies particularly to Belgium where the minimum excise duty is set at 90% of the normal excise duty. Although the Federal Republic of Germany also has a minimum excise duty which is 90% of the normal excise duty, its actual effect is less marked than in Belgium since it contains a high specific component. In Belgium, the existence of a minimum excise duty of 90% of the normal excise duty was the basis for a judgment by the Court of Justice (Fedetab case). The Court ruled that Belgian regulations in respect of taxes on consumption, which are predominantly proportional, and price controls which set the minimum excise duty at 90% of the normal excise duty, have led to a situation where manufacturers and importers are practically unable to compete with each other on the basis of the difference in retail price. This conclusion only applies to Belgium however, since in the other Member States which have a system of minimum excise duty, it is fixed at not more than 60% of the normal excise duty. A minimum excise duty set at this level allows a much wider range of prices and yet, although taxation in these Member States is mainly proportional and although minimum prices are not much in evidence, there is no sign either in these Member States of a cut-throat price war which would result in a downwards price spiral.

13. Hence, in all Member States apart from Italy and France the price controls applied to tobacco are no different from those applied to other products under national price control legislation. The only exception is the possibility of setting a minimum excise duty. Essentially therefore these Member States have

complied with the principle of free determination of prices as set out in the 1972 directive. The Commission should pay close attention to future developments in this field in the various Member States to ensure that they comply with the principle of free determination of prices.

14. Lowering the minimum excise duty to 80% of the duty on cigarettes in the most popular price category will encourage price competition, which is restricted by the possibility of fixing a minimum excise duty. This is particularly true of the Belgian situation. In order to make as much progress as possible towards achieving the objectives of the 1972 basic directive, in particular the free determination of prices and a fair reflection of the difference in manufacturers' selling prices and retail selling prices, efforts should be made to abolish the minimum excise duty on manufactured tobacco completely in the final stage.

15. One question which arises in connection with free determination is whether or not manufacturers are concluding agreements or forming cartels for the purpose of price fixing and thereby infringing Article 95 of the EEC Treaty. After all, the tobacco market in Member States with a high ad valorem tax level, where only a small number of manufacturers operate, provides an ideal situation for price agreements. Therefore, the Commission should check very carefully that the rules on competition set out in the Treaty of Rome, particularly in Article 85, are being observed.

(b) National manufactured tobacco monopolies

16. When the Community was formed two Member States had national commercial monopolies for manufactured tobacco within the meaning of Article 37 of the EEC Treaty: in France, SEITA had a monopoly of both the manufacture and the wholesale of manufactured tobacco; in Italy there was AAMS. Article 37 of the EEC Treaty stipulates that Member States shall progressively adjust any state monopolies of a commercial character so as to ensure that when the transitional period has ended no discrimination regarding the conditions

under which goods are produced and marketed exists between nationals of Member States.

Although the transitional period ended long ago, the tobacco monopolies of a commercial character in Italy and France have still not been entirely dismantled. Agreement between the Commission and the Member States in question on most of the points on which these monopolies were still infringing Common Market regulations was not reached until quite recently.

17. At the end of last year the Commission reached an agreement with France on the measures to be taken to abolish those aspects of the monopoly regulations which had been declared illegal. These included in particular an amendment to the disciplinary regulations imposed on retail traders, adjustment of credit conditions, suspension of uniform trade discount, abolition of compulsory franco deliveries and opening up tobacco retailing to all Community nationals. According to the Commission these measures would put an end to discrimination within the meaning of Article 37 of the EEC Treaty and were to be spread over a period from the beginning of 1982 to the end of 1983, so that by 1 January 1984 at the latest the French tobacco monopoly would comply with the provisions of the Treaty. After France had undertaken to adopt the above measures, the Commission decided to suspend the infringement proceedings which it had instituted against France on the basis of Article 169 of the EEC Treaty. The Commission also initiated infringement proceedings against Italy on the basis of Article 169 of the EEC Treaty. This prompted the Italian Government to announce a number of measures aimed at putting an end to discriminatory practices by its national monopoly. The measures dealt with such questions as the method of operating and managing wholesale establishments, product packaging, conditions of payment of tax stamps, and so on. These measures satisfied most of the Commission's objections, although nothing was done about the compulsory retail margin. Since the Commission was unable to reach agreement with the Italian Government on this point, the infringement proceedings initiated under Article 169 of the EEC Treaty were resumed and

the matter was brought before the European Court of Justice (Case 78/82). As regards the other points which had been resolved satisfactorily, the infringement procedure was suspended.

18. Although the discriminatory practices by the Italian and French monopolies are now gradually being brought to an end, it must be pointed out that the final date for this laid down in Article 37 of the EEC Treaty has long since passed. This raises the question of whether the Commission was firm enough vis-à-vis these Member States. Even though complete agreement has now been reached with France on the adjustment of its monopoly, France still wants to be given until the end of 1983 to introduce these measures fully, despite the fact that it has known for a long while that these final measures had to be taken.

In the case of Italy, on the other hand, the Commission has still not even reached agreement on all aspects of the monopoly which are discriminatory within the meaning of Article 37 of the EEC Treaty.

