

COMMISSION OF THE EUROPEAN COMMUNITIES

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IMPLICATIONS OF FURTHER HARMONIZATION OF THE EXCISES ON MANUFACTURED TOBACCO.

Report by the Commission to the European Parliament

COMMISSION OF THE EUROPEAN COMMUNITIES

CORRIGENDUM

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REPORT TO THE EUROPEAN PARLIAMENT
ON THE IMPLICATION OF FURTHER HARMONISATION
OF THE EXCISES ON MANUFACTURED TOBACCO

CORRIGENDUM

- Page 3 Paragraph 1.1.4. Line 6. Amend "p 5" to read "p 135".
- Page 42 Paragraph 7.1.1. Line 4. Amend "25 %" to read "15 %".
Paragraph 7.1.1. Line 8. Amend "22.9 %" to read "7.5 %".
- Page 43 Table 7.1. Line "IRL". Amend "5600" to read "5900²⁾", "9600¹⁾"
to read "8000²⁾" and "-22.9" to read
"-7.5".
Table 7.1. Line "UK" Amend "111.100" to read "147.500²⁾".
Table 7.1. Line "ALL MS" Amend "457.100" to read "493.800" and
"564557" to read "562957".
Table 7.1 Add footnote "2) Fedetab".
- Page 48 Paragraph 7.3.2. Line 4-5 Delete the phrase in brackets
Paragraph 7.3.2. Line 6-9 Delete the final sentence of the
paragraph "It is striking tax
incidence (see chapter 9)."
- Page 50 Table 7.6. Delete the table and insert the new table 7.6 attached.
- Page 54 In column "UK" in the table : Amend "47.900" to read "37900".
- Page 57 Paragraph 8.3.2 Line 2 - 3 : Amend "by 23,5 %" to read
"by about 15 %".
- Page 118 Paragraph 14.1.4 Line 2 : Delete "about 23 %".

Cigarette consumption per head

	1970	1975	1980
B & LUX	1830 ¹⁾	2030	1920
DK	1310	1420	1370
D	1950	2040	2080
F	1370	1610	1590
GR	1700 ²⁾	2010 ²⁾	2320
IRL	1730	2360	2210
IT	1300	1600	1730
NL	1430	1750	1620
UK	2300	2370	2180
Weighted average	1720	1910	1900

1) Only Belgium.

2) Estimated from the weight of manufactured cigarette tobacco.

Sources: Manufacturers' statistics; Member States tax statistics.

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IMPLICATIONS OF FURTHER HARMONIZATION OF THE EXCISES
ON MANUFACTURED TOBACCO

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1. INTRODUCTION

1.1.1 On 27 June 1980, the Commission made a proposal⁽¹⁾ to the Council for a third stage of harmonization of the excises on manufactured tobacco. Earlier directives (see Chapter 4 below) had established the principles and enacted the first two stages of harmonization, which have in practice been limited to taxes on cigarettes: in particular, they required that the excise on cigarettes should consist of a specific element - a fixed amount per cigarette - and an ad valorem element related to the retail price. The third stage of harmonization was to cover the period from 1 January 1981 to 31 December 1986, during which period the permissible limits for the specific element of the excise, as a percentage of the total tax levied on the most popular price category of cigarettes, would be progressively narrowed as follows:

in 1981 and 1982: not less than 5% nor more than 55 %
(no change from the second stage)

in 1983 and 1984: not less than 7½% nor more than 42½ %

in 1985 and 1986: not less than 10 % nor more than 35 %.

1.1.2 In the explanatory memorandum to the proposal, the Commission indicated that the proposal had been prepared with a view to a ratio between

(1) Draft directive amending Directive 72/464/EEC on taxes other than turnover taxes which affect the consumption of manufactured tobacco (OJ No. C 264, 11.10.1980, p. 6).

the specific element and the total tax which, at the final stage of harmonization of the tax structure, should be 20 %.

1.1.3 By letter of 25 July 1980, the President of the Council requested the European Parliament to deliver an opinion. The proposal was referred to the Committee on Economic and Monetary Affairs as the Committee responsible for preparing a draft resolution and to the Committee on Budgets and the Committee on Agriculture for their opinion.

1.1.4 The report⁽¹⁾ of the Committee on Economic and Monetary Affairs of the Parliament was presented on 13 February 1981, together with a draft resolution. Paragraph 6 of the draft resolution: "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 of retail prices than to fix the relationship between the specific and proportional components of duty" (see Annex 1, page 5) . The resolution also expressed disagreement with the Commission's present proposals and urged a further prolongation of the second stage of harmonization (already prolonged to 30 June 1981 from the original expiry date of 31 December 1980) pending the submission of final proposals which would take into account all aspects of the harmonization question.

1.1.5 In the vote in the plenary session of Parliament on 8 May 1981, the Commission's proposal failed to secure a majority of the votes cast. The Commission having declined to withdraw its proposal, Parliament decided, under Rule 35(3) of the Rules of Procedure, not to vote on the motion for a resolution, but to refer the matter back to the Committee on Economic and Monetary Affairs for further report.

(1) Doc. PE 66.992 Fin

1.1.6. In the discussions with the Economic and Monetary Affairs Committee, the Commission indicated that it could accept two of thirteen amendments (Nos. 1 and 2) to the draft Resolution which had been put forward⁽¹⁾. The first of these limited the third stage of harmonization to the first two phases only of the timetable proposed by the Commission, i.e. to a 7.5% - 42.5% range for the specific element and covering the period to end-1984 (see paragraph 1.1.1 above). The second asked the Commission to present the results of the further investigations requested in the resolution before the end of 1982 and, on that basis, to define the final stage and to submit a proposal for a subsequent (fourth) stage, to commence at the latest on 1 January 1985. The net effect of the two amendments would be to allow the process of harmonization to continue, without excluding the possibility of other approaches at a later stage.

1.1.7. The Commission's preparedness to accept these two amendments was conditional upon the approval by Parliament of the remainder of the Commission's proposals for the third stage. However, at its meeting on 21 and 22 May 1981, the Economic and Monetary Affairs Committee could not agree to this compromise. Instead, the Committee, in its second report to Parliament,⁽²⁾ maintained its original draft resolution unchanged.

1.1.8. In the light of this further report of the Economic and Monetary Affairs Committee, the Commission offered at the plenary session of 18 June 1981, to carry out a thorough and wide-ranging study of the issues. This offer was made on the assumption that, when the conclusions of the study were presented to Parliament, an opinion would then be adopted without delay. The Commission made it clear that its existing proposal for the third stage was not withdrawn. However, the Commission accepted that examination by the Council should be suspended, pending the outcome of the study.

(1) Docs. PE 72.093/1-13

(2) Doc. PE 66.992/Fin/II

1.1.9 In response to the Commission undertaking, the matter was referred back to the Economic and Monetary Affairs Committee under Rule 85.

1.1.10 This report, which examines the implications of further harmonization of the taxes on cigarettes, is presented in fulfilment of the Commission undertaking of 18 June 1981. As far as has been practicable, the study has taken account of the opinions of the Economic and Social Committee, of 25 February 1981⁽¹⁾ on the Commission's proposals for the third stage of harmonization, and of 30 June 1976⁽²⁾ on the second stage proposals. The relevant paragraphs of these two opinions and of the report and draft resolution of the Economic and Monetary Affairs Committee, are set out in Annex I.

1.1.11 It has not always proved possible to obtain comprehensive or identical information on the situation in all ten Member States. Where differing sources have been used in order to offer a comprehensive picture, the sources are indicated.

(1) OJ No. C 138, 9.6.1981, p. 47

(2) OJ No. C 204, 30.8.1976, p. 1

2. THE NEED FOR HARMONIZATION OF THE EXCISE

2.1.1 The establishment of a common market by way of, among other things, the free movement of persons, goods, services and capital and a system that ensures that competition is not distorted is a fundamental objective of the Treaty. This objective has been confirmed on numerous occasions, most recently in the resolution of the Parliament of 15 October 1981⁽¹⁾ on the achievement of the internal market.

2.1.2 Moreover, the role of excise harmonisation in the realisation of this objective has been explicitly recognised. For example, the Council Resolution of 22 March 1971⁽²⁾ on tax aspects of economic and monetary union reads:-

"In order that effectively free movement of persons, goods, services and capital and progress in interpenetration of economies may be achieved at a faster rate, the Council, acting on a proposal from the Commission and having regard to the need to preserve a balance, shall decide on measures concerning:

- (i)
- (ii) the harmonisation of the scope, basis of assessment and the mode of levying excise duties, in particular those which have an appreciable influence on trade
- (iii)
- (iv)
- (v) the progressive extension of duty-free concessions granted to private individuals crossing frontiers within the Community.

Harmonization of the excises on tobacco is an essential element in the realisation of both (ii) and (v) above.

(1) OJ C 287 of 9.11.1981

(2) OJ C 28 of 27.3.1971.

2.2 Excise harmonization and the internal market

2.2.1 As regards (ii) above and as can be seen from Chapters 5 (Raw Tobacco) and 7 - 9 (Employment, production, tax incidence) the importance of the tobacco excises in achieving the internal market is considerable. The tobacco manufacturing industry directly employs more than 100,000, supplied by 250,000 planters of raw tobacco (possibly 600,000 employed) and with perhaps half a million or more involved directly or indirectly in distribution. Tobacco products account for between 1 % and 3,2 % of consumer expenditure, and tax receipts from tobacco account for between 0,7 % and 4,2 % of total Government revenues (social contributions included).

2.2.2 It is striking that, notwithstanding the abolition of Customs duties for intra-Community trade and the implementation of two stages of excise harmonization, there is no true Community market for cigarettes (see Tables 7.2, 7.3 and 7.4). This is all the more surprising, when it is recalled that access to the Community market for third countries is virtually excluded by the 90 % external tariff on imported cigarettes (see Annex III) and that many Community producers are major cigarette exporters to the rest of the world (total exports account for about 20 % and exports to the EEC for about 6 % of total EEC production).

2.2.3 There is general agreement that this state of affairs is due to a wide variety of factors, over and above the continuing differences in the excise systems, such as differences in consumer tastes, the existence of state and private sector producers, differing policies governing advertising, differing health policies. Obviously, not all of these factors apply on all of the markets; nor are they all of equal importance in all cases. Consequently, harmonization of any one of these factors will not of itself lead to the achievement of a single cigarette market. On the other hand, it is clear that significant interpenetration of all the markets will be impeded so long as any one of the major limiting factors is ignored.

2.2.4. As far as the excises are concerned, there can be no doubt that, whatever additional measures may be necessary, harmonization of the excise structures is a pre-condition for the establishment of a single market for cigarettes. Where taxation accounts on average for 70 % or more of retail price, uniform market conditions are not possible unless the tax is levied in a harmonized fashion. At such tax levels, even minor differences in tax structure can make access from one market to another unattractive or difficult. The fact that the first two stages of harmonization have not radically improved market inter-penetration is persuasive evidence of this view: notwithstanding the reduced differences between the excise systems achieved by harmonization to date, those remaining are sufficiently potent to exercise a powerful inhibiting factor on intra-Community trade. Were further proof required, the difficulties encountered by the Community in arriving even at a harmonized structure for the cigarette excise - which has only limited implications for tax revenues - is itself proof of the crucial importance of the excise in the eyes of the industry.

2.2.5. There are of course those who argue that harmonization of the excise should await a common approach on all the other factors bearing on the cigarette market. This is a dubious and dangerous argument. Dubious, because it rests implicitly on the hypothesis that the removal of one distortion is either impracticable or undesirable without the simultaneous removal of all others. Dangerous, because it is in reality a formula for inactivity. For example, the policies of the Member States on the smoking issue are bound to have a considerable impact on the markets. In the absence of a comprehensive Community policy on this issue, divergencies and distortions are unavoidable. On the other hand, although the Commission itself favours the evolution of a common health policy, it has to be acknowledged that there are considerable divergencies in practice between the policies of the Member States and there is as yet no common approach. Consequently, to subject further progress on excise harmonization - the need for which is not challenged - to a successful outcome of the health and

other issues, would be in effect to tie together two processes which, although having the same objective, are at a different stage in their development. Consequently, unless it is possible to accelerate the development of the first, the development of the second would necessarily be slowed down.

2.2.6 It is therefore clear that a single cigarette market cannot be achieved without harmonization of the excise structure, and that the linking of excise harmonization to progress with other factors bearing on the market will tend to put off, rather than bring closer, the realisation of that single market.

2.3 Excise harmonization and the extension of travellers' concessions

2.3.1 The excise also has an essential role in (v) above - the progressive extension of travellers' allowances, the ultimate objective of which is the abolition of fiscal frontiers. This has long been, and still remains, a major political objective of the Community, a fact which the Parliament explicitly recognised in its opinion of 18 April 1980 on the fifth directive on travellers' allowances⁽¹⁾.

2.3.2 Paragraph 6 of that opinion calls on the Commission "to take every opportunity of easing and in time abolishing the quantitative restrictions on tobacco, wine and spirits for private travellers between Member States". Given the generally high excise rates and their importance as a major source of tax receipts, the realisation of this objective is inextricably linked to the programme of harmonization of the excise structures and rates.

2.3.3 It cannot be stressed too strongly that there is no realistic possibility of substantially increasing any one of the quantitative excise allowances so long as significant differences remain between the Member States as regards either the structure or the rates of the excises in

(1) OJ C 117 of 12.5.1980

question, including tobacco. Where tax incidence is generally 70 % or more of retail price, but nevertheless varies by a sizeable margin between individual Member States, there is a considerable incentive for travellers to cross frontiers solely in order to benefit, by virtue of the Community allowances, from buying excise goods abroad at relatively lower tax-paid prices than obtain on their own market. This can lead to deflection both of trade and of tax revenue from high- to low-excise Member States. Quite apart from any other considerations, any narrowing of the gaps between the excise rates is of only limited value so long as excise structures have not themselves been harmonized (since, unless both the field of application and the methods of imposition are harmonized, no uniformity is possible, either as to the products to which the excise rates will apply, or indeed as to the form in which the rates themselves are expressed).

2.3.4 In any case, it is not in the Commission's view either desirable or realistic to attempt harmonization of excise rates before harmonizing structures, partly because structural changes can give rise to revenue changes (as indeed is explicitly recognized in Article 1(4) of the first tobacco directive) which require freedom over tax rates if they are to be adequately corrected, and partly because the Member States are - understandably - reluctant to accept constraints on the absolute levels of individual excises without first knowing the coverage and method of application of the harmonized structure of the excise. Consequently, harmonization of each of the excise structures is an essential condition for the realisation of the internal market and thus for any programme of enlargement of Community excise allowances for travellers. Any delays on this score will inevitably impose similar delays on the achievement of free movement of travellers across intra-Community frontiers.

3. CIGARETTE MARKETS AND TAX SYSTEMS BEFORE IMPLEMENTATION BY THE
MEMBER STATES OF THE FIRST TAX HARMONIZATION MEASURES

3.1. In all the Member States, cigarettes have always been subject to very high consumption taxes (excise duties and other taxes).

3.2. France

3.2.1. On the French market the Service d'exploitation industrielle des tabacs et des allumettes (SEITA), falling under the Ministry of the Economy and Finances, controlled the monopoly of manufacture, importation and sales of manufactured tobacco.

3.2.2. Most SEITA products were manufactured from dark tobacco of French origin. The basic cigarette brands, filter and plain, accounted for about 85 % of the French market. The remaining 15% was taken by blond cigarettes, either manufactured by the SEITA (sometimes under licence from foreign manufacturers) or imported (about 5 %).

3.2.3. The tax on cigarettes was a direct function of the retail price fixed by the Ministry for the Economy and Finances. It was proportional to the retail price at a rate of about 75%.

3.2.4. The range of prices was very wide, with a large difference between the prices of dark and blond cigarettes; between the cheapest brands (ordinary dark cigarettes) and blond cigarettes, the difference could be as much as 300 %.

3.3. Italy

3.3.1. In Italy, the manufacture, importation and sale of manufactured tobacco was also organised and controlled by a State monopoly: l'Azienda Autonoma dei Monopoli di Stato, falling under the Ministry of Finance.

3.3.2. In the early 1970s, the monopoly's own brands accounted for about 65 % of the Italian market, and foreign brands manufactured by the monopoly under licence accounted for a further 15 %. The volume of unofficial imports (i.e. contraband) was considerable, and has been estimated at up to 15 % of the market⁽¹⁾.

3.3.3. The tax due on cigarettes and the retail selling prices were laid down in a scale, as a function of the different wholesale prices. A comparison of the different retail prices with the tax showed that the tax was in fact ad valorem.

3.3.4. Before the first harmonization measures, the rate of the tax was about 80 % of the retail price for most cigarettes, on a slightly degressive scale, down to 70 % for the most expensive cigarettes. As the scale started at a certain retail price, there was in practice a minimum selling price.

3.3.5. The range of prices on the Italian market in cigarettes was even larger than on the French market. The price range was as great as 400 %.

3.4. Belgium and Luxembourg

3.4.1. Before 1973, the Belgian market was supplied by five major manufacturers, most of which were associated more or less closely with international groups, together accounting for more than 85 % of output. There were also a few smaller producers. In Luxembourg there was only one manufacturer, holding about 5 % of the Belgo-Luxembourg market.

3.4.2. Excise duties in Belgium and Luxembourg were almost entirely proportional: a small specific two-tier tax depending on the price

(1) In recent years, the share of contraband in the Italian market has been estimated at: between 35 % and 40% in volume in 1978 (source: UNCTAD); at 18 % in value in 1979 (source: "la Voce del Tabaccaio").

category was levied on top of the ad valorem taxes. The tax burden (including turnover taxes), as a percentage of the retail price, was about 65 % in Belgium and 61 % in Luxembourg. There was a minimum excise duty and thus a minimum retail price.

3.4.3. Despite the predominance of the ad valorem tax, the range of prices on the Belgian and Luxembourg markets was fairly narrow. Cigarettes in the popular price category alone represented almost 80% of the market. National brands were sold in packets of 25 cigarettes, while international brands were sold in packets of 20.

3.5. The Netherlands

3.5.1. Four major manufacturers, all foreign-owned, held 90% to 95 % of the Dutch market, the remainder being shared by a few small producers and by imports.

3.5.2. A feature of the market in the Netherlands was the high percentage of sales of non-filter cigarettes (over 60 % in 1970). As in Belgium, popular brands were sold in packets of 25, mostly at a single price. Cigarettes in the most popular price category accounted for about 75 % of sales.

3.5.3. The Netherlands system of excise duties on cigarettes in 1971 was exclusively proportional. Excise duty and VAT accounted for about 70 % of the retail price of cigarettes. In spite of ad valorem taxation, the price range was very narrow.

3.6. Federal Republic of Germany

3.6.1. Five major manufacturers, mostly allied to international groups, shared the West German market. There were also a few small firms, and a small amount of imports, mainly from the Benelux countries and France.

3.6.2. Until 1973, the structure of the German market depended on a system of taxation involving a scale of specific excise duties. Cigarettes were subject to a mixed system, and were classified according to the retail price into a number of tax categories. The specific and proportional components of the excise duty varied from one category to another. As a consequence of this system, there were minimum retail prices.

3.6.3. The incidence of the excise duty on retail prices was between 50 % and 58 %; there was also VAT at 9.91%.

3.6.4. The range of selling prices was very narrow, with two large and two small price categories.

3.6.5. A special feature of the German market was the large share of sales from automatic vending machines (45 %).

3.7. General remarks on taxation in the six original Member States

3.7.1. At that time - that is, before the 1972 Directive - there were several systems of cigarette taxation in the Community of Six. The system in the Federal Republic of Germany incorporated several categories of retail prices, each subject to a different specific duty, while the other five Member States levied excise duties that were basically proportional to retail prices. In brief, cigarette taxes in the six countries were very high (between 60 % and 80 % of the retail price) and, in practice or by statute, were proportional to the retail price. The schedule of retail prices was decided either autonomously by the tax authorities (in France and Italy), or with their agreement. In some countries, the proportional rate of tax was degressive for the most expensive cigarettes, which, however, held only a small share of the market. A minimum retail price was imposed in practice in all the Member States, but this price was very low in the Benelux countries and very high in the Federal Republic of Germany.

3.7.2. The range of retail prices was very wide in France and Italy, but narrow in the other countries.

3.8. Denmark

3.8.1. There is only one cigarette manufacturer in Denmark, financially linked with an international group. As imports are negligible, this manufacturer enjoys in practice a monopoly position.

3.8.2. For many years, cigarettes in Denmark have been very heavily taxed, which puts them among the most expensive in the world (four to five times the price charged in France for cigarettes in the "popular" price category).

3.8.3. Before joining the Community in 1973 and adopting the provisions of the first Directive, Denmark applied only specific excise duties to cigarettes, with a different level of tax for each price category.

3.8.4. Before 1973, there were in fact only two main price categories. The transition from the system of a multi-tier specific tax to the mixed system provided for in the first Directive did not change retail prices. Demand in Denmark has remained loyal to the cigarettes produced in the country. The tax burden (excise duties plus VAT) is extremely heavy (up to more than 85 % of the retail price), and the range of prices is very narrow.

3.9. United Kingdom

3.9.1. Before the United Kingdom joined the Community, the United Kingdom market in cigarettes was almost exclusively supplied by three major national manufacturers. It was divided into a number of segments according to the format of the cigarettes and their prices. The tax was based on the tobacco content of cigarettes (a specific tax on the weight of the raw tobacco used). Small cigarettes containing less tobacco were therefore taxed less heavily than larger cigarettes.

3.9.2. A special feature of the market, ever since the manufacture of cigarettes on an industrial basis, was the existence of two very popular sizes, the smaller and cheaper of which had no equivalent on any other market except that in Ireland. These two main size categories, which existed before the second world war in the non-filter cigarette sector, also appeared in the filter sector which developed after the war. Since 1960, the range of sizes has increased with the introduction of very large cigarettes (King Size) at one end of the scale, and two slightly smaller variants of the two ordinary sizes.

3.9.3. The shift in demand from plain to filter cigarettes had already substantially eroded the market for the former.

3.9.4. By the early 1970s, plain cigarettes, in two size and price categories, represented only 15 % of the market. The remainder of the market was filter cigarettes, in six size categories and six "recommended" price categories.

3.9.5. The system of taxation based on raw tobacco weight made it difficult to determine exactly the incidence of the tax on the retail price. However, it has been estimated that, for the most popular brands of cigarettes, taxes represented about 70 % of the retail price.

3.9.6. Unlike prices in the continental countries, retail prices in the United Kingdom were not imposed or fixed: they were "recommended" prices. Moreover, some brands offered cigarette coupons. As there were so many different sizes, the range of cigarette prices was fairly wide (up to 150 %).

3.10. Ireland

3.10.1. There are three producers on the Irish market.

3.10.2. The basic structure of the Irish market was very similar in many ways to that of the United Kingdom market.

3.10.3. Tobacco tax was based on weight, as in the United Kingdom.

3.10.4. Consequently, the Irish market was also subdivided according to the size of the cigarettes and the tobacco content. However, while the categories were clearly defined in the United Kingdom, the distinction was less clear in Ireland.

3.10.5. The tightness of the packing and the diameter of cigarettes were much more important on the Irish market than on the British market, where the main criterion was length. For example, small cigarettes have never held a large share of the Irish market.

3.10.6. Among the seven price categories for filter cigarettes, that of the most popular category, with about 30 % of the market, was more dominant in Ireland than in the United Kingdom (where two price categories each accounted for about 25% of the market). There were also two price categories for plain cigarettes in Ireland. Retail prices and the tax incidence were slightly lower than in the United Kingdom, and the range of prices was slightly narrower.

3.11. Greece

3.11.1. When Greece joined the Community, five national manufacturers shared the Greek market in cigarettes, about 90 % of which was accounted for by filter cigarettes, mainly manufactured from oriental tobacco.

3.11.2. In principle, taxes in Greece were collected on an ad valorem basis applied to the retail price. However, the tax was levied at a lower rate on the most expensive categories of cigarette, so that the system had

a degressive effect somewhat comparable to the mixed Community system.

According to the type and price of the cigarettes, the tax amounted to between 63 % and 53 % of the retail price.

3.11.3. There were some dozen retail price categories, fixed by the manufacturers or the importers. Selling prices cannot be increased or reduced without the prior agreement of the tax authorities.

3.11.4. The most popular price category was near the middle of the price range, and accounting for almost 40 % of the market. The range of prices was fairly wide, and imported cigarettes were considerably more expensive than nationally produced cigarettes.

4. BACKGROUND TO THE HARMONIZATION OF THE EXCISES ON MANUFACTURED TOBACCO

4.1.1. In the 1960s analysis of trade in manufactured tobacco, made by the Commission, revealed a particularly high degree of market segregation within the Community. The lack of market interpenetration was not attributable to natural factors but was primarily attributable to artificially distorted conditions of competition. The barriers to market interpenetration and competition were mainly to be found in the three areas of agriculture, State monopolies and taxation. It was for this reason that the Commission transmitted to the Council on 4 July 1967 a proposal for a Regulation concerning these three sectors.⁽¹⁾

4.1.2. On 21 April 1970, the Council of Ministers of the six founder Member States adopted three Resolutions concerning the tobacco sector:²

- (a) a Resolution on taxes, other than turnover taxes, on the consumption of manufactured tobacco;
- (b) a Resolution on national monopolies of a commercial nature in manufactured tobacco;
- (c) a Resolution on an improved control of agricultural markets.

4.1.3. With regard to the third Resolution, Chapter 5 contains further information on the markets in raw tobacco and on the common agricultural policy as it applies in this sector.

4.1.4. As regards the second Resolution, which concerns the adjustment of the tobacco monopolies in France and Italy, see Chapter 6.

¹ Commission proposal to the Council (Doc. 67/564/EEC); OJ No 198 of 17 August 1967, pp. 12-23

² OJ No 6 50 of 28 April 1970, pp. 1 and 2

4.1.5. The Council Directive of 19 December 1972 (see Section 4.3 below), stems from the first Resolution of 21 April 1970. This directive has been supplemented by a Council Directive dated 19 December 1977 (see Section 4.4 below).

4.1.6. The Resolution and Directives referred to in the previous paragraph are in fact concerned solely with the structure of the excise on cigarettes and say nothing about the levels of taxation. Apart from some general provisions regarding the principles of harmonization, the basic 1972 Directive does not contain any special provisions relating to other kinds of manufactured tobacco.

4.2 Entry in Council minutes concerning the Resolution of 21 April 1970

4.2.1. Of the main principles governing the harmonization of cigarette excises, which are laid down in the Council Resolution of 21 April 1970 and reproduced in the basic 1972 Directive, the most important is that which provides: "As regards excise duty on cigarettes, that system will involve a proportional component and a specific component in order that at the final stage, which is to start on 1 January 1980, a fixed relation between those components may be attained so that the range of retail sale prices freely fixed by manufacturers should reflect to a fair extent the differences in delivery prices." The interpretation of the word "fair" has always been a matter of judgement. It should be noted that, on the adoption of the Resolution, the Commission and five of the national delegations had included in the minutes of the Council meeting a statement to the effect that they took the word "fair" to mean that, when excises come to be harmonized, the proportional component should be predominant.

4.3. Council Directive of 19 December 1972¹

4.3.1. Subsequently to the Resolution of 21 April 1970 the Council Directive was adopted on 19 December 1972, following consultations with the three new Member States.

4.3.2. The Directive is divided into three main sections: "General principles", "Special provisions applicable during the first stage of harmonization" and "Final provisions".

4.3.3. The most important of the general principles (Articles 1 to 6) are certainly those which stipulate that cigarettes are to be subject in each Member State to a mixed excise made up of a proportional component calculated on the maximum retail price and a specific component calculated per cigarette, that harmonization is to be achieved in stages and that, at the final stage, a single ratio is to be established between the proportional and the specific components in such a way that the range of retail selling prices reflects fairly the range of manufacturers' delivery prices.

4.3.4. Article 5 of the Directive provides "manufacturers and importers shall be free to determine the maximum retail selling prices 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"².

4.3.5. The special provisions (Articles 7 to 10) relate to the first stage of harmonization, which began on 1 July 1973. This stage was initially intended to cover a period of only two years. It was, however, extended on four occasions, so that it finally covered a five-year period. It ended on 30 June 1978.

¹ OJ No L 303 of 31 December 1972

² Being of the view that France had not respected this principle, the Commission instituted infringement proceedings against this Member State. A reasoned opinion was despatched on 31 October 1980. On 15 July 1981, the Commission decided to refer the matter to the Court of Justice.

4.3.6. Of the special provisions, the principal is that, without prejudice to the solution to be finally adopted, the amount of the specific component in each Member State may not be lower than 5% or higher than 75% of the aggregate amount of the proportional excise and the specific excise levied on cigarettes in the most popular price category. Accordingly, during this stage each Member State could opt for any combination ranging from specific component of 5% coupled with an ad valorem component of 95% to a specific component of 75% coupled with an ad valorem component of 25%, provided the amount of the specific component and the rate of the ad valorem component were the same in a given Member State for all categories of cigarettes. In other words, a Member State may not differentiate the excise between categories of cigarettes.

4.3.7. The final provisions (Articles 11 to 13) stipulate that Member States are to bring into force the provisions of the Directive not later than 1 July 1973. However, during the consultations before they joined the Community, the United Kingdom and Ireland requested a derogation for a period of five years. This derogation, which allowed those two countries to defer implementation until 31 December 1977, was incorporated into the Directive. This delay offered Ireland and the United Kingdom time to replace their own systems of taxation, based on the weight of raw tobacco, by the Community system, based on the finished product.

4.4. Council Directive of 19 December 1977¹

4.4.1. This Directive established a second stage of harmonization and amends one of the general principles laid down in the basic 1972 Directive.

¹OJ No L 338 of 28 December 1977, pp. 22 and 23.

4.4.2. With effect from 1 July 1978, the specific component of the mixed excise on cigarettes has had to be determined, not by reference to the total excise burden, as provided for in the basic Directive, but by reference to the total tax burden (excise plus VAT). This change was necessary because VAT, which had meanwhile been introduced in all Member States, has the same effect as a proportional excise in the taxation of cigarettes.

4.4.3. The second stage of harmonization initially covered the period from 1 July 1978 to 31 December 1980. It has since been extended three times and now runs until 31 December 1982.

4.4.4. During this stage, the amount of the specific component, calculated by reference to cigarettes in the most popular price category, may not represent less than 5% or more than 55% of the total tax burden; Member States are required to revise their calculations at least once a year in order to take account of price changes.

4.4.5. Although the 5% figure has not been altered, inclusion of VAT in the calculations from the start of the second stage has accentuated the incidence of the specific component at its lower level. To take an example: assuming a total tax burden of 75% (including VAT at 15%), during the first stage a specific component of 5% (expressed as a proportion of the excise) was equivalent to 3% of the retail price, while during the second stage a specific component of 5% (expressed as a proportion of the total tax burden) is equivalent to 3.75% of the retail price.

4.4.6. The 5-55% bracket has maintained the trend towards a predominantly ad valorem system and is in keeping with the 1970 entry in the Council minutes and with the First Directive of 1972.

4.4.7. The special provisions in force during the first stage, concerning the option to exclude customs duties from the basis of calculation and the level of the minimum excise (which may not exceed 90% of the excise on "popular" cigarettes), were retained.

4.4.8. For reasons of public health policy the United Kingdom was authorized to charge, initially until 31 December 1980 and then until 30 June 1981, an additional excise on cigarettes with a tar yield of 20 mg or more. The United Kingdom made use of this possibility until 14 March 1981, when it abolished the surtax, at the same time raising the cigarette excise across the board.

4.5. Council Directive of 18 December 1978¹

4.5.1. On 18 December 1978, the Council adopted a Directive defining the different types of manufactured tobacco and classifying them into five main categories. The Directive defines the scope of the excise in particular by establishing a precise distinction between cigars and cigarettes.

4.6. Effects of the first two stages: tax structures

4.6.1. As mentioned in Chapter 2, the levels of cigarette tax are generally high in all Member States, ranging at present from 56% to 88% of the retail selling price. The harmonization measures to date have not affected these levels, which are still freely determined by Member States. Moreover, since the sole purpose of harmonizing cigarette excises is to achieve gradual alignment of excise structures, no Member State has reported any effect on tax receipts that could have been attributed to measures taken during first two stages.

¹ OJ No L 10 of 16 January 1979, pp. 8-10.

4.6.2. As regards the excise structures, (see Table 9.4) at present three Member States (Belgium, Luxembourg, France) apply specific components close to the permitted minimum of 5% of the total tax burden. Italy continues to apply a specific component of less than 5% and the Commission has as a result instituted infringement proceedings against this Member State.¹

4.6.3. On 1 January 1980, the Netherlands introduced a specific component equal to 10% of the total tax burden, and Greece introduced a specific component of 12% immediately upon joining the Community. These two countries have thus made an effort considerably greater than the minimum required of them, but in the six Member States referred to above, the proportional component remain markedly predominant.

4.6.4. In contrast, three Member States (United Kingdom, Ireland, Denmark) apply specific components close to the permitted maximum of 55% of the total tax burden. At the outset, Germany applied a specific component to the permitted maximum but it now applies a lower specific component (around 41%) which constitutes a greater effort than has been required. In these four Member States, the proportional components are thus lower than those found in the six other Member States.

4.7. Effects of the first two stages : market structures

4.7.1. Turning to the effects of the first two stages on the markets for cigarettes, tables showing the evolution of consumption, imports and exports in each Member State during the period 1970-1980 are set out in Chapter 7. However, when analysing these tables, it should first be noted that each stage consisted of relatively modest changes in the tax structure, with no direct effect on tax rates or on the level of cigarette prices overall. Secondly, the seven years between the introduction of the first stage in

¹ On 16 May 1980, the Italian Government tabled in Parliament a draft law for bringing this infringement to an end. As this draft law had still not been adopted, the Commission decided on 15 July 1981 to refer the matter to the Court of Justice.

July 1973 and the submission of the proposals for the 3rd stage in July 1980 were marked by major economic changes. In particular, the rapid and sustained inflation suffered by all the Member States had a radical impact on the economies of the Member States, from which the cigarette market was by no means immune and to which it was on occasion especially sensitive.

4.7.2, The impact of inflation on major determinants of the cigarette market - such as taxation, producer costs, disposable incomes - did not take place evenly or in uniform fashion. On some markets at some periods (e.g. France, 1973-1979) substantial increases in incomes in response to generally increased prices were accompanied by unchanged taxes on cigarettes and unchanged producer prices for certain categories of cigarettes. Inevitably, subsequent adjustments in tax incidence and in prices to recover lost ground had very considerable impact on demand overall and on market shares. In other instances, tax incidence was first allowed to decline rapidly, then restored and substantially increased (e.g. Belgium 1973-1980). In these circumstances, separately to quantify the effects on the markets of either or both stages during this period is impossible.

4.7.3. However, in accordance with Article 1(4) of the first directive, the Commission consulted the Member States following the introduction of both the first and second stages and prior to making further proposals. In the first instance, the seven Member States which implemented the first stage (the United Kingdom and Ireland having exercised their derogation) reported that it had not appreciably affected either tax revenues or market conditions.

4.7.4. Six of these seven Member States ¹ (Italy has not yet implemented

¹ Greece implemented the second stage on 1 January 1981, on accession to the Community, by the introduction of a mixed system with a specific element of 12% of total tax. This system is very similar in its effects to the degressive system previously applied by Greece. So far as the Commission is aware, implementation of the harmonised system changed the price structure only marginally, and disturbed neither revenue flow nor the smooth functioning of the market.

the second stage - see paragraph 4.6.2.) - reported similar conclusions following the second stage and that market interpenetration had improved only slightly (although in the case of France, a declining market share of the State producer, as a result of a sharp trend away from dark cigarettes, had led to increased imports both before and after implementation of the second stage in July 1978 (1) - see Table 7.2.). Of course, all seven of these Member States had, before harmonization began, applied either an ad valorem or a specific tax to the finished product. On implementing the harmonized system, all seven had chosen the specific/ad valorem mixture which came closest to their original system. It is therefore not surprising that the effects of the first two stages were in all cases modest, both as regards changes in the price range and interpenetration of markets.

4.7.5. By contrast, significant changes were reported in the British and Irish markets following the implementation of the second stage. As regards prices, the bottom sector of the price ranges, before harmonization, consisted of small cigarettes with a proportionately low tax burden (this being due to the pre-harmonization system of taxing the raw tobacco, tax being thus broadly proportional to cigarette size). On moving to the harmonized system, both Member States opted for a 5% specific element. The switch to a high specific element meant that differences in price between these small brands and king-size brands became negligible; the small brands were gradually withdrawn from the market and the price range on both markets was substantially compressed as a consequence. These small brands accounted for a large proportion of the market share of the major British domestic producer, whose market share consequently declined from roughly two-thirds to about one half of the British cigarette market. It is striking, however, that imports were more or less unaffected, remaining at a low level, around 2% of the total.

¹ On 4 June 1980, the then Minister of the Budget, addressing the French National Assembly, recognized that French consumers were smoking less of dark products and more and more of blond; that, by reference to the 1970 mean, SEITA had lost, in four months, 5% of its market to imported cigarettes; and that to arrest this trend, it was necessary to launch new products, acquire essential know how, and to develop sales of tobacco abroad.

4.7.6. These - admittedly severe - changes were due to a number of special factors. The 5-year derogation meant that the impact of both the first and second stages arrived either at once (in Ireland) or spread over a relatively short time-span (in the United Kingdom, which began implementation before the derogation expired). Moreover, the previous system of taxing the raw tobacco, (i.e. related to the weight of tobacco in the cigarette) contained a significant proportional element, in contrast to a purely specific system based on a fixed sum per cigarette, irrespective of size. Consequently, the least disruptive move, on implementing the harmonized system, would have been towards a specific element considerably below the permitted maximum of 55%. However, as stated above, both Member States opted for a specific element very close to the 55% maximum. Both markets were therefore subjected, not only to a relatively sudden adaptation but also to a more radical change in system than the harmonization directives required.

4.7.7. The severity of the changes on these two markets cannot therefore be attributed merely to the obligation to move to the mixed system, but also and in large measure to the national decisions to move to the upper extreme of that system. Had France, Italy and the Benelux countries made a comparable choice - that is, to move, virtually in one step, from a wholly ad valorem system to a specific element considerably in excess of the permitted 5% minimum specific, it is likely that their markets would also have been seriously disturbed.

4.7.8. In summary, therefore, the first and second stages can be said to have had no untoward effects and to have imposed only modest changes on the markets of the Member States. Such market disturbances as have been observed during the harmonization period - the sharp trend away from dark cigarettes in France and Italy, the sharp compression of price ranges in the United Kingdom and Ireland and changes in market share in the United Kingdom - have been largely due to other factors in the case of France and Italy and, in the case of Ireland and the United Kingdom, to national decisions.