19. Although most of the aspects of adjusting the French and Italian tobacco monopolies have been settled, there is still one aspect which is causing serious concern; namely the determination of prices in these Member States. This includes not only the fixing of compulsory retail margins which occurs in Italy and on which, as mentioned above, no agreement has yet been reached between the Commission and the Italian authorities but also the fixing of prices generally both in Italy and France. Prices fixed by the national monopolies must not be such that prices of domestic products are kept artificially low or that those of imported products are fixed at an abnormally high level, thereby distorting competition between domestic and imported goods. The price of products manufactured by the national monopolies must not be kept abnormally low by means of subsidies. The case law of the Court of Justice regarding monopolies, and more particularly its judgment of 13 March 1979 in the Hansen case (Case 91/78), is perfectly clear on this point: any action by a national monopoly which consists in marketing a product with the help of public funds at a selling price which is abnormally low in

in comparison with the price exclusive of tax of a product of comparable quality imported from another Member State is incompatible with Article 37 (1) of the EEC Treaty.

In the light of this judgment the practices of SEITA in France and AAMS in Italy should be subjected to close scrutiny. Admittedly the Commission states in its study that it has initiated an investigation into the impact on competition of the sales policy of production monopolies in France and Italy. The investigation covers the retail prices of Gauloise cigarettes and distribution costs in Italy, as well as the selling prices of MS and Nazionali, the most popular cigarettes on the respective markets.

20. The profit and loss accounts produced by the Commission for SEITA<sup>1</sup> show a negative balance since 1976. The French Government attributes these losses to the heavy costs involved in paying a large number of retirement pensions. However, in the light of these heavy losses, a thorough investigation of SEITA's price fixing is absolutely essential. Although SEITA is no longer under the direct control of the Ministry of Finance and has been transformed into a company, cigarette prices are still fixed by the Ministry of Finance not by SEITA. This prompted the Commission to bring this matter before the Court of Justice on 16 March 1982 (Case 90/82).

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<sup>1</sup>Commission study (COM(82) 61 final) page 39

According to the Commission, AAMS also shows a loss for 1979. The Italian situation however is far from transparent. Unlike SEITA, AAMS is not a company but is under the direct control of the Italian Ministry of Finance. A profit and loss account as such does not exist; the profit and loss figures have to be obtained from various different sources. It is urgently necessary, therefore, to obtain an accurate picture of the financial situation of this state monopoly and it is relevant in this connection to refer to the need to implement Directive 80/723/EEC on transparency of financial relations between Member States and public undertakings. This directive is contested, however, by a number of Member States and this has delayed its implementation which was scheduled for January 1982.

A thorough investigation of price formation in these two Member States is necessary, not only because of their losses but also in the light of the relatively low prices at which these products are sold on their market by the national monopolies. The fact that the Commission is conducting a thorough investigation into price fixing policy in France and has brought this matter before the Court is therefore a positive step. However it is not enough, since the determination of prices on the Italian market is also in need of thorough investigation. Parliament would like to be more fully informed about these matters and stresses the urgent need for rapid progress to be made on this question of price formation by the national monopolies for manufactured tobacco.

21. Certain members of the committee have asked whether further harmonization has to wait until the tobacco monopolies have been abolished. The first point to make here is that although the abolition of these tobacco monopolies has taken far more time than was anticipated in the Treaty, the end of virtually all discriminatory practices by the tobacco monopolies is now in sight. Furthermore, it is perhaps useful to refer to the table in Annex VII of the Commission's study according to which the impact of further harmonization on retail prices is greatest in the two monopoly countries. Lastly, trends on the tobacco market in Italy and France indicate that the first stages of harmonization were accompanied by a weakening of the market position of their tobacco monopolies: their share of national production in volume terms fell in France from 91.6% in 1974 to 72.4% in 1980 and in Italy from 70.9% in 1977 to 61.6% in 1980 (see pages 40 and 41 of the Commission's study). This suggests that it is not desirable to interrupt the progress towards harmonization in order to abolish the monopolies.

(c) Neutrality of the proposed tax structure from the point of view of competition

22. Article 4(3) of the 1972 directive defines a neutral tax structure as one which leads to retail prices which reflect fairly the difference in manufacturers' selling prices. To be able to assess the tax structure from this point of view we must first agree on what is meant by 'fairly'. This term is difficult to define accurately and any attempt to do so is bound to be somewhat subjective. There is no doubt, however, that neither of the two tax structures which existed in the Member States before harmonization began satisfied this criterion.