4.8. Proposal for a Council Directive concerning a third stage of harmonization¹

4.8.1. Neither the Council Resolution of 1970 nor the basic 1972 Directive regard the ratio to be established between the specific and the ad valorem component as an end in itself, but simply as a means of striking a fair relationship between the range of retail selling prices and the range of manufacturers' delivery prices (exclusive of tax).

As pointed out in paragraph 4.3.1., this relationship will necessarily depend on the construction put on the word "fair" and must be a matter for negotiation.²

4.8.2. For the first stage of harmonization, the six founder Member States agreed that the specific component was to be equal to between 5% and 75% of the total excise burden. This spread was introduced in recognition of the disproportionate effect that incorporation of a given specific component into an ad valorem system has, in comparison with the incorporation of an identical ad valorem component into a specific system. Bearing in mind that VAT has now been included in the harmonization arrangements, the 5-55% spread adopted for the second stage is roughly equal to a 6-66% spread if, as in the first stage, VAT were excluded. This confirms and even accentuates the original 1 to 5 relationship in in the narrowing process.

4.8.3. For the third stage, the Commission has proposed that the permitted spread for the specific component be compressed once again, to between 10% and 35% of the total tax burden. This further compression is another step along the path followed by Member States in the first two stages; and the new spread lies exactly on the curve joining the current 5-55% spread to a single specific component of 20%, the level which in theory would entail the most equitable distribution of efforts over all national price ranges and would result in a mean range mid-way between the two extremes.

¹ OJ No C 264 of 11 October 1980, p. 6

² The "multiplier" concept loomed large in the talks on future harmonization. It is discussed in detail in Annex II.

4.8.4. In the explanatory memorandum to its proposal (paragraphs 20 and 21), the Commission acknowledges the shortcomings of a partial, theoretical approach, but lists the practical arguments in its favour.

4.8.5. In addition to the main proposal for narrowing the spread for the specific component, the Commission also proposes the following for the third stage:

- abolition of the option of excluding customs duties from the basis of calculation;
- lowering of the ceiling for the optional minimum excise, to 80% of the excise charged on cigarettes in the most popular price category;
- examination of the problems arising in connection with the arrangements for collecting the excise (e.g. tax credits).

5. RAW TOBACCO

5.1. Current situation in the raw tobacco sector

5.1.1. Tobacco accounts for 0.4% of the value of Community agricultural output.

5.1.2. Production of leaf tobacco in the Community of Ten covers about 45% of requirements. In terms of individual varieties, however, there is a large surplus of Oriental tobaccos (for which there is limited demand) and a shortfall in other varieties, (particularly flue cured - see Annex IV, Table 1). Despite the fact that the Community does not meet its own needs, this situation leads it to export up to 30% of its own output, (mainly oriental tobaccos and certain grades of other varieties grown in Italy and Greece).

5.1.3. The total area under tobacco has remained constant for some time (Annex IV, Table 2). Changes in the proportions of the different varieties grown appear to follow changes in demand. Thus the area devoted to light air cured and flue cured tobaccos is increasing, and that devoted to sun cured tobaccos is falling.

5.1.4. The number of tobacco growers has been falling steadily in all the producer Member States in the Community (Annex IV, Table 3). There are currently about 225 000, and the number of permanent farm workers employed in cultivation and in operations prior to the industrial stage can be estimated at about 600 000.

5.1.5. The average holding is not more than 0.8 ha, although this figure has been rising slightly (Annex IV, Table 4).

5.1.6. Income per hectare varies with the variety grown. But income from the same variety also varies from one country to another (Annex IV, Table 5). The average income per annual labour unit in tobacco farming stands at about 50% of the national average income, but the value of the gross yield per hectare is among the highest. Thus the gross marketable production of very small farms would not be sufficient to provide an acceptable family income without the major contribution made by tobacco.

5.1.7. The geographical distribution shows that tobacco growing is localized at two levels:

- (a) within the Community, Italy and Greece each produce about 40% of total Community output;
- (b) within Italy, the regions of Apulia, Campania and Abruzzi produce about 80% of Italian output; in Greece, Macedonia and Thrace produce over 60% of Greek output; in France, practically all growing is concentrated in the départements of the South-West.

The tobacco-growing regions are among the least favoured regions of the Community.

5.1.8. The possibility of switching to other varieties or crops is fairly limited, owing to the small size of farms and the particular climatic and soil conditions. Where soil and climatic conditions are suitable for other crops, farmers may be deterred from switching by the fact that income per hectare of tobacco is a great deal higher than that from possible substitute crops.

5.2. Production and consumption trends

5.2.1. Total Community demand for leaf tobacco is expected to fall gradually, declining from 630 000 tonnes in 1980 to 570 000 tonnes by 1988. This forecast is based on the following factors:

- (a) the growth in sales of filter cigarettes, at the expense of plain cigarettes, and the use of longer-filters;
- (b) the diminution in the diameter of cigarettes, and the use of tobaccos with a greater filling power;
- (c) a fall in cigarette consumption as a result of anti-smoking campaigns and the steady rise in retail prices.

5.2.2. In terms of individual varieties, given the increase in consumption of "American blend" cigarettes, composed mainly of flue cured, Burley and oriental tobaccos (used in small quantities to provide aroma), flue cured and Burley varieties can be expected to be more in demand, at the expense of sun cured (oriental) and dark air cured tobaccos.

5.2.3. Production is currently relatively stable, but it is difficult to say what level it will reach as a result of the accesssion of Greece. However, as stated above, the main difficulty in production is not the total volume produced, for the Community is only 45% self-sufficient, but rather the crop shares of the different varieties grown.

5.2.4. As regards the crop shares, the projected fall in the production of sun cured and dark air cured varieties should be offset by a rise in the output of flue cured and Burley tobaccos. This would allow the current volume of production to be maintained.

5.3. Rules governing trade with non-member countries

5.3.1. The customs tariff on raw tobacco (Annex III) is bound under GATT. Clearance of tobacco imported into the Community from non-member countries is subject only to the Common Customs Traiff (tariff heading No 2401. A: duty of 23%, minimum 28 EUA and maximum 30 EUA per 100 kg; and tariff heading No 2401. B: duty of 14%, minimum 28 EUA and maximum 70 EUA per 100 kg).

There are preferential rates for tobacco imported from ACP countries, associated countries and GSP countries:

- (a) zero duty on imports from ACP and associated countries,
- (b) reduced rate on imports from GSP countries .

Imports from these two sources amounted to about 140 000 tonnes in 1980, out of total imports of about 430 000 tonnes.

5.4. The Premium system

5.4.1. The system of premiums is the result of two factors:

- (a) customs duties on all products subject to market organization are bound under GATT;
- (b) Community prices are higher than world prices, because of structural and labour cost differences (Annex IV, Table 6).

5.4.2. An aid scheme (following the deficiency payments system) has therefore been established, in order to ensure that the norm price is maintained and to guarantee a market for Community produced tobacco. Premiums are normally paid to buyers of leaf tobacco, but in some cases to farmers or associations of farmers if they themselves bale the tobacco. The recipient of the premium must sell the baled tobacco for use in manufacture or for export, unless he carries out these operations himself.

5.4.3. The premium is equal to the difference between the total cost price for Community tobacco in bale and the price of competing tobacco imported from non-member countries. A separate rate of premium is established for each variety of tobacco.

5.5. Cost of premium scheme

5.5.1. The cost of the premium scheme accounts for about 90% of total Community expenditure in the tobacco sector (Annex IV, Table 7).

Guarantee Section expenditure on raw tobacco is estimated at 327 million ECU in 1981, which is 3% of Guarantee Section expenditure and 50% of the value of tobacco production. Expenditure has risen as a result of the accession of Greece, and will probably reach 618 million ECU in 1982.

5.6. Objectives¹

5.6.1. The long-term objectives are:

- (a) to maintain the current volume of production;
- (b) to increase the volume of exports through a more active commercial policy;
- (c) to guide production towards varieties in demand by industry and trade, notably through an inter-trade cooperation agreement, which is already being studied.

5.7. Measures to be taken¹

5.7.1. In order to attain these objectives, the Commission has advanced the following measures:

- (a) Intervention. Action can already be taken under the present regulations to reduce the intervention price if the quantity offered for intervention by an enterprise exceeds 25% of its output. These measures should be continued and if necessary reinforced.
- (b) Conversion. Action can also be taken under the present regulations to pay aids for conversion to other varieties and to reduce the intervention price for certain varieties. Use should continue to be made of these measures.
- (c) Other measures. The element of processing cost, used in calculating the aids for tobacco, should be adjusted. There should be research into the improvement of tobacco varieties.

¹ See the Commission communication "Guidelines for European Agricultures", (COM(81) 608 final, paragraphs 95 and 96).

6. MANUFACTURED TOBACCO MONOPOLIES

6.1. The first adjustments to the systems

6.1.1. Two Community Member States, France and Italy, have State monopolies of a commercial character coming under Article 37 of the EEC Treaty. This Article requires Member States progressively to adjust any such monopolies so as to ensure that when the transitional period has ended, no discrimination regarding the conditions under which goods are procured and marketed exists between nationals of Member States.

6.1.2. When the EEC Treaty came into force, the SEITA (Service d'Exploitation industrielle des Tabacs et des Allumettes) in France and the AAMS (Azienda Autonoma dei Monopoli di Stato) in Italy had sole rights over the production of manufactured tobacco, and the wholesale distribution of domestic and imported manufactured tobacco. In both countries, raw-tobacco-growing was subject to the approval of the State monopoly; in France, retail marketing was subject to State authorization and constituted a State monopoly; in Italy, authorization for retailing was granted by the AAMS through the issue of licences.

6.1.3. During the transitional period, both France and Italy took a series of measures to open their markets to manufactured tobacco products from other Member States. At that time, the products were purchased firm by the State monopolies and resold at prices that were fixed at the monopolies discretion. On the recommendation of the Commission, Italy and later France introduced excise duties on manufactured tobaccos and imposed trade margins at wholesale and retail levels, discontinuing the practice of firm purchase. Both systems of excise duties were ad valorem; France in addition applied different rates to dark tobacco and blond tobacco, to the distinct advantage of the former.

6.1.4. Following action by the Commission, this distinction was gradually eliminated. Italy was obliged to reduce the rate of proportional excise duty considerably, in an attempt to combat contraband. Acting on recommendations by the Commission, both Member States also opened import quotas for manufactured tobaccos from other Member States, and gradually increased them.

6.2. Recent developments

6.2.1. Although Article 37 of the EEC Treaty requires Member States progressively to adjust any State monopolies by the end of the transitional period (31 December 1969), the Council adopted a Resolution on 21 April 1970 under which France and Italy undertook to relinquish by 1 January 1976 the State's sole rights for the importation and wholesale distribution of manufactured tobacco from other Member States.¹ France passed a law and the implementing decrees in 1976, but Italy, having adopted a similar law before the end of 1975, never promulgated the necessary implementing decrees.

6.2.2. Allowing for the different situations in the two countries and in the light of the new case law of the Court of Justice in the field, the Commission has initiated infringement proceedings against France and Italy since 1976. These proceedings referred also to other aspects of the monopoly systems which the Commission considered incompatible with the requirements under Article 37 of the EEC Treaty. As regards Italy, mention should be made of the system for setting up and operating wholesale warehouses and the system of payment for tax stamps.

6.2.3. As regards the sole retailing rights, the Commission has criticised, among other things, the nationality requirements imposed by the French and Italian monopolies on tobacconists, the lack of autonomy of tobacconists in relation to the State, and the compulsory setting of uniform trade margins.

¹ It should be noted that the Court of Justice has ruled that the maintenance beyond the transitional period of the sole right of importation of products from other Member States is incompatible with the provisions of Art. 37, which Article is directly applicable since 1.1.1970 (judgment of 3.2.1976, given in case 59/75, Manghera).

6.2.4. As France and Italy were not prepared to comply with its reasoned opinion, the Commission decided on 28 October 1981 to take the matter before the Court of Justice. However, this decision was subject to a short delay in application, in order to permit final efforts to find solutions to the remaining problems. These attempts having met with largely positive results, the Commission therefore decided to suspend the infringement procedure against France. This decision took into consideration undertakings given by the French Government that legislation and other measures would put an end to aspects of the monopoly regime considered by the Commission to be incompatible with Article 37 of the EEC Treaty, by the end of 1983. It will be recalled that the aspects covered included fixed retail margins; the freedom for the producer to decide where he will market his products; the ensuring of the commercial independence of the State-licensed retail-outlets and the allocation of publicity space in these latter. As regards Italy, undertakings were obtained covering the conditions for the payment of tax-stamps; the opening and operating of wholesale warehouses and the packaging of products. The sole question remaining to be brought before the European Court is thus that concerning the fixing of retail margins.

6.2.5. Against this background, and in the light of the case law of the Court of Justice on monopolies, in particular its judgment of 30 March 1979 in case 91/78 (Hansen), the Commission has been examining the effects on competition of the marketing policies of the French and Italian manufacturing monopolies. More specifically, the matters at issue are the retail selling price of Gauloise cigarettes, distribution costs in Italy and the selling prices of MS and Nazionali cigarettes, the brands with the biggest sales on their respective markets.

6.2.6. In the case referred to, the Court held that "any practice by a State monopoly which consists in marketing a product with the aid of public funds at an abnormally low resale price compared to the price before tax of products of comparable quality imported from another Member State is incompatible with Article 37 (1) of the EEC Treaty."

6.2.7. The Commission has found that the financial results of both monopolies, which showed a profit until a few years ago, now show a substantial loss. (According to the French Government, this is largely due to the unusually heavy costs imposed by the large number of pensioned staff).

Balances on the profit and loss accounts for the SEITA have been as follows : (1) (2) (3)

1973 : + FF 41 million
 1974 : + FF 0.4 million
 1975 : + FF 0.5 million
 1976 : - FF 7.6 million
 1977 : - FF 161.6 million
 1978 : - FF 302.6 million
 1979 : - FF 236.1 million
 1980 : - FF 147.8 million (9 months)

The results of the AAMS have been as follows : (2) (3)

1977 : + Lit 8 500 million
 1978 : + Lit 23 200 million
 1979 : - Lit 21 000 million
 1980 :

¹Source: Annual reports of the SEITA.

²Source: Annual reports of the AAMS and Libro bianco sulla riforma dei Monopoli di Stato.

³ Given the different presentation of the financial results of the two monopolies, it is probable that the respective results are not comparable from one country to the other.

6.3. Market trends

6.3.1. In this context, it should be noted that the market shares of both the SEITA and the AAMS are steadily declining on their respective markets.

6.3.2. In France, the share of national output (including manufacture under licence) in total national consumer sales has declined as follows: ¹

1974 : 91.6% (91.9% of value)
 1975 : 90.9% (about 84% of value)
 1976 : 89.6% (83.3% of value)
 1977 : 86.9% (79.8% of value)
 1978 : 83.9% (72.8% of value)
 1979 : 79.2% (70.2% of value)
 1980 : 72.4% (60% to 62% of value)

In 1980, the share of blond and dark tobaccos in the French cigarette market was as follows : ²

manufacturer	Volume share of market	
	Dark tobacco %	Blond tobacco %
SEITA	66.98	5.69
Others	-	23.58

(the remaining 3.75% represents minor brands not included in the calculations).

¹ Source: Annual reports of the SEITA

² Source: Le Nouvel Economiste of 9 February 1981, p. 43.

6.3.3. The figures for Italy are as follows (in volume): (1)

1977	:	70.9%	;	including production under licence:	77.8%
1978	:	67.6%	;	including production under licence:	75.0%
1979	:	60.9%	;	including production under licence:	71.3%
1980	:	61.6%	;	including production under licence:	71.7%

The cigarette with the highest sales, (MS) introduced a few years ago by the monopoly and accounting for 35.8% of consumption in 1980, is manufactured from blond tobacco. The AAMS recently introduced another blond tobacco cigarette, the MS internazionale, intended to compete with high-quality foreign products.

6.4. Distribution and sales

6.4.1. The distribution and sale of manufactured tobacco is organized along similar lines in the two Member States with tobacco monopolies. By virtue of exclusive contracts with producers from the other Member States, the SEITA and AAMS are virtually the sole distributors and retailers of both national and imported manufactured tobacco. In this way, they still have a de facto monopoly at the wholesale stage, the retail monopoly being held de jure by the State in both countries.

¹ Source: Annual reports of the AAMS and "Libro bianco sulla riforma dei monopoli di Stato".

7. PRODUCTION AND CONSUMPTION OF MANUFACTURED TOBACCO

7.1. Production

7.1.1. Production of cigarettes takes place in all ten Member States. In Italy and France, the State exercises a production monopoly (See Chapter 6). Table 7.1 shows the evolution of production from 1970 to 1980. Between 1970 and 1976, production increased by about 25 % to about 560.000 mio pieces, but has since stabilised at this level. However, since 1976, the pattern of production between the Member States has varied considerably (see also Section 2 below). Production has fallen in Ireland, France and Denmark by 22.9 %, 16.3 % and 5.8 % respectively. By contrast, production has increased in the Netherlands, Germany and Belgium/Luxembourg by 31.5%, 8.9 % and 6.1 % respectively. In the remaining Member States, the changes since 1976 have been less than 5 %. Nevertheless, in all Member States, production in 1980 was higher than it was in 1970, although in three Member States (France, Ireland and Denmark) the present trend is sharply downwards.

7.2. Importation/exportation

7.2.1. The evolution in the Member States of total imports and exports, as well as intra-Community imports and exports, is shown in Tables 7.2 and

7.3. Taken as a whole, the ten Member States imported in total, including intra-Community trade, in 1980 about 5 times more cigarettes than in 1970. Total exports were about three times the 1970 level, due to the fact that exports to third countries, which accounted for more than half of total exports in 1970, only increased by about 55 %.

7.2.2. Due to the very high external tariff (see Annex III) the Community cigarette market is virtually closed to third country imports. (In fact, Table 7.2 shows that the Netherlands in 1980 imported more than 6.000 mio

TABLE 7.1.

Production of cigarettes in the Member States (in mio pieces)

	1970 ¹⁾	1976	1978	1980	% change in production from 1976 to 1980
	mio	mio	mio	mio	%
B } LUX }	20.800	24.942	24.695	26.454	6,1
DK	8300	9794	9265	9223	- 5,8
D	129700	147722	152400	160926	8,9
F	69900	86546	80856	72478	-16,3
GR	17000	22900 ¹⁾	24900 ¹⁾	21903	- 4,4
IRL	5600	9600 ¹⁾	7600 ¹⁾	7400 ¹⁾	-22,9
IT	71600	73645	71585	73105	- 0,7
NL	23100	30408	35200 ¹⁾	40000 ¹⁾	31,5
UK	111100	159000	151525	156050	- 1,9
ALL MS	457100	564557	558026	567539	0,5

Source : Members States and ¹⁾EUROSTAT

pieces. However, these figures relate to the importation of cigarettes made in a third country from temporarily exported materials. This practice, which ceased in 1980, arose from a temporary shortage of Community production capacity). Excluding the Netherlands figures, imports from third

TABLE 7.2.

Importation of cigarettes from EEC and other countries

Member States	Import from	1970 ¹⁾	1976	1978	1980	Change from 1976 to 1980 in %
B + LUX	EEC	mio 2397	mio 2249	mio 2198	mio 2047	% - 8,9
	OTHER	2	5	0	8	60,0
	TOTAL	2399	2254	2198	2055	- 8,8
DK	EEC	324	461	444	159	-65,5
	OTHER	468	281	305	1	-99,6
	TOTAL	792	742	749	160	-78,4
D	EEC	466	1382	1382	1651	19,5
	OTHER	175	88	121	370	320,5
	TOTAL	641	1470	1503	2021	37,5
F	EEC	4467	8405	13347	22692	170,0
	OTHER	42	30	11	13	-56,7
	TOTAL	4509	8435	13358	22705	169,2
GR	EEC	10	NA	NA	328	-
	OTHER	11	NA	NA	29	-
	TOTAL	21	77	NA	357	363,6
IRL ¹⁾	EEC	84	356	318	293	-17,7
	OTHER	28	32	18	4	-87,5
	TOTAL	112	388	336	297	-23,5
IT	EEC	3292	18.653	22.420	27863	49,4
	OTHER	291	11	1	0	-100,0
	TOTAL	3583	18.664	22.421	27863	49,3
NL	EEC	1799	8313	10843	12733	53,2
	OTHER	35	54	262	6440 ³⁾	11825
	TOTAL	1894	8367	11105	19173	129,2
UK	EEC	297	1400	2235	2408	72,0
	OTHER	643	600	600	400	- 33,3
	TOTAL	940	2000	2835	2808	40,4
TOTAL	EEC	13.136	41.219 ²⁾	53.187 ²⁾	70.174 ³⁾	69,5 ²⁾
	OTHER	1.755	1.101 ²⁾	1.318 ²⁾	7.265 ³⁾	
	TOTAL	14.891	42.397	54.505	77.439	82,7

Source : Member States and ¹⁾ EUROSTAT

2) excl. Greece

3) Almost the whole of the Netherlands figure is accounted for by materials temporarily exported and subsequently re-imported as finished cigarettes. This practice, which ceased in 1980, was due to a temporary shortfall in Community production capacity.

TABLE 7.3.

Exportation of cigarettes to EEC and other countries

Member States	Export to	1970 ¹⁾	1976	1978	1980	Change from 1976 to 1980 in %
		mio	mio	mio	mio	
B + LUX	EEC	3.363	7.358	10063	10297	40,0
	OTHER	0	208	850	718	245,2
	TOTAL	3.363	7.566	10913	11.015	45,6
DK	EEC	100	419	509	646	54,2
	OTHER	1666	737	786	754	2,3
	TOTAL	1766	1156	1295	1400	21,1
D	EEC	3658	16194	22204	27783	71,6
	OTHER	1344	2031	5620	3821	88,1
	TOTAL	5002	18225	27824	31604	73,4
F	EEC	2833	2498	2175	3670	46,9
	OTHER	962	5119	4921	7149	39,7
	TOTAL	3795	7617	7096	10819	42,0
GR	EEC	6	NA	NA	2	-
	OTHER	28	NA	NA	16	-
	TOTAL	34	82	NA	18	-78,0
IRL ¹⁾	EEC	153	470	379	983	109,1
	OTHER	677	1314	1247	1005	-23,5
	TOTAL	830	1785	1626	1988	11,4
IT	EEC	80	68	79	141	107,4
	OTHER	34	130	304	253	94,6
	TOTAL	114	198	383	394	99,0
NL	EEC	4543	9776	19814 ¹⁾	29583 ¹⁾	202,6
	OTHER	1430	351	587 ¹⁾	534	52,1
	TOTAL	5973	10127	20401 ¹⁾	30117 ¹⁾	197,4
UK	EEC	3036	7000	8510	13687	95,5
	OTHER	17750	19000	20160	23230	22,3
	TOTAL	20786	26000	28670	36917	42,0
TOTAL	EEC	17.772	43.783 ²⁾	63.733 ²⁾	86.792	98,2
	OTHER	23.891	28.890 ²⁾	34.475 ²⁾	37.480	29,7
	TOTAL	41.663	72.755	98.208 ²⁾	124.272	71,0

Source: Member States and ¹⁾EUROSTAT¹⁾ Excl. Greece

Discrepancies between the import and export figures for trade between Member States are in large measure due to exports to third countries via other Member States being incorrectly regarded as intra-Community trade and partly due to duty-free traffic.

countries in 1980 represented less than 0.2 % of total Community consumption of cigarettes. By comparison, in the same year, exports from the Community to third countries accounted for 6.6% of total production.

7.2.3. The footnote to Table 7.3. explains that export figures from one Member State to another are not wholly reliable. For this reason, measures of market interpenetration are based on the import figures, which are not in general subject to any significant margin of error. Table 7.4., which sets out imports and exports as a percentage of consumption, shows that intra-Community trade in cigarettes has increased considerably in recent years. This now accounts for about 13.7% of total consumption, as compared to about 7.9 % in 1976. Imports in 1980 of cigarettes by Member States from elsewhere in the Community range from 1.5 % of consumption in Germany to 55.4 % in the Netherlands. (The import figures for France should be qualified by a reminder that the State production monopoly prevents other manufacturers from operating in France. This is also the case in Italy, although AAMS produces 10.1 % of total consumption under licence for other producers.).

7.2.4. Also expressed as a percentage of consumption, 1980 exports range from zero in Greece to 128.8 % in the Netherlands. So far as intra-Community trade is concerned, most of the Member States are net exporters, led by the Netherlands, Belgium/Luxembourg, and Germany. Italy is the biggest net-importer, with 28.3 % of consumption covered by imports and exports of only 0.1% of consumption. The pattern for France is very similar, with imports at 26.5 % and exports at 4.3 % of consumption, giving a net-import figure of 22.2 %.

TABLE 7.4.

Market interpenetration and 3rd Country exports

Member States	Import from or export to	Import 1980 mio	Import in % of consumption	Export 1980 mio	Export in % of consumption	Net Export in % of consumption
B + LUX	EEC	2.047	10,4	10.297	52,4	42,0
	OTHER	8	0,0	718	3,6	3,6
DK	EEC	159	2,3	646	9,2	6,9
	OTHER	1	0,0	754	10,7	10,7
D	EEC	1.651	1,3	27.783	21,7	20,4
	OTHER	370	0,3	3.821	3,0	2,7
F	EEC	22.692	26,5	3.670	4,3	- 22,2
	OTHER	13	0,0	7.149	8,3	8,3
GR	EEC	328	1,5	2	0,0	- 1,5
	OTHER	29	0,1	16	0,1	- 0,1
IRL ¹⁾	EEC	293 ¹⁾	3,9	983 ¹⁾	13,1	9,2
	OTHER	4 ¹⁾	0,1	1.005 ¹⁾	13,4	13,3
IT	EEC	27.863	28,3	141	0,1	- 28,2
	OTHER	0	0,0	253	0,3	0,3
NL	EEC	12.733 ²⁾	55,4	29.583 ¹⁾	128,8	73,3
	OTHER	6.440 ²⁾	28,0	534 ¹⁾	2,3	- 25,7
UK	EEC	2.408	2,0	13.687	11,2	9,3
	OTHER	400	0,3	23.230	19,1	18,7
TOTAL	EEC	70.174 ²⁾	13,7	86.792	16,9	
	OTHER	7.265 ²⁾	1,4	37.480	7,3	

Source: Member States and ¹⁾ EUROSTAT

²⁾ See footnote ³⁾ Table 7.2.

7.3. Consumption

7.3.1. The number of cigarettes taxed in the Member States is taken as the measure of consumption. These figures are given in Table 7.5. They show that the trend of consumption is steadily downwards in the United Kingdom and Denmark. These are also the countries with the highest price levels (see Chapter 10). The Belgian and Luxembourg figures are misleading, because it is believed that a substantial proportion of cigarettes taxed in Luxembourg are in fact consumed in other M/S. The combined figures show a slightly downwards trend. Consumption in Germany has changed very little between the two years 1976 and 1980, but fell somewhat in 1978. In both Italy and France the trend is upwards considerably - see also Chapter 10 - with the relatively low price levels in these Member States. The Irish and Dutch figures, whilst inadequate to establish clear downwards trends, nevertheless show that both markets have ceased to expand in recent years.

7.3.2. The consumption of cigarettes per head in 1970, 1975 and 1980 is shown in Table 7.6. Substantial increases took place between 1970 and 1975, but then became more or less stabilised at the 1976 levels. In six of the Member States, consumption decreased between 1975 and 1980 (and fell sharply in Ireland) whereas a substantial increase took place in Greece and in Italy. It is striking that, although the United Kingdom had the second-highest tax level in 1980, it also enjoyed the second-highest cigarette consumption per head, the highest consumption being in Greece, which has the lowest tax incidence (see Chapter 9).

7.3.3. Finally, Table 7.7 shows the evolution in the market share of filter cigarettes. In all Member States, there is a pronounced trend towards filter cigarettes, although the filter share differs considerably. At present, the filter share is lowest in France (61% in 1980) and highest in the United Kingdom (93%). It seems likely that the trend over time will be for filter cigarettes to account for almost the whole of the Community cigarette market.

TABLE 7.5.

Taxed cigarettes in the Member States

	1976	1978	1980	Change from 1976 to 1980 in %
	mio	mio	mio	%
B	19.630	15.980 ¹⁾	16.956 ¹⁾	- 13,6 ¹⁾
DK	7.820	7.401	7.026	- 10,2
D	129.097	123.342	128.353	- 0,6
F	81.268	82.478	85.651	5,4
GR	NA	NA	22.260	-
IRL	NA	7.656	7.518	-
IT	89.737	88.821	98.608	9,9
LUX	579	1.972 ¹⁾	2.680 ¹⁾	362,9 ¹⁾
NL	22.523	23.463	22.975	2,0
UK	135.000	125.690	121.931	- 9,7
ALL M.S.			513.958	

Source: Member States

¹⁾ Although no precise figures can be given, it is believed that a substantial proportion of cigarettes taxed in Luxembourg are in fact consumed in neighbouring Member States (in particular, Belgium).

TABLE 7.6.

Cigarette consumption per head

	1970	1975	1980	% change from 1970 to 1980
				%
B + LUX	2000	2150	2040	2,0
DK	1490	1710	1630	9,4
D	2069	2090	2160	4,4
F	1390	1660	1650	18,7
GR	1930	2400	2720	40,1
IRL	1630	2470	1680	3,1
IT	1400	1640	1800	28,6
NL	1460	2260	2140	46,6
UK	1640	2580	2450	49,4
Weighted average	1653	1996	2037	23,2

Source : EUROSTAT

TABLE 7.7.

Consumption of filter cigarettes as % of total
consumption of cigarettes

	1974	1976	1978	1980
B + LUX	72,2	77,2	79,1	81,7
DK	52,6	56,6	60,6	62,1
D	84,8	86,4	87,2	88,2
F	53,8	59,3	58,3	61,2
IRL	80,1	81,3	85,0	87,0
IT	87,5	85,0	86,7	N.A.
NL	49,0	54,0	57,9	65,0
UK	84,5	88,1	90,5	93,0
GR	84,4	86,9	NA	NA

Source : Maxwell International Estimates - Fedetab, Seita

7.4. Consumer expenditure on manufactured tobacco

Table 7.8 below shows the proportion of consumer expenditure devoted to manufactured tobacco.

TABLE 7.8

Tobacco expenditure as % of consumer expenditure

	1970 %	1975 %	1979 %
B	2.1	1.8	1.7
DK	4.7	3.6	NA
D	2.4	2.9	1.8
F	1.2	1.1	1.0
GR	3.5	2.9	2.4
IRL	6.8	5.5	NA
IT	2.8	2.3	2.0
LUX	1.8	1.5	NA
NL	2.8	2.3	2.5
UK	4.6	3.6	3.3

Source: EUROSTAT

The table shows that notwithstanding substantial variations between the Member States in the tobacco elements in consumer expenditure, there is a steady downwards trend in eight of the ten Member States, and in the remaining two countries (Italy, Netherlands) the proportion in 1979 was somewhat lower than in 1970.

8. EMPLOYMENT ASPECTS

8.1 Introduction: statistical problems

8.1.1 While ideally an examination of employment statistics at Community level should be based on harmonized data, in practice the difficulties in collecting such data at Community level for all Member States with a sufficient degree of accuracy and contemporary relevance make this approach untenable. Statistics exist at the level of the International Labour Office, but these are more widely based, and do not provide the degree of detail required. The Commission has therefore been obliged to adopt a more pragmatic approach. The co-operation of trade unions and industrial associations was enlisted both at Community and national level in order to collect the relevant data. This method naturally involved certain risks regarding accuracy: in many cases the information from different sources in the same Member States conflicted, depending on the reference month, regions covered, inclusion of unemployed trade union members or not, etc. Similarly, although the same source is used for data for each country in reviewing past trends, the source may vary from country to country. Overall data for the Community are therefore subject to significant margins of error, and may only be used as indicators of orders of magnitude.

8.2 Employment trends in the Community tobacco industry

a) General pattern

8.2.1 Bearing in mind the comments above, the pattern of employment in the manufacture of tobacco products can be said to have shown a general decline in the latter half of the seventies as reflected in the table:

Year	B (a)	DK(a)	D (c)	F (a)	I (a)	IRL(b)	NL (b)	UK (b)	EC
1975	8 100	3 000	26 700	11 700	13 100	2 200	10 600	42 600	118 000
1980	6 800	2 300	25 400 ¹⁾	10 200	14 200	2 000	9 000 ¹⁾	47 900	107 800
change 1975-80	-1 300	-700	-1 300	-1 500	+1 100	-200	-1 600	-4 700	-10 200
% change	- 16%	- 23%	- 5%	- 13%	+ 8%	- 9%	- 15%	- 11%	- 8,6%

1) est.

Source: (a) Tobacco trade unions
(b) Tobacco industry associations
(c) Statistical Office of EC

8.2.2 In the Community as a whole (excluding Greece and Luxembourg, for which it was not possible to obtain information) the number of workers employed fell during 1975-1980 by a total of 10 200, representing an 8,6% drop in employment. Most Member States registered a gradual fall in employment in this sector, although fluctuations in an upward direction took place in the Federal Republic of Germany and Italy during the reference period. However, even in Italy (still showing more workers employed in 1980 than in 1975) the current trend is downwards. Discussions with trade union representatives in November 1981 indicated that a further decline in employment would be recorded for 1981 varying from 1% in Italy to as high as 17% in Denmark.

b) Female employment

8.2.3 The breakdown of the labour force by sex was not available for every country, but the information provided showed that in Belgium, for example, the drop in employment between 1975 and 1980 was wholly at the expense of women: the number of male workers actually increased, although women still account for 60 % of the work-force (mainly in manual grades). Similarly, in the United Kingdom the number of male workers was the same in 1980 as in 1975, while female employment dropped by over 20 %, but still accounts for over 50 % of the work-force (nearly 60 % in 1975). In Denmark the proportion of

female workers is over 80 %. One is thus led to conclude that reductions in employment in the tobacco manufacturing industry have been largely achieved at the expense of women, who nevertheless still comprise a substantial proportion of the labour force. Whether any further losses in employment in the industry would affect women more than men remains to be seen.

c) Employment in cigarette and cigar manufacture

8.2.4 Given the integrated nature of much of the industry in the Community, the precise proportion of the tobacco manufacturing workforce involved in the production of cigarettes and cigars is difficult if not impossible to quantify. However, in Denmark only 7,5 % of the workforce is involved in cigarette production, in Ireland and the Netherlands the proportion is around 30 %, in Belgium around 37 %, while in the Federal Republic of Germany it can be assumed to be nearly 70 %. As regards cigars, in France between 12 % and 13 % of the workforce is engaged in their production (not counting those involved in administration, research, distribution, etc.). In Belgium and the Netherlands approximately 20 % work in cigar and cigarillo production, while in Denmark the proportion is 46 % (over 90 % of which is female employment).

d) Employment in distribution and sales

8.2.5 No accurate statistics are available on the number of people employed in the distribution and sale of tobacco products. Few industrial or trade union sources were able to supply any detailed information. In a report prepared in 1979⁽¹⁾ it was indicated that in 1976/77, 6000 wholesalers were involved in the distribution of tobacco products in the Community with 168 900 special retail outlets, of which almost 90 % were in France, Italy and the United Kingdom (respectively 46 000, 61 000 and 43 600). A further complicating factor regarding Italy is the special phenomenon of smuggled

(1) Agence Européenne de l'Information, Brussels

tobacco, which in 1979 was estimated to account for $\pm 18\%$ of total turnover⁽¹⁾, and 35% - 40% of the internal market⁽²⁾. This situation constitutes a severe problem for the Italian authorities since several thousand families in the Mezzogiorno earn their living in this way.

In the 1976/77 period it was estimated that over 500 000 people were employed in the distribution network⁽³⁾, but there has been some thinning out of specialised retailers since then (in the Netherlands there has been more than a 20% reduction in the number of specialised retailers since 1976, and in France around a 5% reduction). Such employment figures must therefore be treated with reserve. Tobacco products are sold in supermarkets, newsagents, kiosks, restaurants, bars etc., in combination with a wide range of other goods. Only by gathering statistics on the proportion of the outlets' turnover accounted for by tobacco products could one hope to assess the degree of importance such sales represent for employment. For the present purposes it is not considered that such an exercise would be cost effective.

8.3 Reasons for the decline in employment

8.3.1 Various reasons have been advanced for the decline in employment in the tobacco manufacturing sector:

- The general economic climate and high levels of unemployment have had a depressive effect, especially on cigarette sales at the cheaper end of the market. Slow growth in incomes, or even negative growth, especially among the unemployed, is a considerable factor in the reduction in cigarette consumption among individuals, or a total abstention from smoking in an attempt to reduce consumption of non-essentials.

(1) La Voce del Tabaccaio - November 1980

(2) "Marketing & distribution of tobacco" - United Nations - UNCTAD-1978, p.74

(3) Agence Européenne de l'Information, Brussels.

- The vigorous anti-smoking health campaigns run in many countries are also believed to lower consumption, coupled with a growing recognition among the public of the medical dangers associated with smoking.
- In a number of Member States, and consistently with anti-smoking policies, tax incidence (see Chapter 9) has increased sharply in recent years, with consequential effects on prices, consumption, production and employment.
- At the company level, a frequent response to tax increases has been increased price competition, leading to plant re-organisation, the increasing use of new technologies, more modern equipment, faster machines⁽¹⁾ and smaller crewing⁽²⁾; these have all contributed to plant closures and employment cut-backs. In general, average wages in tobacco manufacturing have at best kept pace with, or fallen behind, the overall level of wage increases in manufacturing industry in recent years.

8.3.2 However, the Commission notes (See Table 7.1 - Production) that the overall level of Community production of cigarettes in fact increased by 23,5 % between 1970 and 1976 and marginally between 1976 and 1980. This suggests that the factor immediately above has been principally responsible for the reduced level of employment in the industry.

8.4 Measures to deal with reduced employment

8.4.1 The reduced employment prospects in the industry have been dealt with in various ways in the Member States for which information is available.

a) Early retirement

8.4.2 A measure commonly used is that of early retirement which is used in one form or another in most countries. In the Federal Republic of Germany, the national scheme for early retirement at 63 for men and 60 for women is

(1) Machines producing up to 10 000 cigarettes per minute are now becoming available. This compares with an average production rate for the Community of 5 000 per minute.