23. A number of Member States applied a very high ad valorem duty to manufactured tobacco. Taking the manufacturer's selling price as 20% of the retail selling price, the distribution margin 10% and the total tax burden 70%, a percentage variation in the manufacturer's selling price under a wholly ad valorem system of taxation produces the same percentage change in the retail selling price. Differences in the ex-factory price are reflected by a difference in the retail selling price which is equivalent to five times that of the ex-factory price; thus, the total multiplier is five. In this case, the fiscal multiplier which represents the ratio of the difference in the sum of the manufacturer's selling price and the distribution margin, is 3.33. This type of tax structure, in which differences in ex-factory prices are multiplied in the retail price, gives an advantage to lower quality, lower-priced cigarettes. Opponents of this high ad valorem system maintain that it leads to cut-throat price competition, because differences in ex-factory prices are multiplied many times over in the retail selling price. This leads ultimately to a downwards price spiral, and the government has to adjust the rate of duty if it wishes to maintain its tax revenue from manufactured tobacco. This argument has already been explained under the section dealing with free determination of prices, in which it was pointed out that although several Member States have a high ad valorem tax there has so far been no evidence there of any downwards price spiral. It is clear, however, that an excessively high ad valorem duty works to the advantage of low-priced cigarettes and is not neutral from the point of view of competition.

24. In certain other Member States the tax on manufactured tobacco prior to harmonization consisted predominantly of a specific component, i.e. the component of the tax which remains unchanged irrespective of the manufacturer's selling price. Returning to the example of the retail selling price of

cigarettes, in which the tax burden accounts for 70%, the manufacturer's selling price 20% and the distribution margin 10%, with a specific component of 100% we obtain the following results: assuming an increase in the manufacturer's selling price of 50% and 100% respectively, and a proportional increase in the distribution margin, the final retail price increases by only 15% and 30% respectively. Hence a substantial change in the manufacturer's price (50-100%) results in a proportionally small change in the retail price (15-30%). Clearly, this type of tax system gives manufacturers no incentive to keep cost prices down and therefore benefits in particular the more expensive cigarettes with a high ex-factory selling price. It follows that a tax system with a high specific component is no more neutral from the point of view of competition.

25. In the 1972 directive the Council therefore opted for a mixed tax system, which avoided giving lower quality cigarettes an undue advantage through a high ad valorem component and also avoided favouring high-quality cigarettes through a high specific component. Under this directive the tax on manufactured tobacco should consist of both a specific component and an ad valorem component. The objective of the final stage is that the ratio between the specific and the ad valorem component (in which VAT was also included in the second stage) is identical in all Member States for the most popular price category. What is the ideal ratio of the specific component to the ad valorem component in order to arrive at a tax structure which is neutral from the point of view of competition? It is very difficult to calculate this point of equilibrium. One thing which is certain, however, is that the first stages of harmonization of the tax on manufactured tobacco represent a step towards more neutral conditions of competition: the increase in the specific component opens up the market to higher-priced, higher quality cigarettes in Member States whose tax on manufactured tobacco is predominantly proportional and a more open market is created for low-priced, lower quality cigarettes in Member States where the tax includes a high specific component. The proposal for a third stage of harmonization is without doubt a further step towards a more neutral tax structure.

26. As we have already said, it is difficult to locate the point at which competition is genuinely neutral, which is the aim of the final stage. The successive proposals for the various stages of harmonization have been characterized largely by a pragmatic approach by the Commission with the aim of

prompting comparable efforts from Member States with a predominantly ad valorem tax and those with a predominantly specific tax. To this end the ratio of specific excise duty to the total tax charged was fixed at between 5 and 75% in the first stage. In the second stage of harmonization the ratio of the specific component to the total tax, which includes VAT, was brought within the range of 5% to 55%. In the proposal for a third stage of harmonization now under consideration, the ratio between the specific excise duty and total tax has been narrowed to the range of 10%-35%. This appears at first sight to demand a greater effort from countries with a high specific tax than from those with a high ad valorem tax: already in the second stage Member States with a high specific component had to reduce their maximum specific component by 20% under the harmonization procedure and are being asked again in the third stage to reduce the maximum by 20%; countries with a high ad valorem component, on the other hand, are only being asked to increase their minimum specific component in the third stage from 5 to 10%. The table in Annex VII of the Commission's study illustrates the effect on retail prices of a change-over from the existing tax structure to that of the proposed third stage. It shows clearly that countries with a high ad valorem component - primarily Italy and France - will certainly have to make an effort comparable to if not greater than countries with a high specific component. The price movement brought about by the third stage of harmonization is kept to less than 2% for practically the whole market in most Member States. Price movements of between 2 and 5% are practically negligible in most countries and represent at most 2.1% of the market, with the exception of France where 30.4% of the market would be affected by such a price change and in Italy where 27% of the market would be affected. In fact in Italy there will be price changes of 5 to 10% for 15.9% of the market and in France for 7.1% of the market.