(2) Virtually automatic machines are also under trial.

supplemented in the tobacco industry by the opportunity to leave two years earlier. This can be done either by continuing to work half-time on full pay (20 hours per week instead of 40) or by leaving completely with a pension equal to 75 % of the final wage, maintenance of social security contributions and the normal retirement pension after 2 years. Whenever a plant closure is envisaged, national legislation requires schemes to be negotiated between trade union and employer representatives in order to fix redundancy compensation. In France it is possible to retire at 56 years and 2 months with a 2-year bonus. The scheme is particularly popular with women, but the eligible age range is almost exhausted and to continue the scheme much further would require a drastic reduction in the age range. In the United Kingdom, early retirement is possible at 60 but without any State support. In Belgium, in addition to general early retirement provisions (62 for men and 58 for women), some company agreements have provided for early retirement at 60 for men and 55 for women; however, such agreements have been little used in the tobacco industry. In Denmark, there is a national early-retirement scheme in the form of a voluntary extra wage (ATP), a scheme run by the trade unions. It provides for early retirement from 60 onwards on relatively generous terms.

b) Other social measures

8.4.3 In addition to early retirement, the decline in tobacco employment has been handled in Member States through various other methods; natural wastage and no new recruitment, shorter working hours, part-time and short-time work; however, it is not possible to give any detailed indication of the extent of such schemes.

c) Diversification

8.4.4 As regards the diversification of production and employment out of tobacco products, experience varies between Member States. In the Federal Republic of Germany, tobacco multinationals have in the past extended their base of operations by buying-up firms in other sectors; textiles, food

processing, breweries. However, this has not created many employment prospects for ex-tobacco workers, largely due to poor employment opportunities in the sectors concerned, but also because of tobacco workers' lack of mobility and relevant qualifications. In the United Kingdom manpower planning agreements have been negotiated between trade unions and the four major tobacco firms which in theory enable ex-tobacco workers to undertake training and re-training with a view to finding employment in one of the firms' subsidiaries. In practice, due to the economic climate, the lack of job opportunities in the non-tobacco subsidiary firms have made the agreements somewhat ineffective. In Belgium, previous attempts at diversification by tobacco firms were not successful, although currently experiments are being undertaken in the pharmaceutical sector and in the production of filters. In France, diversification is at present impossible given the statute of the French tobacco manufacturing concern (until recently a monopoly and now a public company). The French trade unions are in favour of broadening the production base, possibly by the extraction of protein from tobacco for human and animal consumption.

8.4.5 There is in general a reluctance among tobacco trade unions to countenance diversification into other sectors or types of product in view of the likely outflow of investment resources from the tobacco sector, resources which, in the trade union view, should remain within the sector.

8.5 Tax harmonization and tobacco employment

a) Tax rates and tax structure

8.5.1 As a preliminary comment, a distinction has to be drawn between the effect on employment in the tobacco manufacturing industry of policies relating to the absolute levels of taxation and those relating to the establishment of a harmonized tax structure.

8.5.2 As regards tax rates, the policy aim of the majority of the Member States, and of the Commission, is in particular to maintain or to increase the incidence of taxation on cigarettes, in order to reduce smoking overall. This policy (quite apart from the effect of any other policy measures or economic factors) is likely over time to reduce the Community market for cigarettes and implies, all other things being equal, some reduction in the overall levels of employment in the industry as a whole. (Such a downwards trend has been demonstrated, and its underlying reasons discussed, in Sections 8.2 and 8.3 above).

8.5.3 By contrast, harmonization of the tax structures leaves Member States free to fix the tax rates they consider appropriate. Obviously, as a major aim of harmonization is interpenetration of markets, structural harmonization may well lead to changes in the shares held by individual producers, whether in national markets, or in the Community market as a whole. But harmonization of the tax structures will not materially affect the size of the Community market and should not therefore affect the overall level of employment in the industry.

8.5.4 It is difficult to quantify the effects on employment of individual tax increases, but one example is in the Federal Republic of Germany where the last excise duty increase in cigarettes took place on 1.1.1977.. Cigarette consumption fell in 1977, which was estimated to have an effect on production and employment in 1976 and 1977; between 1976 and 1977 employment in the cigarette industry regressed by 0,7 %.. In the United Kingdom a 7½ % increase in tax on cigarettes in 1975 (prior to any harmonization of tax structure) was followed by a 4,2 % reduction in employment. Large tax increases in 1981 are expected to depress 1981 sales by 9 % below those in 1980, with a further consequent reduction in employment. Reports from other countries have suggested that consumption is sensitive to price increases, by as much, in the case of cigars, as a 1,5 % fall for a 1 % increase. (The effects of price changes on demand are more fully discussed in Chapter 11 - Market stability).

b) Harmonization of the excise structure

8.5.5 The trade union organisations reiterated their support for tax harmonization. However, no common view emerged from consultations with trade unions as to the effects which further harmonization would have on consumption, production or employment. Moreover, none of the trade union or producer organisations consulted were able to provide quantitative indications, either of continuing with the present approach of harmonizing on the basis of fixing the specific element as a proportion of total tax, or of following the alternative approach of harmonizing the ad valorem element as a proportion of retail price. Nor was it possible for them to provide any information as to the likely impact on employment of a suggested range of multipliers.

8.5.6 The trade union organisations nevertheless placed on record that the introduction of a tax based on a percentage of the retail price could serve as an alternative approach and expressed doubts whether the harmonization of excise duties could remain in line with the principle of neutral competition by a levy on the retail price or an increase in the proportional taxation.

8.6 Conclusions

8.6.1 Employment in the manufacture of tobacco products (including sales and distribution) represents approximately 0,6 % of total employment in the Community (excluding Greece), although, as indicated, the sales network is by no means wholly dependent on tobacco products. Employment in this sector has shown a steady decline in recent years, in a climate of public concern over the effects of smoking on health, increases in tax incidence and above all in response to a very rapid technical evolution.

8.6.2 It will doubtless be argued that in a situation of high and growing unemployment the Community's prime concern must be to help maintain employment wherever possible in individual sectors rather than presiding over its decline. However, as regards the tobacco sector, the noxious effect on health, not only of smokers themselves but also of those subject to secondary inhalation cannot be ignored. Public health considerations must be the major priority, and in this vein the Commission espouses policies aimed at reducing the level of tobacco consumption, particularly cigarettes. Ideally, the Commission would prefer to see employment maintained in tobacco manufacturing companies while these companies diversified into other less harmful products. However, experiences to date have not been encouraging; in the current economic climate diversifying to any sector runs certain risks and is by no means certain to provide comparable employment opportunities. This is as true for other manufacturing sectors as it is for the tobacco industry. The Commission is not convinced, though, that sufficient effort or research has been allocated to the search for new product ranges; in at least one country there are legal restrictions on diversifying out of tobacco products. More progress needs to be made on the problem of training and retraining tobacco workers for other occupations, and of tobacco firms ~~assisting~~ them to find alternative employment outside the tobacco sector. The high proportion of female workers in the sector, and their consequent employment vulnerability, is a cause for concern and should obviously bear heavily on the type of training or retraining needed.

8.6.3 Against this background, the impact of harmonization of the tax structure can only have a marginal effect, if any, on the overall level of employment in the sector. The relative importance of the ad valorem and the specific element (i.e. the size of the multiplier) could perhaps affect the ability of tobacco firms to fund additional research, training/retraining schemes, diversification, etc., in order to lessen the dependence of employment on the manufacture of tobacco products. For high-cost

producers, a high specific system would exercise relatively less pressure on costs than a high ad valorem system, and could therefore arguably leave these manufacturers with more resources to fund such operations. However, the Commission would point out that the reverse would be true for low-cost producers. Moreover, there could be no guarantee, even if a relatively high specific system were chosen, that tobacco firms would follow such a course and indeed trade union opposition has already been voiced to the notion of diversifying externally (see paragraph 8.4.5 above).

9. TAX INCIDENCE, RECEIPTS AND PRESENT TAX STRUCTURES

9.1. Incidence

9.1.1. "Tax incidence" on cigarettes means the total tax (excise + VAT) as a percentage of retail price. The mixed taxation system for cigarettes has the effect (see Chapter 11) that tax incidence on cigarettes more expensive than those in the most popular price category will be lower than the incidence on cheaper cigarettes. For the purposes of this study, therefore, the most appropriate guide to the evolution of tax incidence is that on the most popular price category in each of the Member States.

9.1.2. In Table 9.1. is set out the tax incidence on cigarettes in the most popular price category in all Member States - except Greece - since 1.7.1973 and every second year. In the last column is shown the change in the tax incidence during the 8-year period. The same information is shown in the form of a graph on the following page.

9.1.3. In the period from 1.7.73 to 1.7.79, changes in tax incidence were modest, compared with those which took place in the next two years. The trend has not been the same in all Member States. In the two countries with state production monopolies - Italy and France - and in Germany the incidence fell by up to 5.9 % points in Italy, whereas it increased in all the other "old" Member States, by up to 6,9 % in Ireland and up to 7,1 % in Belgium.

9.1.4. The general level of tax incidence followed the same trend. From July 1973 to July 1979, the average tax incidence (excluding Greece) was between 70,0 and 70,7 %. By August 1981 this average had increased to 72,7 % (71,1 % including Greece - where tax incidence is 56,2 %).

TABLE 9.1.

TOTAL TAX AS % OF RETAIL PRICE ON CIGARETTES IN MOST POPULAR PRICE CATEGORY

	1.7.73	1.7.75	1.7.77	1.7.79	1.8.81	Change 1.7.73 to 1.8.81 in % points
	%	%	%	%	%	
BELGIUM	64,6	67,2	68,7	71,3	71,7	7,1
DENMARK	83,3	85,4	86,2	88,5	87,7	4,4
GERMANY	72,5	70,3	70,6	70,3	70,3	- 2,2
FRANCE	75,3	72,5	72,5	72,8	72,8	- 2,5
IRELAND	62,0	62,0	62,0	60,6	68,9	6,9
ITALY	78,8	74,4	73,7	73,1	72,9	- 5,9
LUXEMBOURG	61,0	60,8	61,1	61,5	63,5	2,5
NETHERLANDS	67,5	67,1	66,7	69,2	72,7	5,2
UNITED KINGDOM	70,0	70,0	70,0	69,0	74,1	4,1
Average 9 old MS	70,5	70,0	70,2	70,7	72,7	
Standard deviation	7,63	7,31	7,40	8,06	6,45	
GR	(1)	(1)	(1)	(1)	56,2	
Average all MS	N/A	N/A	N/A	N/A	71,1	

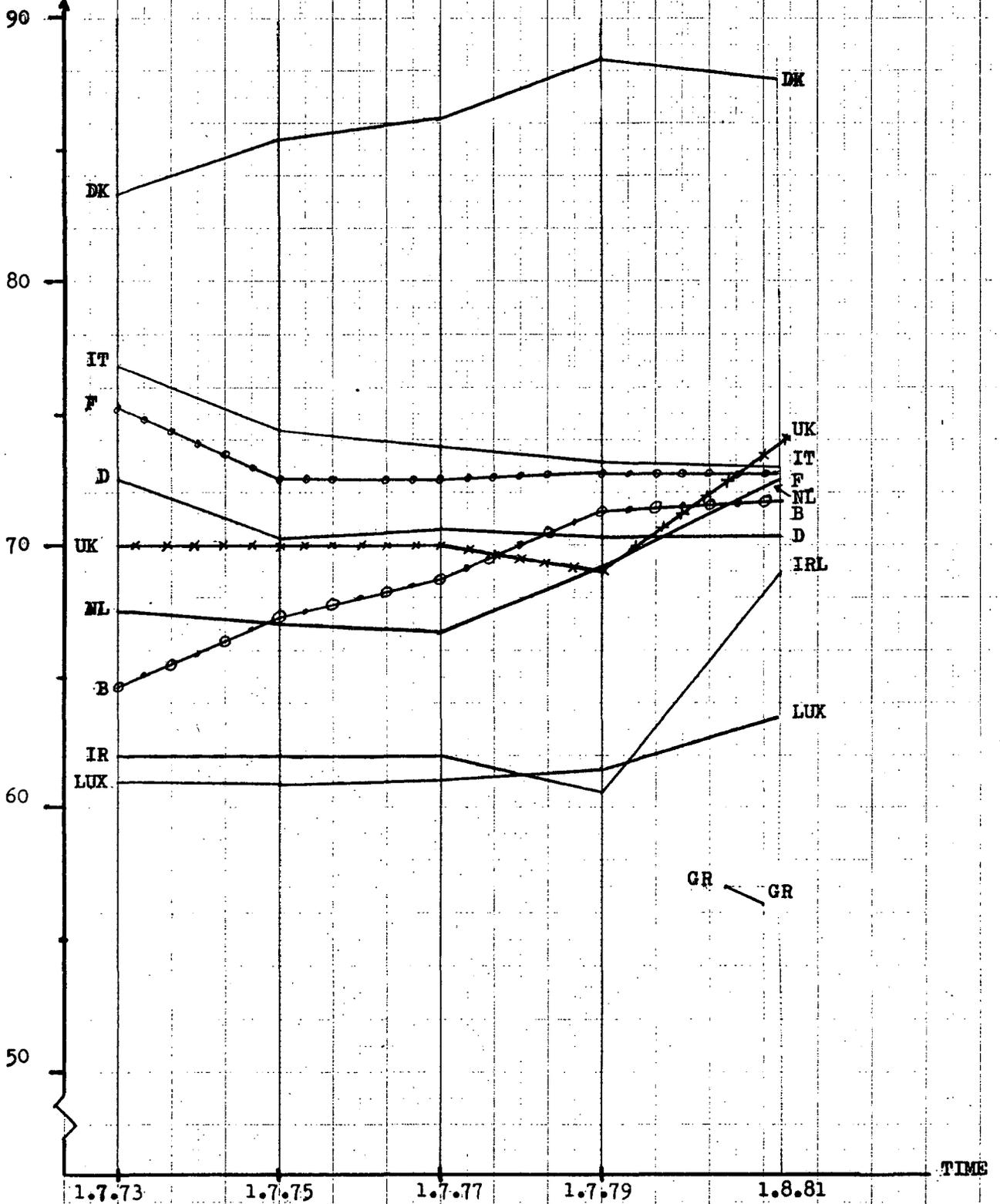
Source : Member States

(1) The Community system was introduced in Greece on 1.1.1981.

GRAPH 9.1.

Total tax as
% of retail
price

EVOLUTION OF TOTAL TAX INCIDENCE ON CIGARETTES
(in most popular price category)



Source: Member States.

The present economic situation and health policy considerations suggest that this level of tax incidence will be at least maintained and probably increased

9.1.5. One important result of the successive enlargement of the Community in 1973 and 1981 was a marked increase in the range of tax incidence between the Member States. Immediately prior to the 1973 enlargement, the range for the Six was from 61,0 % (Luxembourg) to 78,8 % (Italy). The accession of Denmark increased the upper figure considerably to 83,3 %, which has since further increased to 87,7 %. The accession of Greece in 1981 reduced the lower figure to 56,2 %. Consequently, the Greek and Danish tax incidences have markedly increased the overall range ⁽¹⁾. **Excluding the Greek and Danish figures, the range of incidence would be much narrower than in 1973, from 63,5 % (Luxembourg) to 74,1 % (United Kingdom).**

9.1.6. The standard deviation in tax incidence as indicated in Table 9.1. shows the effect of the changes in tax incidences which have taken place in the last 8 years, in leading to convergence or divergence of tax rates. The trend has been markedly convergent since 1979, with a standard deviation reduced from 8,1 to 6,5.

9.2. Tax receipts

9.2.1. Consumer expenditure on tobacco and the tax incidence are the two factors determining tax receipts. In Table 9.2. are shown the total receipts from manufactured tobacco for 1970 and 1978.

(1) In Spain, the tax incidence is currently 52 % at most.

TABLE 9.2.

Tax receipts from manufactured tobacco

	1970		1978	
	Tax receipts in nat. currency mio.	As % of total tax receipts & social contrib. %	Tax receipts in nat. currency mio.	As % of total tax receipts & social contrib. %
B	7679	1,75	16445	1,23
DK	2141	4,48	4043	3,03
D	6536	2,79	10459	2,06
F	4351	1,56	5915	0,71
GR	N.A.	N.A.	N.A.	N.A.
IRL	50,5	9,83	88,77	4,23
IT	771.709	4,46	1497700	2,06
LUX	283	1,68	984	1,81
NL	886	1,91	1620	1,23
UK	1150	5,96	2153	3,85

9.2.2. As the table shows, the excise duty on tobacco products is a valuable revenue source for government in all the Member States, although its relative importance varies considerably - in 1970 about 10 % of Ireland's total tax receipts came from the tobacco duty, whereas in France it only represented 1,6 % of the total. Between 1970 and 1978, the tobacco excise in all Member States except Luxembourg fell in importance as a revenue source but still counted for 1 % to 4 % in all the Member States except France, where the figure was 0,7 %. It is of interest that in general the tax receipts from the tobacco excises account for a greater part of revenue in the Member States with relatively high specific elements on cigarettes than in those where the specific element is low.

9.2.3. In Table 9.3. is shown the percentage of total revenue from tobacco products yielded by the excise and VAT on cigarettes. In 1980, 82 % to 99 % of the revenue came from cigarettes, a part which seems to be growing in most Member States. Also shown in the same table is the evolution of revenue from cigarettes between 1976 and 1980, together with the evolution of the consumer price index. Although the growth of receipts from cigarettes exceeded the price index in four Member States, it is striking that in other cases the growth in receipts fell behind the price index, notwithstanding declared policies to limit smoking. In most Member States the 1980-revenue was within 5 - 10 % of the 1976 revenue except in Luxembourg and the Netherlands where it increased by more than 50 % and 20 % respectively. Consumption of cigarettes is of course also a relevant factor (see Chapter 7). If the figures were adjusted for the evolution in cigarette consumption, then the situation would have been as indicated in brackets in the final column.

9.2.4. Table 9.3. shows the uneven effects of inflation on tax receipts from cigarettes between the Member States. In its report on the scope for convergence of tax systems in the Community ⁽¹⁾, the Commission drew attention (in paragraphs 84-86) to the fact that all the Member States, in the period 1973-79, had allowed some or all of their excise rates to fall, relative to the general price level. As shown in the table, the cigarette excise was no exception. It is sometimes argued that such erosion of the excise base in an inflationary situation can be countered by ensuring the highest possible ad valorem component in the harmonised excise. In fact, this is a considerable over-statement. By its very nature, the mixed system must result in some erosion of tax receipts if rates are unchanged when prices increase. Of course, the degree of erosion will be less, the lower the specific element in the tax total : nevertheless, the erosive effect will always be present and will require regular increases in the

(1) Bulletin, Supplement 1/80.

TABLE 9.3:

Tax receipts: cigarettes and all manufactured tobacco

	1976			1980			Consumer price index		Tax receipts on cigarettes 1980 deflated by (7) (8) in % of (2) and in brackets regulated for consumption
	Total tax receipts from manufactured tobacco incl. VAT nat. currency	Tax receipts from cigarettes incl. VAT		Total tax receipts from manufactured tobacco incl. VAT nat. currency mio	Tax receipts from cigarettes incl. VAT		1976	1980	
		in nat. currency	in % of (1)		in nat. currency	in % of (1)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
B	17131	15639	91,3	22.286	20.505	92,0	109	136	105 (123)
DK	4010	3470	86,5	5682	5044	88,8	109	164	97 (108)
D	11.118	10.784	97,0	13605	13125	96,5	104	122	104 (105)
F	7538	6679	88,6	12102	11117	91,9	110	165	111 (105)
GR	N.A.	N.A.		15399	15281	99,2	113	213	-
IRL ¹⁾	97,538	± 89,7	92,0	147,6	137,1	92,9	118	193	93 (-)
IT	1424698	1381957	97,0	2579511	2502126	97,0	117	213	99 (83)
LUX	1,131	1086	96,0	2109	2056	97,5	110	134	155 (33)
NL	1.642	1300	79,2	2366	1940	82,0	109	135	120 (118)
UK	2.040	±1795	88,0	2934	2640	90,0	117	196	88 (97)

± Commission estimate

1) excl. VAT

tax rate, proportionate to price increases, if the tax yield is to be maintained over time. If maintenance of tax yield is the prime consideration, the appropriate solution, in the Commission's view, lies in some form of indexation of the tax rate.

9.3. Present tax structure

9.3.1. The total tax on cigarettes consists of three components : a specific amount per unit, a proportional excise levied on tax-inclusive retail price, and VAT. At present, Member States are free to fix each of the three components as they see fit, but are obliged to ensure that at least 5 % and not more than 55 % of the total tax is expressed as a specific amount per cigarette. The tax structure applied on 1.8.81 in all the Member States to the most popular price category of cigarette is shown in Table 9.4, broken down into the three tax elements.

9.3.2. Table 9.4. also shows the part of the retail price going to the producer and distributor. The table shows that the relationship between the production and distribution share of the non-tax portion of retail price tends to vary with the tax incidence. Where the total tax incidence is about 70 % of retail price, the non-tax portion is broken down into roughly two-thirds (about 20 % of retail price) for producers and one-third (about 10 % of retail price) for distributors. Where tax incidence is substantially above 70 %, the distribution share rises as a proportion of the non-tax portion. (In Denmark, the extreme case, with a tax incidence of about 86 %) the split between production and distribution is roughly equal). Where tax incidence is substantially below 70 %, the distribution share falls. In Greece, at the bottom extreme, the distribution share is less than one quarter of the non-tax portion.

Table 9.4.

"Popular" cigarettes (20) : Price and tax structure : Situation at 1.8.1981

Member State	Retail selling price		TAX PORTION							NON-TAX PORTION					
			Excise duty		Total Excise duty %	VAT %	TAX TOTAL		Spec. component of exc. duty as % of tot. tax	TOTAL		Share accounted for by manufacturer		Share accounted for by distribution (wholesale + retail)	
	in national currency	in EUA	Spec. (1000 cigs.) in nat. currency	Ad. val (% of retail price)			%	EUA		%	EUA	%	EUA	%	EUA
(ECU at Monday 3.8.1981)															
BELGIUM (44,1441)	38	0,861	68	62,42	66,00	5,66	71,66	0,617	4,99	28,34	0,244	18,89	0,163	9,45	0,081
LUXEMBOURG (44,1441)	27,20	0,616	53	57,55	61,45	2,00	63,45	0,391	6,14	36,55	0,225	25,95	0,160	10,60	0,065
NETHERLANDS (2,80014)	2,60	0,929	9,45	50,72	57,99	14,7	72,69	0,675	10,00	27,31	0,254	17,31	+0,161	+10,00	+ 0,093
FRANCE (5,98231)	3,40	0,568	6,19	43,56	47,20	25,6	72,80	0,414	5,00	27,20	0,154	19,20	0,109	8,00	0,045
F.R. GERMANY (2,52346)	2,857 (3DM per 21 piece)	1,132	41,00	30,10	58,80	11,50	70,30	0,796	40,82	29,70	0,336	19,75	0,224	9,95	0,112
ITALY (1250,39)	700	0,560	518	56,20	57,68	15,25	72,93	0,408	2,03	27,07	0,152	19,07	0,107	8,00	0,045
DENMARK (7,93878)	17,10	2,154	410,00	21,68	69,63	18,03	87,67	1,888	54,70	12,33	0,266	6,14	0,132	6,19	0,134
U.K. * (0,553070)	0,95	1,718	19,03	21,00	61,06	13,04	74,10	1,273	54,06	25,90	0,445	17,36	0,298	8,54	0,147
IRELAND (0,691718)	0,89	1,287	16,80	22,10	59,78	9,1	68,88	0,886	54,81	31,12	0,401	+ 22,12	+0,285	+ 9,00	+ 0,116
GREECE (61,6072)	27,00	0,438	82,08	50,16	56,24	-	56,24	0,246	10,81	43,76	0,192	33,76	0,148	10	0,044

*at 7.9.1981

Source: Member States

+ Commission estimate

10. PRICE RANGES AND MARKET STRUCTURES

10.1.1. The price range for cigarettes is determined by a number of factors - such as the relative and absolute price differences in ex-factory prices, the tax structure (high or low specific component as a proportion of total tax) and the tax incidence.

10.1.2. Table 10.1. shows in national currency three price categories - cheapest, most popular and most expensive-for each Member State. Column (4), which shows the most expensive price category as a percentage of the cheapest category, is intended as an index of the price ranges. Only price categories which represent more than 1 % of the market have been taken into account in preparing this column. The figures clearly show the wide variation between Member States; Ireland and Italy are at the two extremes, the most expensive cigarette costing respectively 10 % and 500 % more than the cheapest. It is striking that the price range index is in general lower for the high-specific countries (DK, UK, IRL and D) than for the high-ad valorem countries (the rest).

10.1.3. Column 5 shows the total multiplier (see Annex II) for each of the Member States. The correlation between the total multiplier and the price range index is shown in Graph 10.1. Italy and Greece apart, there is a significant correlation between the two variables. (The correlation coefficient is 0,77 if Italy and Greece are excluded from the calculation and 0,55 if they are included.) The graph also indicates the existence of two broad groups. One group manifests narrow price ranges and small multipliers, and the other, much wider price ranges and considerably higher multipliers.

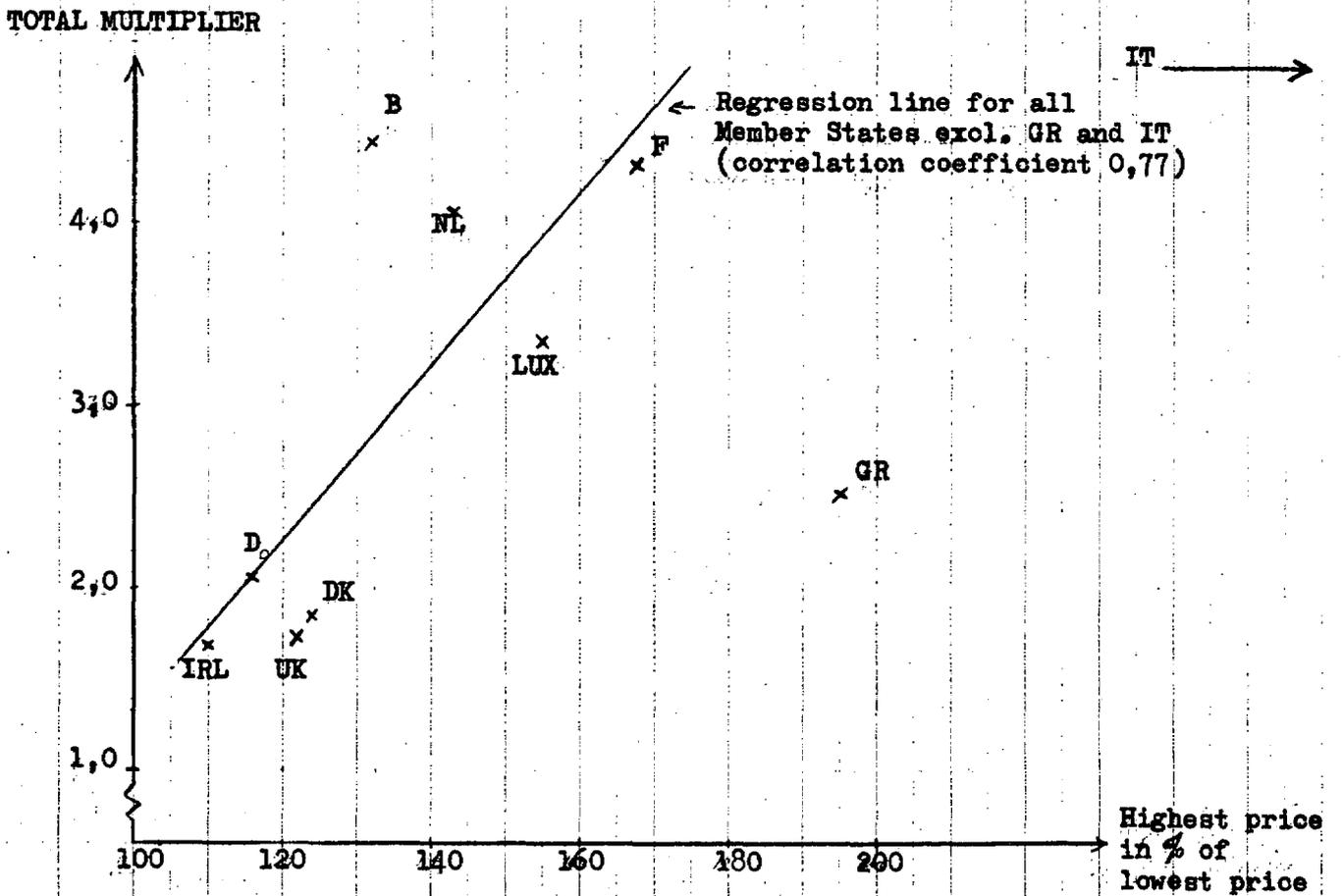
Price range for cigarettes

Member State	Price categories ¹⁾ in national currency			Highest price (3) in % of lowest price (1)	Total multiplier
	Lowest	Most popular	Highest		
	(1)	(2)	(3)	(4)	(5)
B	38	38	50	132	4,45
DK	16,90	17,10	20,90	124	1,85
D	2,75	2,85	3,20	116	2,06
F	3,40	3,40	5,70	168	4,32
GR	19	27	37	195	2,51
IRL	0,83	0,89	0,91	110	<u>±</u> 1,69
IT	200	700	1200	600	4,87
LUX	25,60	27,20	39	155	3,35
NL	2,28	2,60	3,25	143	4,07
UK	0,90	0,95	1,10	122	1,74

± Commission estimate

1) Price categories with a market share less than 1% are not taken into account.

GRAPH 10.1.



10.1.4. Also shown on Graph 10.1. is a regression line for all the Member States except Italy and Greece. The regression line offers some indication of the likely area of encounter between the two groups, in terms of the total multiplier and price range index. It can be seen that this area lies around a total multiplier of 3 and a price range index of about 135.

10.1.5. This picture of the price ranges in the Member States ignores both the relative market shares of particular price categories within each price range, and the position of the most popular price category, relative to the two extremes of the price range. This information is set out in Graph 10.2 and 10.3.

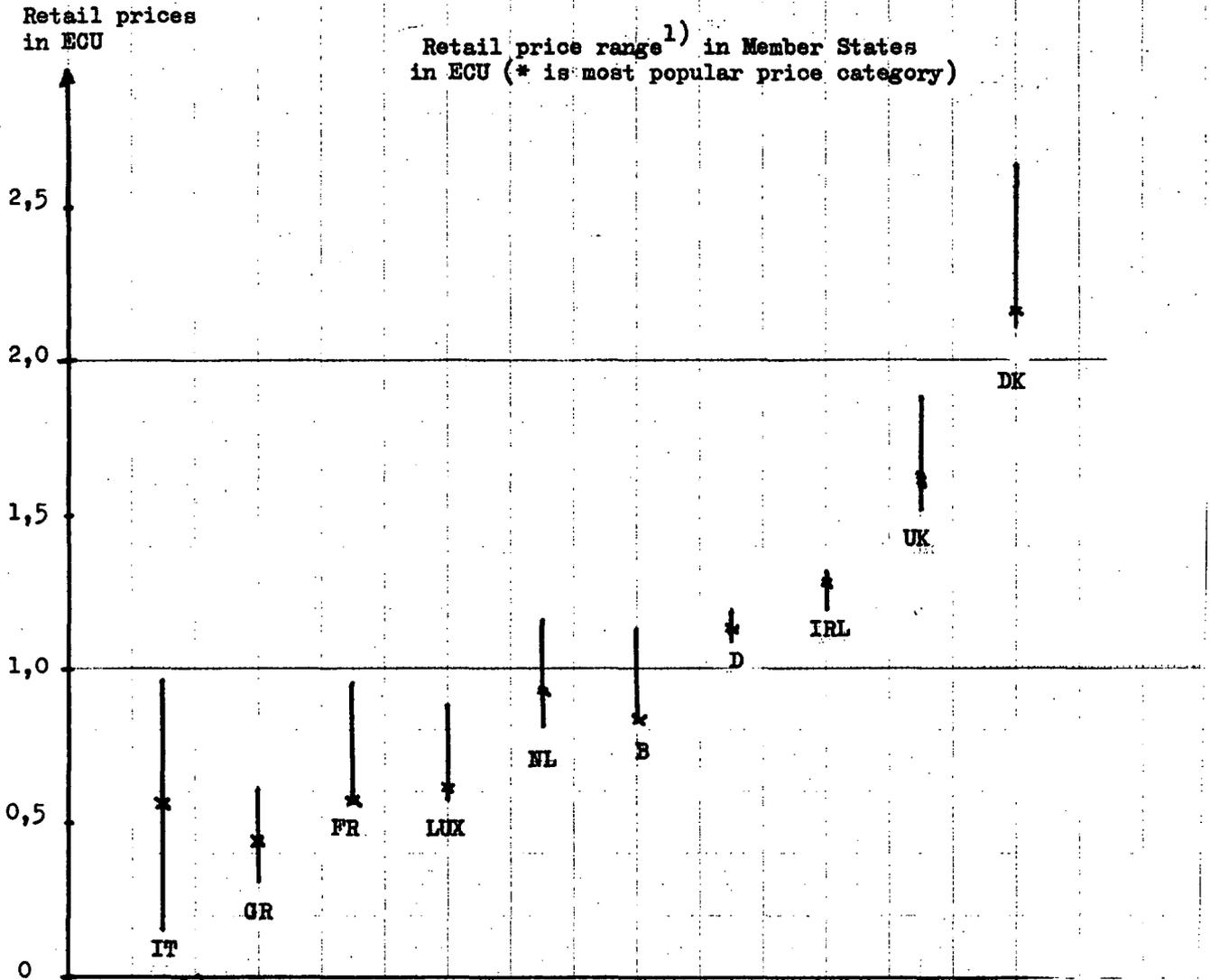
10.1.6. Graph 10.2. shows, in ECU, the price range in each Member State with an indication (x) of where the most popular price category is placed within this price range. The Member States are shown in ascending order from the lowest absolute price category. The graph provides an overall picture, both of the price ranges within the Community and of the relative prices of cigarettes sold on different markets. For example, the cheapest cigarette in Denmark costs about four times the most expensive cigarette in Greece.

10.1.7. The market shares and distribution of individual price categories are set out in Graph 10.3. With the exception of Italy, all the Member States show a tendency for the greater part of the market to be claimed, either by the most popular price category alone, or by this category and those very close to it in price. The effect is most pronounced in the "high specific" Member States (Denmark, Ireland, Germany, and the United Kingdom) where almost the whole market is found at, or close to, the most

popular price category. The effect is in general considerably less pronounced in "high-ad valorem" Member States, such as Belgium, Netherlands, Luxembourg, Greece and France, where not only the price range overall, but also the distribution of different price categories over the price range is considerably greater. Italy shows a considerable number of distinct price categories, all with a certain market share. (As regards prices charged by the French and Italian state producers, see also Chapter 6, section 6.2.).

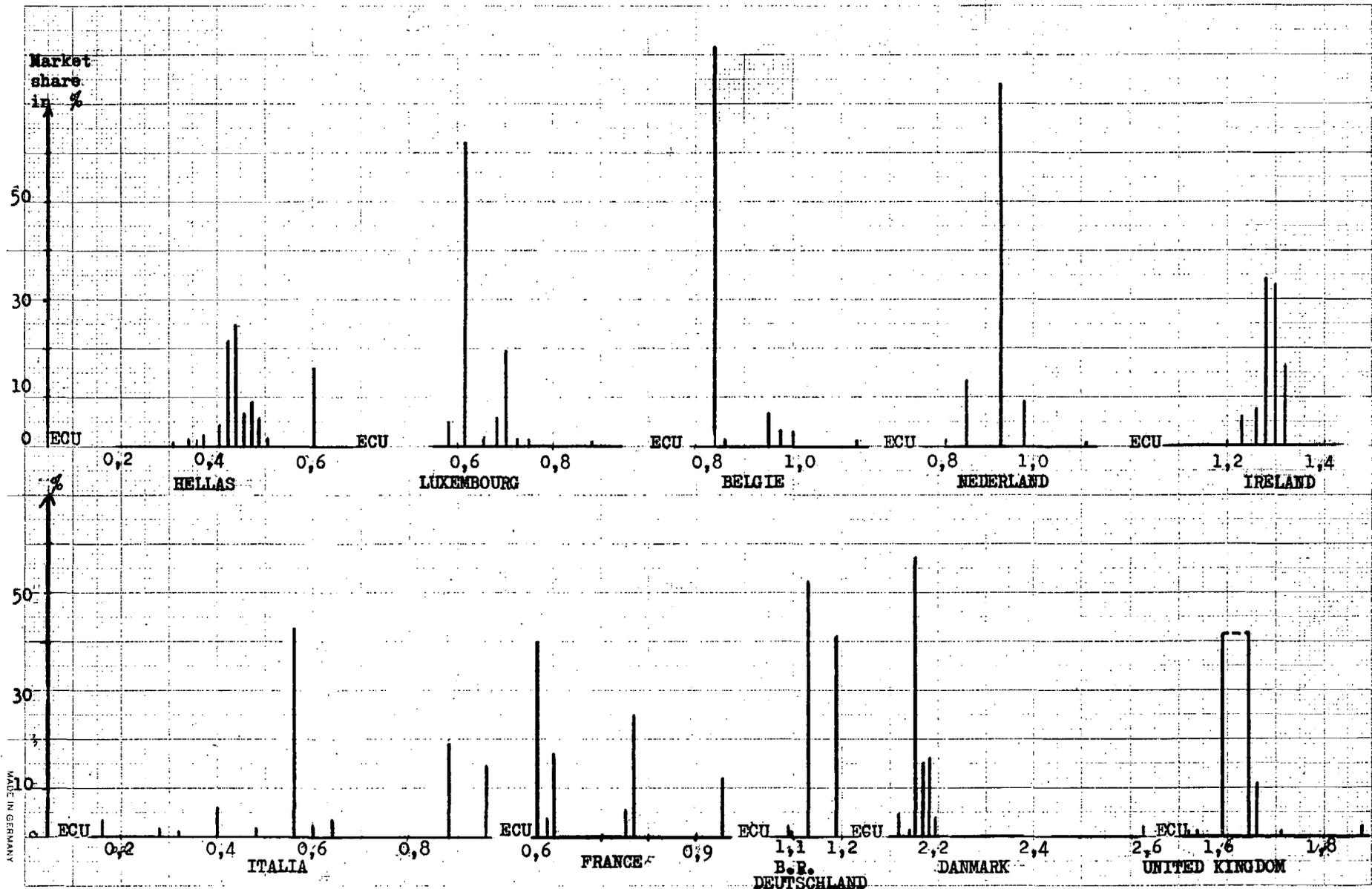
10.1.8. In so far as price range and substantial market shares for different price categories are a guide to consumer choice, the implication of this pattern is that consumer choice is in general relatively greater on those markets at present subject to relatively high ad valorem tax structures.

GRAPH 10.2.



(1) Price categories representing less than 1 % market share not taken into account.

Market shares and distribution in Member States
(retail prices in ECU)



11. AN ALTERNATIVE APPROACH TO HARMONIZING THE CIGARETTE EXCISE

11.1 The proposals of the Economic and Social Committee

11.1.1 In 1976⁽¹⁾ and 1981⁽²⁾, in its opinions on the Commission proposals for the second and third stages, proposals for an alternative approach were put forward by the Economic and Social Committee. For ease of reference, these proposals are set out in extenso in Annex I together with the arguments on which they are based and the reactions to the proposals of the Commission and of the Economic and Monetary Affairs Committee of the Parliament.