27. An assessment of the proposed third stage of harmonization of the tax on manufactured tobacco in the light of the objective of a neutral tax structure from the point of view of competition shows that this third stage is definitely a step towards a more neutral tax structure. Furthermore, this third stage requires comparable efforts of the various Member States. This does not answer the question, however, of whether the final stage of harmonization anticipated by the Commission will really satisfy the objective of neutrality from the point of view of competition. The Commission proposes that the specific excise duty should be 20% of the total tax in the final phase. Assuming that the retail price breaks down into 20% manufacturer's selling price, 10%

distribution margin and 70% tax, the total multiplier in the case of an ad valorem component of 80% will be roughly 3. This means that a change in the manufacturer's selling price will be multiplied by a factor of 3 in the retail selling price. Certain national trade organizations feel that a multiplier of 3 is too high and maintain that this will have an adverse effect on quality, since it is mainly the cheaper lower quality cigarettes which are favoured under this system. They want a multiplier of 2 which would be equivalent to a specific component of 40% of the total tax. It must be realized however that the manufacturer's selling price accounts on average for only 20% of the retail price and that cigarette production costs vary very little (with a few exceptions, the difference in the ex-factory cost of cigarettes manufactured in the Community never exceeds a factor of 1 or 2). Hence, there is very little scope for the passing on to the retail price a difference in ex-factory cost price resulting from differences in quality or more efficient production; sales are only affected when the difference in production costs is reflected in the retail price as a result of a sufficiently high multiplier. However, it is very difficult to judge whether retail prices reflect fairly the difference in manufacturers' selling prices with a multiplier of 3 or whether this multiplier should be somewhat lower. Given that opinions differ on this question, it would seem advisable to withhold judgment on the final stage until experience has been gained in the implementation of the third stage of harmonization.

26. Moreover, a multiplier of 3 does not automatically correspond to a specific component of 20%. Where the tax burden is high, as in Denmark, the specific component must be higher to achieve a multiplier of 3. Understandably, therefore, Denmark will encounter problems in introducing the proposed tax structure unless it adjusts its high tax burden. Consequently, the Commission proposes in its study the possibility of a special measure for Denmark, so that once a multiplier of 3 is reached any further reduction in the specific component may be postponed until the tax rates are harmonized.

Clearly, the purpose here is not to establish a fixed relationship between the specific component and total tax, but to arrive at a particular multiplier. Assuming the target is a multiplier of 3, the ratio of the specific component of duty to total tax will then depend on the total tax burden. Under the Danish system, where the tax burden is approximately 87% of the retail price, the multiplier will still only be 2.7 when the third stage of harmonization with its specific component of 35% is introduced. Given the tendency towards higher tax rates in the Member States, it is likely that in order to reach a

multiplier of 3 the specific component will be higher than the 20% indicated by the Commission, in the other Member States, too.

29. The pragmatic approach which has been adopted so far, namely to demand broadly equal efforts from the Member States with a predominantly ad valorem system and from those with a predominantly specific system, may prove inappropriate for the final stage. The final stage must first and foremost comply as far as possible with the criterion of neutrality from the point of view of competition and thus certain Member States may have to be asked to make greater efforts to achieve the objective of a genuine common market in manufactured tobacco. The table in Annex VII of the Commission's study illustrates the effects on retail prices of a change-over from the existing tax structure to a tax structure in which the specific excise duty accounts for 20% of the total tax. As in the case of the third stage, it is Italy and France which will be required to make the biggest adjustments in prices as a result of the transition to the final stage. Although the countries with a high specific component will clearly have to make just as great an effort as the other Member States, the main yardstick by which the final phase should be judged is whether it is in fact neutral from the point of view of competition, and this may mean that these countries will have to make an even greater effort. It is worth examining in this context whether a better way of achieving this point of equilibrium might not be a ratio between the specific component and total tax of between 20% and 30%, making allowance for the trend in the tax burden. One factor which must be taken into account when defining the arrangements for the final phase is the removal of the possibility of setting a minimum excise duty. Only then will price formation be genuinely free and the tax structure neutral from the point of view of competition.

The Committee on Economic and Monetary Affairs takes the view that it is not possible at the present stage of harmonization to pass judgment on the final stage. It therefore calls on the Commission to submit by the end of 1985 a proposal for the final stage of harmonization based on an analysis of trends in the various national markets, after the third phase has been fully introduced, which under its proposal for a third directive should have taken place from January 1985.

(d) Alternative approach to the harmonization of the tax structure in respect of manufactured tobacco: harmonizing the percentage of the ad valorem component in the retail price

30. In asking the Commission to study the harmonization of the excise duties on manufactured tobacco, Parliament asked specifically that the existing approach of harmonizing the percentage of specific excise duty should be weighed against the alternative approach, namely harmonizing the percentage of ad valorem duty in the retail price. Is not this alternative approach more neutral from the point of view of competition? Paragraph 6 of the motion for a resolution which was put before Parliament read as follows:

'Requests the Commission therefore to investigate as soon as possible whether as regards the final stage it would not be more neutral from the point of view of competition to determine the effect of proportional taxation on retail prices than to fix the relationship between the specific and proportional components of duty;'

Harmonizing the proportion of ad valorem tax in the retail price also implies harmonization of the tax multiplier. This means that differences in prices exclusive of tax in the various Member States are multiplied to the same extent in the retail price, which will create uniform conditions of competition.

31. However, uniform conditions of competition, which can be achieved just as easily with a multiplier of 2 as with a multiplier of 5, are not synonymous with neutral conditions of competition. The problem of which multiplier is the most neutral from the point of view of competition still remains. Moreover, it is left to the discretion of the Member States to determine the total tax burden by setting the specific component according to their financial requirements. This will lead to a situation where higher quality cigarettes face less competition in countries with a very high specific tax component than in countries with a low specific component, despite the fact that the proportional tax component in the retail price is identical in all Member States.