11.1.2 In essence, the alternative proposals would replace the present approach to harmonizing the cigarette excise (which consists of arriving, at the final stage of harmonizing the excise structure, at a fixed ratio between the specific and ad valorem components in the tax total) by an approach which consists of fixing the ad valorem tax components as a proportion of retail price.

11.1.3 The central difference between the two approaches is as follows:-

- The present approach, whilst harmonizing the ratio between the specific and ad valorem elements in total tax, does not harmonize the tax multiplier⁽³⁾; this will continue to vary, with the overall tax incidence in each Member State, until tax rates are fully harmonized.

(1) OJ C 240 of 30.8.1976, p. 1

(2) OJ C 138 of 9.6.1981, p. 47

(3) A detailed explanation of the tax and total multipliers is set out in Annex II. This difference between the present and alternative approaches is also examined later in this chapter, in Sections 11.5 and 11.6.

- The alternative approach harmonizes the tax multiplier, whether or not tax rates are harmonized. Once the ad valorem elements are harmonized as a fixed percentage of retail price then, whatever the differences in tax incidence at the time and whatever changes in incidence take place in the future, the tax multiplier will invariably remain the same. This is due to the fact that differences in total tax incidence and future changes in incidence will only be possible via different specific elements. As the specific element is included in retail price and as the relationship between retail price and the ad valorem components is a harmonized constant, the tax multiplier is also a harmonized constant, whatever the total tax incidence. (As the distribution margin, which is also included in retail price, varies from one Member State, and from one commercial situation, to another, the total multiplier cannot become a harmonized constant, unless the distribution margin were itself to be harmonized. In the view of the Commission, such harmonization of the distribution margin is neither desirable, nor permitted by the Treaty).

11.1.4 The Commission has indicated in its third stage proposals that it envisages that the present approach should result in a specific element of the order of 20 % of total tax and an average total multiplier of about 3. No figure has as yet been proposed by the Economic and Social Committee for the ad valorem components as a percentage of retail price (although see also Section 11.7 below).

11.1.5 Before commenting in detail on the specific conclusions of the various opinions, it is perhaps useful to consider the issues raised by the two approaches in rather more general terms. (It should be made clear from the outset that the discussion which follows is confined to the relative merits of the present and the alternative approach as means of achieving a harmonized mixed system, and does not seek to consider whether other

systems - such as a wholly ad valorem or a wholly specific - are more, or less, desirable from the competition standpoint, since any other system has been excluded by the adoption of the mixed system as the basis for harmonization).

11.2 Competition

11.2.1 Much of the debate on harmonization of the cigarette excise, particularly in recent years, has focussed on whether the approach followed to date, or the alternative approach, could be expected to achieve a greater degree of competitive neutrality.

11.2.2 Five preliminary comments should be made on the competition issue. First, no tax achieves competitive neutrality: whatever system or structure is chosen for the taxation of a category of substitutable goods, the mere imposition of the tax inevitably alters in some degree the preferences of consumers from those which existed in the non-tax situation. Consequently, the structure of any given tax will, in strictness, favour certain goods within a taxed category relative to others in that category (e.g. a specific excise tending to favour expensive products relative to cheap, or an ad valorem excise tending to favour cheap products relative to dear). The direction and degree of bias in a given tax structure is not a theoretical but a political choice, reflecting collective social and economic priorities.

11.2.3 Secondly, by far the greatest contribution made by tax harmonization (both of structure and rates) in reducing distortions of competition (see Annex V) is that made by the establishment of a single tax structure. This is not to say that any tax structure will be as neutral in its effects as any other: nevertheless, the competitive neutrality offered by any one harmonized tax structure relative to any other is marginal, by comparison to the neutrality offered by the establishment of either one as the basis of a single harmonized system.

11.2.4 Thirdly, as regards the choice of tax structure to apply, it should be remembered that cigarettes are probably one of the most homogeneous products in international trade and the scope for free-of-tax price competition is therefore relatively limited. In the typical case, 70 % of the retail price of a cigarette is accounted for by tax and roughly 10 % by the distribution margin. Typical production costs are therefore 20 % or less of retail price⁽¹⁾. There are of course variations in the price of raw tobacco, cigarette paper, filters, packaging etc., and there are in addition variations in the relative efficiency of production plant and in labour costs. Nevertheless, differences in the ex-factory costs of cigarettes produced in the Community rarely exceed a factor of 1 to 2. These differences between the production costs of cigarettes are very small, relative to differences between the production costs of other heavily taxed consumer goods, such as, for example, spirits.

11.2.5 In the case of spirits, the production costs of a quality cognac are up to 10 times those of grain whiksy. There are, in addition, considerable variations in production costs even between different brands and varieties of the same drink - for example, between brandy and cognac, between cognacs of different quality, and between blended and malt whiskies. These differences in production costs reflect, not merely differences in packaging or in the brand image of the product, but substantial differences in the raw materials used (ranging, for example, from potatoes to maize and to grapes), in the methods of production (ranging from continuous, virtually industrial processes to traditional, labour-intensive methods involving the production of small quantities at a time) and from substantial differences in the ageing to which the products have been subjected. Consequently, the application of a wholly

(1) Untypically low ex-factory prices have been notified to the Commission in respect of cigarettes produced in France and Italy. The prices are under examination by the Commission from the standpoint of Article 37 of the Treaty (see paragraphs 6.2.5 - 6.2.7).

specific excise to spirits (as proposed by the Commission in April 1972⁽¹⁾), although tending to favour the more expensive product, nevertheless results in a wide range of retail prices, thus ensuring vigorous price competition.

11.2.6 By contrast, the relatively narrow range of production costs of cigarettes, if similarly subject to a wholly specific tax at the high tax rates generally prevailing, would result in a very narrow retail price range. Moreover, producers would have only limited incentives to compete via price, as reductions in production costs would have only a marginal effect on consumer choice between one retail price and another. Consequently, the application of a tax with a significant multiplier effect is desirable so that a satisfactory range of retail prices may be possible.

11.2.7 It is not therefore surprising that there has throughout been agreement on the principle that the cigarette excise should be based on a mixed specific/ad valorem structure. This principle has been confirmed by the Member States on the occasion of both enlargements of the Community. Moreover, it has been endorsed by both the Economic and Social Committee and the Parliament in all their opinions to date on tobacco excise harmonization. This principle is not therefore in dispute.

11.2.8 Fourthly, whether the present or the alternative approach is followed, the specific amount and ad valorem percentage have to apply to all price categories. The relative incidence of the combined specific and proportional elements will thus be different for each price category within the price range. This is due to the specific element. Moreover, the absolute tax amount falling on each price category will also be different. This is due to the ad valorem tax.

11.2.9 Consequently, the inevitable effect of any mixed excise structure, whatever the proportion of ad valorem and specific components, whether

(1) OJ No. C 43 of 29.4.1972, p. 23.

the structure is based on fixing the ratio of specific to ad valorem (as at present) or of fixing the ad valorem components as a percentage of retail price (as suggested by the Economic and Social Committee) is to benefit one price category of cigarettes at the expense of another.

11.2.10 Fifthly, as is shown in Annex V, the effect of the mixed system in favouring certain price categories relative to others is unaffected by harmonization of tax rates. Of course, if harmonized tax rates were to apply, then the incidence of the mixed system on a given price category would be uniform throughout the Community. But this would mean no more than the uniform application, throughout the Community, of the effect of the mixed excise in favouring certain price categories relative to others.

11.3 Market stability

11.3.1 One criticism levelled at the present approach, by those who support a high specific element, is that at existing tax rates, a relatively high ad valorem component (as is implied by a specific element at the final stage of about 20 %) must inevitably destabilise the market.

11.3.2 The argument runs that a total multiplier in excess of (say) 2 offers powerful incentives to manufacturers to cut prices, because the greater part of the retail price cut falls on the tax authorities, rather than on the producer. Price cuts of this kind, it is argued, will then be matched by other producers, resulting in a generally lower price level. Unless the fall in prices were matched by an equal increase in demand, tax revenues would decline and Government would be obliged to increase the tax rate. This would in turn increase the multiplier, and thus increase the incentive to competitive price cutting, leading to a downwards spiral in prices and tax revenues. Alternatively, the decline, or potential decline, in tax revenues, would tend to encourage Government to concert price control measures with the industry.

11.3.3 It is argued that any such effect could be avoided, were the ad valorem tax elements, as a proportion of total tax, equal to the price elasticity of demand for cigarettes. (In that event, tax revenue would be relatively insensitive to changes in prices). It is moreover suggested that such evidence as there is on the price elasticity of demand indicates figures of the order of minus 0.5 or less (that is, for every 1 % change in price, demand changes by 0.5 %). If the price elasticity were taken to be minus 0.5, then the matching ad valorem rate, for a tax incidence of 70 %, would be $0.5 \times 70\% = 35\%$. Such an ad valorem rate gives rise to a tax multiplier of about 1.5, and a total multiplier, assuming a retail margin of 10 % of retail price, of about 1.8.

11.3.4 The Commission wishes first to make clear that it fully accepts the effect of a predominantly ad valorem system in encouraging producers to reduce ex-tax prices to a minimum (whether by reducing production costs, distribution costs, publicity, or profit margins) in order to obtain an enhanced competitive advantage, via the multiplier effect of the tax, at the retail stage. This effect is common to all ad valorem taxes, and is indeed one of their attractions, in that it encourages both increased efficiency and competition, with the added benefit of generally lower prices to consumers.

11.3.5 Secondly, it should be noted that multipliers of up to 2 are accepted by all the cigarette producers; the state producers support the highest possible multiplier and the private sector producers accept a total multiplier of 2 or thereabout (equal to a tax multiplier of about 1.8 - see Annex II).

11.3.6 Thirdly, in proposing a mixed system as the basic principle of the first directive adopted in 1972, the Commission nevertheless accepted that, given the generally high rates of cigarette excises, it was desirable to avoid excessively high multiplier effects. In judging the effects of individual multiplier figures, it is necessary to compare such figures

with the multipliers applying in the Member States. At present, the tax multiplier figure for the Member States ranges between 1.7 in Ireland to 4.9 in Italy (which is in fact in breach of the harmonization directives). The present approach being followed by the Commission implies at the final stage, on the assumption of a tax incidence of about 70 % of retail price, a total multiplier of about 3, which of course implies considerable reductions in the multiplier in the majority of Member States.

11.3.7 In essence, therefore, the destabilisation argument rests on the contention that whereas a total multiplier of 2 will give rise to healthy price competition, a total multiplier of the order of 3 will so intensify this competition that the market and tax revenue can only be stabilised by imposing artificial constraints on competition in order for the cigarette industry to remain viable. The fact that downwards price and revenue spirals are not a feature of the market in those Member States where total multipliers greatly in excess of 3 currently apply, suggests that such a phenomena is more theoretical than real (see also the following section).

11.3.8 The linking of the tax structure to the price elasticity of demand for cigarettes raises a number of considerations. Price elasticities are notoriously difficult to estimate, the major difficulty being to isolate the effects of changes in price from other factors, such as changes in other prices and changes in disposable incomes. The problem is especially difficult for cigarettes, where anti-smoking campaigns are a further complicating factor, the effects of which are not easily quantified. And it goes without saying that no such factor has been established, or can be established, for the Community as a whole.

11.3.9 Even the results of different studies for a single market⁽¹⁾ have indicated a wide range of elasticity estimates, varying with time and with

(1) See Metra Consulting Report, October 1979, on cigarette advertising in the United Kingdom, page 4. (Metra themselves endorsed a figure for the United Kingdom of -0.42 to -0.52).

the study, from virtually zero to unity. This range of demand price elasticity could as well be used to justify either a 100 % ad valorem tax (demand elasticity of unity) or a wholly specific tax (zero demand elasticity) as a means of ensuring stable tax revenues.

11.3.10 Moreover, it must be pointed out that the likelihood of demand price elasticities, even if precisely measurable, proving to be the same in all Member States and remaining so over time, is so remote as to be discounted. Consequently, even if it were accepted that the harmonized system should seek to secure revenue stability, there is no satisfactory means whereby the appropriate harmonized ad valorem rate could be determined, nor indeed could any single rate guarantee such stability, whether in all Member States, or over time. In any case, it should be pointed out that tax revenues are also subject to income elasticity.

11.3.11 Finally, it is of interest to apply the stability argument to the present approach, currently leading towards an ad valorem element of 80 % of total tax, giving rise, with a tax incidence of 70%, to a total multiplier of about 3 at the final stage. Thus, applying the same arguments, the present approach would also give rise to revenue stability in response to price changes, if the price elasticity of demand were to be, not -0.5 , but -0.8 . This latter figure is well within the range of possible demand price elasticities for cigarettes. The evidence is therefore insufficient for it to be concluded that the present approach must result in revenue instability.

11.4 Restrictive practices

11.4.1 Other criticisms of the present approach go further, and argue that large-scale competitive price-cutting, resulting in the downwards spiral, does not take place on those markets where high multipliers at present apply, only because of a variety of fiscal measures intended to restrict competition, or of competitive restrictions exercised by the producers themselves.

11.4.2 In this context, particular reference has been made to the Court ruling of 29 October 1980, in cases 209-215/78 and 217-218/78. In giving its decision on these cases, the Court, in findings 127 to 130⁽¹⁾, held that a combination of factors, including fiscal measures, rendered price competition virtually non-existent on the Belgian market. This observation by the Court has been quoted as evidence of the distorting effects of a predominantly ad valorem tax structure for cigarettes.

11.4.3 As regards the fiscal measures, the Court drew attention to two tax provisions: the high ad valorem system and the minimum excise amount applied by Belgium. Both these measures are in conformity with the harmonization directive⁽²⁾, although both are at the maximum authorised; the ad valorem element being 95 % of total tax and the minimum excise being 90 % of the tax levied on the most popular price category. In fact, it would be permissible to have an ad valorem element of 45% of the total tax and no minimum excise at all. Consequently, neither of these measures, nor this combination of measures, is an obligation under the present directives. The Court explicitly recognised the essentially ad valorem system as working in favour of the consumer. As regards the minimum excise, however, the Court noted that this was fixed at such a level as to limit the effects on retail price which would otherwise flow, by virtue of the essentially ad valorem system, from changes in the prices of the lower-priced products.

11.4.4 However, the essential point to note is that, were the Commission's third-stage proposals to be adopted by the Council, the ceiling for the minimum excise would be reduced, from 90 % to 80 % of the tax falling on the

(1) See Annex VI

(2) The minimum excise, authorised as a faculty by Article 10(b)(5) of Directive 77/805/EEC, is intended as a safeguard against too great a fall in tax revenue as a consequence of the sale of unusually cheap cigarettes.

most popular price class⁽¹⁾. Moreover, the present upper limit for the ad valorem element would also be reduced, from 95 % to 90 % of total tax. Subsequently, in further stages, the Commission envisages a final objective of an ad valorem element of 80 % of total tax, and whether a minimum excise would be necessary at the final stage remains to be seen.

11.4.5 To illustrate this point, the total multiplier (i.e. tax and retail margin) in Belgium is currently 4.4. Were the tax system wholly ad valorem - as was the case before harmonization began - the multiplier would be 5.2. By contrast, the Commission's third stage proposals would reduce this figure to 3.8 and the final objective of a 20 % specific/80% ad valorem would further reduce this figure to 3.0.

11.4.6 As regards the minimum excise, the third stage proposals, as has been said, would reduce the ceiling from 90 % to 80 % of the tax on the most popular category, and this could well be reduced further, or abolished, at the final stage. Comparable changes would also come about in the other Member States which originally applied wholly ad valorem taxes and high minimum excises. It follows that the effects of harmonization policies have already been to reduce the highest ad valorem components (and the highest multipliers) and the minimum specific excises, and would in the future reduce them very much further. In fact, therefore, the tax harmonization process can be seen to be moving in the direction (as sought by private sector producers) of reducing the multiplier effects of the previously wholly ad valorem systems. It is of course at the same time inducing modest multiplier effects in those systems which were previously wholly specific.

11.4.7 As regards the other measures referred to by the Court, the Commission would point out that

(1) Notwithstanding the implied criticism of too high a minimum excise in the cases in question, both the opinion of the Economic and Social Committee (paragraph 22 of CES 242/81) and the draft resolution of the Economic and Monetary Affairs Committee of the Parliament (point 8 of PE 66.992) have rejected as premature the Commission's proposal to reduce the minimum excise during the third stage.

- it remains to be demonstrated that these measures are an inevitable result of the tax regime;
- the particular combination of tax provisions at present in force in Belgium is not, as has been said, imposed by the harmonization directives.

11.4.8 Furthermore, as has been said, the present approach to harmonization, if continued, will substantially reduce both the ceiling for the ad valorem element and for any minimum excise.

11.5 Approach of the Economic and Social Committee : Commission comments

11.5.1 The preliminary comments above are necessary in order to provide a context within which comments can be made on the arguments advanced in Annex I in favour of the alternative approach. It is in the Commission's view desirable that detailed comments be made on each of these arguments, the essential elements of which appear below, notwithstanding the fact that this involves some repetition of earlier parts of this chapter and of Annex V.

(i) "Because of the multiplier effect, the conditions of competition induced by the taxation systems are determined by the rates of proportional taxation on retail prices and not by the ratio relationship between the specific and proportional taxation". (paragraph 3.3.3 of CES 691/76).

"At very high levels of tax, the rate of ad valorem taxation has a greater influence on the conditions of competition than any other element in the fiscal structure". "Since the objective is to eliminate ... distortions or restrictions on competition, it is desirable to move towards harmonizing the element of ad valorem taxation..." (paragraphs 13 and 14 of CES 242/81).

Commission comment on (i) :

11.5.2 The implication of the reference to distortion or restrictions on competition is that tax harmonization is aimed at the removal of all distortions and restrictions - that is, at some concept of strictly neutral competition. As has been stated earlier in this chapter, this is not so, and cannot be so. In particular, it has been shown that a mixed excise structure (whatever its precise form) invariably favours certain price categories relative to others. Harmonization of the ad valorem elements as a percentage of price, which will in turn harmonize the tax multiplier, will merely ensure the general application of this effect, but will in no way modify it, or make it more neutral between one price category and another.

x x x

(ii) "... significant differences exist between Member States in the incidence of the total taxation burden on cigarettes. The achievement of a fixed relationship between the specific duty and proportional taxes on the most popular price class ... would ... only go some way towards ... uniform conditions of competition within the Community. This would be achieved only when a subsequent harmonization ... of the rates of taxation on cigarettes would also have been completed ..." (paragraph 3.3.3 of CES 691/76).

To "fix the incidence (i.e. the rates) of proportional taxation on maximum retail prices ... would ensure the earlier realisation of uniform conditions of competition in the Community as a unified market" (paragraphs 3.3.3 and 3.3.4 of CES 691/75).

Commission comment on (ii)

11.5.3 What is meant by "uniform conditions of competition with the Community" is not defined. The Commission presumes that the term is

equated with the establishment of a harmonized tax multiplier, since this is the essential difference between the present and alternative approaches.

11.5.4 A harmonized multiplier would indeed result in more or less uniform competitive conditions. As pointed out in the comments under (i) above, however, it should not be assumed that uniform competitive conditions will also be neutral.

11.5.5 The effects of the mixed excise in favouring certain price categories relative to others always remain, whether the present approach or the alternative approach is followed. The alternative approach, by anticipating to some degree the harmonization of tax rates, would move more rapidly towards uniform (not neutral) conditions of competition than the present approach, by its partial anticipation of the harmonization of the excise rates. However, as pointed out in Annex V, the improvement of competitive neutrality offered by rates harmonization (over and above that offered by a harmonized structure) is uncertain and probably marginal. Consequently, any competitive advantage offered by the alternative approach is, at best, limited. Moreover, even with the alternative approach, absolute differences in tax rates will remain, because the specific elements will vary until such time as tax rates are harmonized.