32. As already stated, under the present approach to harmonization, determining the level of the proportional component in the retail price, raises precisely the same problems as establishing the final phase. Where the retail price is made up of 70% tax base, 20% ex-factory selling price and 10% distribution margin, a total multiplier of 3 corresponds to an ad valorem component of 56%. The argument advanced in support of the present approach, namely that a total multiplier of 3 is not neutral from the point of view of competition, and that the target should be a total multiplier of 2, applies equally to the alternative approach to harmonization. In this case the percentage of proportional duty in the retail price would have to be fixed at only 40%, as compared to the 56% proposed by the Commission in its study.

33. If the Commission does introduce a multiplier of 3, the minimum tax burden in all Member States - assuming a price structure as outlined above - would have to be 56%. This is precisely the figure currently applied in Greece; in Spain and Portugal, which are currently negotiating conditions of accession, the tax burden is lower and if the alternative approach were adopted and the ad valorem component harmonized, the tax burden in these countries would have to be increased.

34. The Commission argues that ultimately the two approaches produce the same result. If tax frontiers are to be abolished, ultimately the whole excise duty will have to be harmonized. This means that under the alternative approach the specific component will also have to be standardized; this will lead to a tax structure in which both the specific and the ad valorem components of duty are a fixed proportion of the total duty, which is the ultimate objective of the present approach. The opposite can also be argued, namely that the present approach to the harmonization of excise duties will lead inevitably to a situation where the percentage of proportional duty in the retail price will be fixed uniformly throughout the Community, i.e. the same end result as with the alternative approach. While this may be true, the stage of full harmonization of rates of duty and tax structure is a very long-term objective.

35. The alternative approach to harmonization therefore poses similar problems to those of the present approach. Moreover, although the alternative approach creates identical conditions of competition, it provides no better guarantee that the tax system will be neutral from the point of view of competition, which is the ultimate aim of harmonization. In the light of these arguments the Committee on Economic and Monetary Affairs believes that there is no point at present in changing the existing approach to harmonization and feels that the principles set out in 1972 should be upheld.

#### IV. Conclusions

36. It is a fact that the tobacco i.e. cigarette market which the Commission proposes to harmonize is far from being a free market with more or less normal conditions of competition. The question arises therefore as to whether further harmonization should be postponed until such conditions have been created. However, the first two stages have clearly started the market moving towards the objectives which harmonization is intended to attain. This applies particularly to countries with tobacco monopolies (as shown in Table VII/4). Interrupting the process of harmonization would only lead to delays on the road to a normal market situation.

37. It must be realized that irrespective of the harmonization model chosen the high tax burden (around 70% on average) plays a decisive role. Consequently, the existence of one single tax structure is the biggest single contributory factor in the achievement of equal conditions of competition. Other factors, such as health, packaging, taste and other factors influenced by national legislation are also important. It can be concluded that the effects of the present and alternative approaches are not sufficiently different (see also the table in Annex VII of the Commission's study) to warrant a change in the system. There is also the fact that the two systems ultimately converge in the final stage. Lastly, the question raised by the existing differences is which is better: a multiplier of 2 (narrow price ranges) or 3 (slightly wider price ranges)? Decisive arguments in favour of one or the other have not been forthcoming. Nevertheless it does not appear desirable to introduce multipliers much lower than 2 or higher than 3. This might have a bearing on the proposal for the final stage in a situation of increasing tax rates.

38. What has been said in the preceding paragraph raises doubts about the acceptability of the proposed 20% for the specific component of duty. This would result

in a multiplier of more than 3 in the present tax situation. It would seem desirable, therefore, to aim for a specific component of at least 25% or 30%. Admittedly this would mean a somewhat greater effort by the state-monopoly countries, but on the other hand it has advantages from the point of view of competition.

39. The Commission's proposal in respect of Denmark is the only option given the relatively high tax burden in Denmark. It once again underlines the desirability of a slightly higher specific component in the final stage to avoid an excessively high multiplier. The committee can therefore recommend approval of the Commission's proposals on the basis of the following considerations:

- interrupting harmonization would in turn delay the process of creating free competition;
- the alternative system, in particular with regard to competition, offers no particular advantages over the present system;
- both systems converge in the final stage.

When the final stage is introduced will, however, depend, firstly, on compliance with Article 37 of the EEC Treaty by Member States with state monopolies and, secondly, on the completion by all Member States of the second stage of harmonization.

The Committee must reserve its position however with regard to the proposals concerning the final stage. In the light of trends in tax rates in particular, a specific component slightly higher than 20% would seem desirable.

OPINION OF THE COMMITTEE ON BUDGETS

Draftsman : Mr NOTENBOOM

On 25 September 1980 the Committee on Budgets appointed Mr Notenboom draftsman.

It considered the draft opinion at its meeting of 10 October 1980 and adopted it by 14 votes to 6 with 1 abstention.

Present: Mr Lange, chairman; Mr Notenboom, vice-chairman and draftsman; Mr Spinelli, vice-chairman; Mr Adonnino, Mr d'Angelosante (deputizing for Mr Gouthier) Mr Ansquer, Mr Arndt, Mr Baillet, Mr Barbi, Mrs Boserup, Mr Colla, Mr Dankert, Mr Fich, Mr Forth, Mrs Hoff, Mr Howell, Mr R. Jackson, Mr Langes, Mr Nielsen (deputizing for Mr Nord), Mr Ryan, Mrs Scrivener, Mr J.M. Taylor and Mr Tuckman.

1. This proposal for a Council directive concerns the third stage in the harmonization of the structure of excise duty on cigarettes. Excise duty on cigarettes is made up of two components: a specific component and a proportional component. Under the basic Council directive No. 72/464/EEC the amount of the specific excise duty and the rate of the proportional excise duty must be the same for all cigarettes. The ratio between the two components is not prescribed. This ratio still differs considerably from Member State to Member State and is the subject of the harmonization process which must lead to the retail selling prices reflecting fairly the manufacturers' selling prices. This can only be the case when the proportional component is large enough.

2. In the first stage of harmonization from 1 July 1973 to 30 June 1975 - subsequently extended until 30 June 1978 - the specific component of the excise duty had, in each Member State to be within the range 5-75%. In the second stage from 1 July 1978 to 31 December 1980 the difference had to be reduced to between 5% and 55% of the total tax (excise duty + VAT) on cigarettes in the most popular price category. The third stage from 1 January 1981 to 31 December 1986 should reduce the difference to between 10% and 35%. However there will be a transitional period: until 31 December 1982 5% to 55% and until 31 December 1984 7.5% to 42.5%. The Commission has suggested 20% as possibly the ultimate ideal ratio.

3. The length of the stages and the extent of the acknowledged differences point to the great divergence in the markets. This problem and also matters such as the criterion for harmonization (ratio of the specific to the proportional component instead of, for example, the tariff itself), the possibility of excluding customs duties from the basis for calculating the proportional element of excise duty, fixing the minimum excise duty and harmonization of the method of levying excise duty come within the terms of reference of the committee responsible and are therefore not covered here.

4. The Committee on Budgets feels bound to point out, however, that the Commission's calculations presuppose an extremely static situation. When calculating the effect of tax structures on retail prices a constant amount of tax for cigarettes in the most popular price category is assumed. In the evaluation of the consequences of the proposed directive on the French market it is also assumed that tax revenue must remain constant and that therefore the retail price of the most popular cigarette will increase by 2%. For the Italian market the assumption is extended to cover a static producer and retail price.

5. The financial implications are calculated only on the basis of the developments envisaged for the French and Italian market. These in fact account for almost 95% of tobacco produced in the Community and would therefore occasion most intervention purchases and additional imports from third countries. However the possibility cannot be ruled out that harmonization will also affect intra-Community trade and thus reduce the estimates of intervention purchases for France and Italy and could also reduce imports from third countries.

6. The consequences for expenditure are covered by the EAGGF Guarantee Section: if constant production is assumed, lower consumption of tobacco produced in the Community will result in:

- additional intervention purchases: 1050 tonnes at 2,726 EUA  
per tonne = 2.86 m EUA
  - additional exports with refunds: 250 tonnes at 338.5 EUA  
per tonne = 0.08 m EUA
- 2.94 m EUA

The receipts arise from:

- additional imports of light tobacco: 1300 tonnes at 300 EUA  
per tonne = 0.39 m EUA
  - imports of light instead of darker tobacco which yield less duty: 750 tonnes at (300-280)  
EUA per tonne = 0.01 m EUA
- 0.40 m EUA

However this will only occur at the end (1985) of this stage of harmonization. In the years ahead expenditure and receipts would be lower. Under the circumstances the static situation assumed as a basis for calculation seems strange.

7. The tobacco market is changing. There is a trend, already noted, towards lighter types of tobacco. There is also increasing action by pressure groups and governments to reduce tobacco consumption. Such trends lie outside strictly fiscal considerations. However they could throw a completely different light on the financial consequences envisaged here.

#### 8. Conclusion

The Committee on Budgets welcomes the proposal for harmonization of taxes on the consumption of tobacco. It has serious reservations about the inadequate assessment of the changes in the tobacco market structure which would be caused by the proposal and thus the financial consequences. It is also regrettable that the proposal only projects the immediate and directly induced consequences and does not take into account general shifts in the tobacco market.

OPINION OF THE COMMITTEE ON AGRICULTURE

Draftsman: Mrs Barbara CASTLE

The Committee on Agriculture appointed Mrs Barbara Castle draftsman on 26 November 1980.

It considered the draft opinion at its meeting of 16/17 February 1981 and adopted it by 9 votes to 8 with 14 abstentions.

Present: Sir Henry Plumb, chairman, Mr Caillavet, vice-chairman, Mrs Castle, draftsman, Mr Abens (deputizing for Mrs Cresson), Mr Barbagli (deputizing for Mr Ligios), Miss Barbarella, Mr Clinton, Mr Colleselli, Mr Cronin (deputizing for Mr Davern), Mr Curry, Mr Dalsass, Mr De Keersmaeker (deputizing for Mr Bocklet), Mr Delatte, Mr Diana, Lord Douro (deputizing for Mr Battersby), Mr Fanton, Mr Gautier, Mr Hord, Mr Jürgens, Mr McCartin (deputizing for Mr Früh), Mr Maffre-Baugé, Mr Maher, Mr Nielsen, Mr d'Ormesson, Mr Papaefstratiou, Mr Skovmand, Mr Sutra, Mr Tolman, Mr Vernimmen, Mr Wettig and Mr Woltjer.

The Committee on Agriculture hereby submits to the Committee on Economic and Monetary Affairs and to the European Parliament the following amendments to the Motion for a Resolution:

Delete paragraph 2.

Add the following new paragraphs:

- 2a. Believes that the saleability of cigarettes and tobacco depends as much on variations in taste as on differential variations in price and that it is therefore wrong to penalize the tastes of particular consumers in an effort to compel them to change to cigarettes which they do not find acceptable;
12. Invites the Commission to strengthen measures to encourage Community tobacco producers to grow those varieties required by the Community market.

#### Justification

1. The Commission's proposal is the third stage of the harmonization of excise duty levied on cigarettes. Under Council Directive 72/464/EEC of December 1972, which launched the first stage, harmonization is to be achieved by fixing the ratio between two tax components: a fixed amount per cigarette ('specific component') and a variable amount proportional to the current retail price ('ad valorem'). During the first stage ending on 30 June 1977, the specific component was to be brought within a bracket of between 5% and 75% of the total excise duty levied on cigarettes, excluding VAT. During the second stage, which came into effect on 1 July 1978 and has been extended to June 1981, it must be brought within a bracket of between 5% and 55% including VAT. During the third stage, which under the terms of the proposal must be completed on 31 December 1986, it will have to be brought within a bracket of between 10% and 35%.

2. Member States in the Community are divided into two main groups for tobacco tax purposes: those producing high quality, higher priced cigarettes for whom a specific tax is therefore more appropriate and those producing cheaper varieties who have historically preferred an ad valorem tax. Commission figures show that five Member States (the Benelux countries, France and Italy)

apply specific components close to the authorized minimum of 5%; three more (United Kingdom, Denmark and Ireland) apply a specific component close to the authorized maximum of 55% while the Federal Republic of Germany has reduced its specific component from 51% to 40% of total tax. A process of harmonization designed to establish a fixed and uniform relationship between the two components represents a threat to the interests of each group, which explains why progress has been so slow.

3. The Commission has stated that the only possible basis of harmonization should be 'a process of broadly equal efforts of adaptation by Member States'. But in fact this has not been the case. Since the first stage of harmonization Member States historically levying excise duty through ad valorem tax have only had to accept a specific tax element of 5% whereas those preferring specific tax have had to accept an ad valorem element of 45-50%. In addition the United Kingdom and Ireland, where before accession excise duty had for a century been based on the weight of the leaf tobacco used in manufacturing, were compelled to move to specific tax under the Directive passed a fortnight before they joined. These developments have involved them in an effort of adjustment not matched anywhere in the Community.

4. The multiplier effect of an ad valorem tax applied to high quality cigarettes has undesirable social and economic consequences. Not only does the tax increase with the price, but it also reduces when the price reduces, thus giving manufacturers an incentive to engage in a price cutting war. This lessens their ability to offer consumers wider choices of product within a given price range. Ad valorem tax also penalizes expenditure on scientific research and development arising out of the public concern about the problem of smoking and health. Reductions in price and quality under the influence of a high ad valorem tax could also reduce the ability of Community cigarettes to compete with higher quality products on the world market. Finally, the reduction of tax yield which follows price cutting could compel governments to intervene to check this loss of revenue by fixing prices, contrary to the principles of harmonization and free competition. It is significant that countries with the highest ad valorem tax get the lowest tax yield because manufacturers reduce both quality and price in order to compete.

5. The Commission admits that the degree of market inter-penetration produced by harmonization has so far not been great. This is because the saleability of cigarettes depends more on variations in taste than in price. Also the existence of state monopolies in France and Italy, giving their governments complete control over prices, and the close government supervision of prices in the Benelux countries, has done more to distort competition than tax differences have done. Moreover there are large differences in the overall level of cigarette taxation in Member States, the level in the Member State with the highest taxation being six times as great as that in the Member State with the lowest level. It is not to be expected that Member States will be willing to give up the freedom to impose the levels of tax that most suit their social policies.

6. The third stage of harmonization now proposed would mean a further unequal adjustment in tax, the countries preferring specific tax having to reduce this element to 35% while countries preferring ad valorem tax would merely have to move from 5% specific tax to 10%. The Commission justifies this as an interim step towards its final goal of a 20% component of specific tax. Such a component, it argues, represents the arithmetic mean of the price changes which would result from all Member States adopting the two extremes of specific tax element fixed for the second stage, 5% to 55%, and therefore represents a 'broadly equal effort of adaptation' by Member States in the two groups. Not only does this method of calculation make no attempt to determine the optimum tax structure for the Community, but it has been challenged as fallacious. For example, it assumes that tax changes do not affect the level of tax exclusive prices, whereas a high ad valorem tax can be shown to have such an effect.

7. A more important criticism lies in the fact that account is not taken of the major implications of their proposal upon the market. A very high ad valorem element amplifies any cut or increase in prices to an extreme degree; the government in fact through loss of revenue subsidizes such price cuts. This exaggerated impact on prices (or the multiplier effect) inevitably leads to destabilization of the market and a reaction by national treasuries unhappy at loss of revenue. Wherever a high ad valorem element has been applied, governments have entered to apply price controls, leading inevitably to distortion in competition and in direct contradiction to basic concepts underlying the Treaty.

8. Moreover, Community cigarette producers should be able to compete in the world market, and any system, such as a high ad valorem tax, which mitigates against the production of the high quality cigarettes is not to be welcomed.

9. During the second stage of harmonization the Economic and Social Committee in Brussels proposed an alternative method of harmonization based on the extent to which proportional taxation increased retail selling prices and asked for an inquiry but the Commission rejected this as incompatible with Directive 72/464/EEC. What the Commission ignores, however, is that its own proposal for increasing the ad valorem element to 65% and eventually 80% is incompatible with Article 3 of the Treaty which calls for the elimination of distortions of competition. Such figures would produce multipliers exceeding two and eventually an average multiplier of three, which would severely distort competition. Most consumer products bear a multiplier as a result of the ad valorem elements of VAT and distributive margins, but in most cases it is around 1.5 or less. The Commission itself has criticized levels of indirect taxation on articles of mass consumption which produce a multiplier of two and has done so on the grounds that high multipliers distort competition. It is therefore ironic that it should itself be proposing high multipliers in the case of tobacco. If harmonization is to be achieved on the basis of a ratio between the two components, the multiplier effect should not exceed 1.7, which gives a specific component of around the present level of 50%. A ratio of 50/50 specific and ad valorem would therefore be the one which accords most closely with the basic aim of the Community, ensuring that competition is not distorted, set out in Article 3.

10. A move from the present specific component of 5% to 50% would cause grave difficulties for certain Member States. If it were to be proceeded with, therefore, a long period of derogation would be required to enable the producers of lower priced tobacco, notably in France and Italy, to adjust to the new situation. At present, despite CAP expenditure on support for tobacco growers running at 210 million units of account in 1978, the Community still produces very little tobacco in the grades and varieties needed in the north European markets and there is surplus production of some varieties, such as Oriental tobacco, which will be exacerbated following the accession of Greece, which is a large producer of Oriental. These difficulties should be recognized by changes in the type of CAP support so as to encourage farmers to move towards the production of the qualities and varieties the market needs. The introduction of a common market organization for tobacco in 1970 was intended to enable tobacco tax harmonization to be dealt with on its own merits and it would be quite wrong for the failure of the CAP system of support to encourage the growth of the right types of tobacco to be used as a reason for harmonizing tax on a basis which protects the producer of lower grades and penalizes the consumer of higher quality imported varieties. These consumers already carry the burden of an import levy on the tobaccos which have to be imported because they are not grown in the Community, whereas consumers of lower quality varieties made of indigenous tobacco are spared such a levy. The demand now being pressed by the growers for the imposition

of a supplementary Community excise duty on the quantity of imported tobacco in cigarettes should be resisted as not only would this discriminate against developing countries (from whom most of the Flue Cured Virginia Type tobacco used in certain Member States comes), but against the consumers who prefer the varieties which the Community itself does not grow.

11. Should a 50/50 ratio between specific and ad valorem tax not prove acceptable, the Commission should be asked to conduct an inquiry into the whole system of harmonization through a fixed ratio with a view to finding alternative ways of equalising competition.

12. It should be noted that the views expressed above are those of the draftsman and are only partly shared by the Committee on Agriculture as a whole. It did not agree with the draftsman on the following points, which she had included in her draft opinion:

- ' - Notes that the stages of harmonization which have so far taken place have not significantly increased the inter-penetration of markets, and that one of the greatest obstacles to freer competition in tobacco products among Member States lies in the continuing existence of state tobacco marketing monopolies contrary to the objectives of the Treaty of Rome;
- Believes that the establishment of a fixed relationship between the specific and proportional elements in tobacco tax is not the most effective way of ensuring fairer competition in the Community, but believes, if harmonization on this basis is to be pursued, that an equitable division between ad valorem and specific tax would be close to a 50-50 division so as to reconcile the interests of the two major groups of manufacturers in the Community;
- Requests the Commission therefore to revise its proposal so as to allow for a more comprehensive approach to the problem of facilitating trade in the cigarette sector, and to suspend any further proposals for tax harmonization until other barriers to the inter-penetration of markets, notably the existence of state tobacco monopolies, have been removed.'