11.5.6 The advantage offered by the alternative approach and its harmonized multiplier is not therefore that competitive conditions will be significantly more or less neutral than under the present approach but that, whatever the tax rates in the individual Member States, the extent to which differences in ex-factory prices will be enlarged at the retail stage will become a constant. Under the present approach, because the multiplier will vary with the tax rate, a harmonized multiplier will not emerge until tax rates are themselves harmonized. By contrast, the alternative approach will fix, from the outset and once and for all, the degree of bias in the harmonized system for or against certain price categories.

The attraction, relative to the present approach, is therefore of offering certainty to cigarette producers for the future, irrespective of present differences in tax rates, or of future changes.

x x x

(iii) "Member States would remain free to fix their own rates of specific excise duty ... at whatever level they judged necessary to meet their national fiscal needs. (paragraph 15 of CES 242/81)."

Commission comment on (iii)

11.5.7 It is of course true that harmonisation of the ad valorem components alone would leave Member States free (at least until the time of harmonization of tax rates) to fix the specific element as they chose. This is self-evident. However, from the standpoint of the Member States, this offers no greater revenue flexibility than the present approach, which is focussed solely on harmonizing the ratio of the components in the tax rate, thus leaving Member States completely free to adjust the overall tax level as they please.

x x x

(iv) "this approach ... seems likely to provide a more flexible approach in the conditions of an enlarged Community".

Commission comment on (iv)

11.5.8 Whether the alternative approach would prove more flexible than the present approach, and whether or not in relation to an enlarged Community, is open to doubt. The maximum ad valorem tax, expressed as a proportion of retail price, is limited by the lowest tax incidence amongst the Member States. In Greece, the incidence is at present about 56% (and in Spain and Portugal it is even lower). Consequently, the range of choice in fixing the final objective is already limited by the nature of the alternative approach.

11.5.9. In any case, so far as Greece is concerned, and as has already been pointed out (see paragraph 4.7.4.) Greece on accession immediately introduced a specific element which exceeds that which would be required under the Commission's third stage proposals. As regards Spain, the present final stage objective implies a total multiplier of 3. This in turn implies a minimum ad valorem tax rate of about 56%. Consequently, if the alternative approach of harmonizing the ad valorem rate were followed, the implication would be either that Spain would have to increase tax incidence from its present level of about 52 % at most (levied on imported blond cigarettes) to at least 56 %, or - if that result were to be avoided - that a multiplier lower than 3 would have to apply in all Member States.

11.5.10. As regards the present Member States, attached at Annex VII is a table, showing the implied changes in prices in moving from the present situation to

- a) a third stage (whether expressed as a specific element of 10 - 35 % of total tax, as at present, or as its equivalent, under the alternative approach, of an ad valorem rate of 44 % - 66 % of retail price);
- b) a final stage (whether expressed as a specific element of 20 %, as at present, or as its equivalent, under the alternative approach, of an ad valorem rate of 56% of retail price);
- c) a final stage expressed as an ad valorem rate of 40 % of retail price (this latter being the figure supported by private sector producers, and equivalent to a specific element of about 44 % of total tax).

11.5.11. The table shows that moving from the present situation to a), b) or c) has much the same effect on prices in each of the Member States, whether the present or the alternative approach is followed. The degree of adaptation for the Member States is broadly the same, whichever approach

is followed. Consequently, so far as flexibility is concerned, the two approaches do not significantly differ.

11.5.12. Further comments on the implications of a move to c) - a final stage of a 40 % ad valorem rate - are given in section 11.7 below.

x x x

(v) "Experience has shown that a low multiplier permits healthy price competition" (Economic and Monetary Affairs Committee of the Parliament, paragraph 14, PE 66.992/Fin).

Commission comment on (v)

11.5.13. This viewpoint has already been discussed in the earlier comments (see in particular paragraphs 11.2.4. - 11.2.6.) and those on market stability (see Section 11.3.).

x x x

The Commission has the further additional comments to make on the two approaches.

11.6. Effects on the two approaches of harmonization of tax rates

11.6.1 The abolition of fiscal frontiers will ultimately require harmonization of the excise rates, either at common levels, or within narrow ranges. Consequently, the effect on the cigarette excise will then be that the specific element will be fixed at a uniform amount, or at amounts differing only by small margins. At that time, the approach based on harmonization of the ad valorem components as a percentage of retail price will of necessity revert to the present approach, in that both the specific and ad valorem components will each account for a fixed proportion of the total tax. This is precisely the final objective of the present approach.

11.6.2. It is therefore apparent that, in reality, the alternative approach is an intermediate phase on the road towards achievement of the present approach. The difference between the two approaches could be expressed, either as being that the fixed relationship between the specific and ad valorem components would be deferred until the time of harmonization of excise rates, or that the harmonization of the ad valorem component (which would, under the present approach, be deferred until the time of harmonization of rates) will take place at the time of structural harmonization.

11.6.3. It is thus apparent that the alternative approach carries the risk of drawing into the discussion on harmonization of the excise structure, problems which would not otherwise be encountered until attention was turned to harmonization of tax rates.

11.6.4. The present approach implies a final objective for the specific element of 20 % of total tax, giving, with a (typical) tax incidence of 70 %, a total multiplier of about three⁽¹⁾. Assuming the total multiplier of three is retained, then the alternative approach would give rise (see Annex VII) to an ad valorem tax rate of 56 % of retail price.

11.6.5. If the alternative approach were followed, all Member States would be obliged to ensure a tax incidence at least equal to the 56% figure (see paragraph 11.5.8.). (In fact, to permit some specific element, the tax incidence would have to be rather higher than the ad valorem percentage). As the lowest tax incidence (in Greece) is at present about this figure, a total multiplier of three could-just-be reached via the alternative approach, without obliging any of the Member States to increase tax incidence in order to conform to harmonization of the tax structure.

(1) That is - see Annex II - a multiplier taking account of both the tax and the distribution margin. On this basis, the average tax multiplier would be about 2.3.

11.6.6. However, multiplier figures higher than three would certainly require an increase in tax incidence in Greece beyond its present level. Moreover, in the event of further enlargement of the Community, even a multiplier of three would require an increase in tax incidence in new Member States (see paragraph 11.5.9.).

11.6.7. Consequently, the alternative approach implies, either constraints on the minimum level of tax incidence, or constraint on the maximum total multiplier. A need to increase tax incidence in some instances could be avoided only if the ad valorem component were fixed at a figure lower than the tax incidence imposed by any present or prospective Member State. Such an ad valorem percentage - of 50 % or less - implies a multiplier considerably below three. At this stage in the process of tax harmonization, the Commission regards such constraints as undesirable, particularly in relation to further enlargement of the Community.

11.7. Objectives

11.7.1. In this context, it should be stressed that the Economic and Social Committee has not itself put forward a figure for the ad valorem components as a percentage of retail price. Consequently, as it stands, the alternative approach could as well be directed towards the same multiplier objective as the present approach. However, if the alternative approach were linked to an ad valorem rate of substantially less than 56% of retail price - for example, as proposed by the private sector producers, 40 % or less, equal to a total multiplier of 2 or less - then the two approaches would diverge. But the same result would be obtained if the final objective of the present approach were changed from a specific element of 20 % of total tax to a specific element of the order of 44%.

11.7.2. Put in other words, and on the assumption of a tax incidence of 70 %:-

- | | | |
|---|---|---|
| - the present approach, ending in a specific element of 20 % of total tax | = | the alternative approach, with an ad valorem rate of 56% of retail price; |
| - the alternative approach, if the ad valorem rate were fixed at 40 % of retail price | = | the present approach, with a specific element of about 44 % of total tax. |

11.7.3. It is therefore clear that, were the alternative approach to be applied, any significant departure from an ad valorem rate of 56% would involve, not merely a change in the modalities of operating the harmonized excise, but also a radical departure from the final objective implied by the two stages of harmonization already adopted by the Council.

11.8. "Fairness"

11.8.1. The Commission has repeatedly stated that the balance to be struck between the specific and ad valorem components is essentially a matter for pragmatic negotiation. The only guideline is still that set out in Article 4(3) of the first directive (72/464/EEC) which provides

"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".

11.8.2. By definition, there is no objective means by which the fairness or otherwise of the system can be measured and the final choice remains a political one. Nevertheless, purely for illustrative purposes, Annex VIII sets out one possible measure of the relative "fairness" of differing approaches in striking a balance between the specific and ad valorem components for a tax incidence ranging from 50 % to 90 % of retail price.

11.8.3. Graph 2 attached to Annex VIII has been prepared on the arbitrary assumption that "fairness", in the sense of Article 4(3) of the first directive, would be achieved if half of the relative price difference between the producer price of the most popular price category and those of a high-cost and low-cost product is reflected in retail price. The Commission stresses that this is a wholly arbitrary measure of fairness: other measures - for example, reflection in the retail price of more than half, or less than half of the relative price difference could equally be regarded as fair. However, as the graph shows both a wide range of tax incidence and all the positions between full reflection and no reflection of relative price differences, it has the advantage of permitting a comparison, on the basis of a variety of assumptions as to "fairness", between the present approach and the alternative approach put forward by the Economic and Social Committee.

11.8.4. The graph shows that any increase in existing tax incidence will tend to improve the relative competitive position of high-cost producers, whichever of the two approaches is followed. However, the effect in favour of high-cost producers is relatively greater if the alternative approach is followed. This stems from the fact that under the present approach, both the specific and ad valorem components change in response to any given change in tax incidence, whereas under the alternative approach, once the ad valorem component is fixed as a percentage of retail price, only changes in the specific element are possible.

11.8.5. It is not suggested that this graph is in any way decisive for determining future stages. However, it is striking that the present approach (assuming a 20 % specific at the final state) offers a "fair" solution over a wider range of tax incidence than does the alternative approach, whatever the assumed ad valorem tax rate (in fact, in the graph, 40 %, 50 % and 60 % ad valorem tax rates are shown).

11.9. Certainty

11.9.1. It is acknowledged in paragraph 11.5.6 that the alternative approach has the attraction (not enjoyed by the present approach) of permanently harmonizing the tax multiplier, once structural harmonization has been completed, since the tax multiplier thereby established will be unaffected either by subsequent changes in tax incidence or my measures to harmonize tax rates.

11.9.2. The certainty offered by the alternative approach, in fixing the tax multiplier, independently of any further changes in tax rates, is at first sight attractive. It has to be recognised that, under the present approach, an agreement on a total multiplier of 3 to apply at the final stage of structural harmonization would be subject to variation on two counts:

- a) the figure of 3 would apply only where tax incidence was of the order of 70 %. Tax incidence in most Member States in fact falls close to that figure, so that the variations from the figure of 3 would in their cases be relatively small. But Greece has a tax incidence (56%) well below 70 %, and Denmark, an incidence (87 %) well above it. For these two Member States, the multipliers implied by a 20 % specific would be
 - Greece 2.2
 - Denmark 4.2

Moreover, as both these Member States have currently multipliers of 2.5 (Greece) and 1.8 (Denmark), the effect of the present approach would be to take Greece further away from the objective of about 3, and Denmark first to 3 and then considerably beyond it.

- b) Once structural harmonization is completed, it will presumably be desirable to maintain the multiplier broadly at or in the region of 3. However, as the multiplier is in fact a function of tax incidence, future changes in tax incidence will change the multiplier. Given the tendency (see Chapter 9) for tax incidence to rise, and given also the need eventually to harmonize tax rates, it is possible that the average total multiplier could be increased, either by individual tax increases, or by harmonization of tax rates.

11.9.3. As regards a)

- the problem does not arise in relation to the third stage proposals. Greece has already chosen of her own accord to apply a specific element of 11 %, which exceeds the 10 % proposed. If Denmark were to move, as proposed for the third stage, to a specific of 35%, the total multiplier (2.7) would still be short of 3. The special problem presented by Greece and Denmark therefore arises only in relation to subsequent stages;
- so far as Greece is concerned, and whether the present or the alternative approach is followed, the problem remains the same, since it stems, not from the approach followed, but from Greece's relatively low tax incidence. Whether the final stage consists of a 20% specific, or an ad valorem tax of 56% of retail price, the total multiplier in Greece (about 2) will still be significantly lower than the present multiplier of 2.5 and even farther away from an average of 3;
- the Danish problem could more easily be solved by a special Danish provision, rather than by a general change of approach. It would (for example) be possible to provide that, once the

structural harmonization had produced a multiplier of 3 in Denmark, then that multiplier should be broadly maintained by deferring further reductions in the specific element until such time as tax rates were harmonized.

11.9.4. As regards b), the present approach offers no solution. In the event of a general agreement that, once the final stage of structural harmonization is reached, a total multiplier of about 3 should be retained, notwithstanding future changes in tax incidence, it would be possible to consider converting from a harmonized specific/ad valorem ratio to a fixed ad valorem component as a percentage of retail price.

11.9.5. It might well be asked why the Commission could envisage making such a change once the final stage of structural harmonization is reached, but not before. The reasons lie in the disadvantages inherent in the alternative approach which have already been mentioned in sections 11.6 and 11.8, which seem likely to make agreement on further stages more, rather than less, difficult.

11.9.6. For these reasons, and given that the alternative approach offers no advantage from the standpoint of competition (see Section 11.2) the Commission considers it undesirable to switch to the alternative approach prior to achievement of the final excise structure. It would not at that stage rule out the possibility of "freezing" the multiplier thus achieved, by then converting the specific/ad valorem ratio into a harmonized ad valorem element. However, on the one hand, it would be desirable also to examine other possible solutions and, on the other hand, whether it would be desirable to do so at that time would depend upon the overall situation then obtaining - in particular on the differences in tax incidence then applying between the Member States and on the agreed period of tax credit. This latter point is discussed in Chapter 12.

12. HARMONIZATION OF RULES FOR COLLECTION OF THE EXCISE

12.1. General

12.1.1. In all its proposals for harmonization of the other major excises, (on mineral oils, wine, beer, alcohol) the Commission has included provision for a period of credit before payment of the excise. The aim of these provisions is to avoid imposing a financing cost on production and distribution. Article 6 of the first directive provides that harmonization of the rules of collection of the excise must be completed not later than the final stage. Major elements of the harmonized excise have of course already been determined and are no longer under discussion.

- i) a mixed specific/ad valorem structure (first directive)
- ii) excise to apply to the retail price of the finished product (first directive)
- iii) field of application: definition of manufactured tobaccos (second directive).

12.1.2. These elements already determine in large measure the control system; and the revenue interest of the Member States is such that, although formal provisions to oblige the Member States to control the excise in adequate fashion should for good order be included, it may nevertheless be assumed that effective fiscal control can be relied on. Consequently, of the rules of application still to be formulated, the means by which the tax should be collected (whether by a tax stamp or in monetary payment), and the period of credit for payment of the tax are the only ones likely to have a significant impact on the industry.

12.2. Tax stamps

12.2.1. As regards the means of collection, the Commission is aware that the tax stamp system can be applied in a discriminatory fashion. However,

the Treaty offers adequate provision for Article 169 action by the Commission in such cases. The Commission is also aware that the tax stamps system, even when applied in a non-discriminatory way, is inherently inflexible, both from the standpoint of intra-Community trade (in that it makes the switching of cigarettes from one market to another difficult) and from the standpoint of price competition (in that the price of retail stocks cannot readily be changed). On the other hand, the system of tax stamps is, in several Member States, linked to more general questions of tax enforcement and certainty of revenue receipts. It is a matter of judgement whether the inclusion of issues such as these will accelerate or delay the process of harmonizing the tobacco excise structure. However, it is in the Commission's view preferable to leave open the question of whether or not to retain tax stamps until such time as a decision is essential to the harmonization process. Neither the Parliament nor the Economic and Social Committee has suggested that this is yet the case.

12.3. Tax credit periods

12.3.1. As regards the effects on competition of differences in collection rules, the situation is by no means clear-cut. Indeed, the Economic and Social Committee has itself put forward differing views on this issue in its 1976 opinion on the second stage⁽¹⁾ and its 1981 opinion on the 3rd stage⁽²⁾.

(1) "Of particular note are widely varying practices between Member States concerning funding arrangements by way of extended tax credit and other current or potential subsidized sources of capital. Clearly, such arrangements have a major bearing upon the cost structure of the cigarette industry in the different countries and upon an equitable choice of taxation structure in the final phase of the present programme of harmonization."

(2) "There are however differences of view as to whether the different credit periods allowed in Member States amount in practice to a distortion of competition in the Community as a whole" and "The Committee considers that further study is required before a decision could be made regarding the appropriate time for adopting common rules for collecting the excise duty".

12.3.2. The credit periods for the excise and VAT in the Member States are set out in Table 12.1. It can be seen that the periods differ considerably. There are two basic arguments on the effects on competition of differences in deferment periods from one Member State to the other. The first is simply that, so long as the same period is accorded on a given market to national producers and to importers, competition is unaffected, since national and other Community producers compete on that market on equal terms.

12.3.3. The second argument goes rather further, by comparing the tax credit period on a given market with that accorded by producers to the distribution chain, and is illustrated by the following example:

	Market A	B	C
Tax credit (days)	30	20	50
Commercial credit (days)	15	20	30
Credit period to producers' advantage	<u>15</u>	<u>Nil</u>	<u>20</u>

12.3.4. As the example shows, differences between the tax and commercial credit periods give rise to different degrees of advantage - in the form of an interest-free loan of the tax due - to producers (and to importers) on each of the three markets. Let it now be assumed, however, that the different producers on markets A, B, and C split their production as follows:

	To Market	A	B	C
		%	%	%
Producer in A		50	20	30
" B		10	80	10
" C		70	10	20

To these shares of production can now be attributed the benefits of the difference between tax and commercial credit periods on the three markets⁽¹⁾, thus

Producer in A	50%	x	15	+	20%	x	Nil	+	30%	x	20	=	13.5 days
Producer in B	10%	x	15	+	80%	x	Nil	+	10%	x	20	=	3.5 days
Producer in C	70%	x	15	+	10%	x	Nil	+	20%	x	20	=	14.5 days

12.3.5. Consequently, the total operations of the three different producers benefit from widely differing periods of free financing. The second argument rests basically on the contention that these different interest-free loan periods constitute a distortion of competition.

12.3.6. As regards the first argument - and notwithstanding the equality of competitive conditions on a given market, provided that the same deferment period applies to both domestic and imported products - it is nevertheless understandable that many producers see some link between the final structure for the harmonized excise (i.e. the size of the multiplier) and the harmonized period of tax credit.

12.3.7. Existing periods of tax credit may or may not confer an element of government financing on different producers. What is clear is that any change in existing tax credit periods, whether up or down, will have an impact on production costs, which will in turn be increased at the retail stage to an extent which will depend on the final multiplier effect of the harmonized structure. As a general statement, harmonization implies an increased multiplier for high-cost producers and a lower multiplier for low-cost producers. Consequently, in taking a view on what constitutes an acceptable multiplier, any producer will also wish

(1) This simple model could of course be further elaborated by taking into account the different tax rates, the fact that part of the tax is VAT subject to different credit mechanisms, that commercial credit covers both tax and the delivered value of the goods, differences in interest rates etc. The basic argument is unaffected.

to have some indication of the likely effect on his costs of harmonization of the tax credit period. In addition, because of the mixed tax structure, whatever the harmonized tax credit period finally adopted, it will tend to benefit lower cost producers relative to high-cost, since any given financing benefit, all other things being equal, will represent a higher proportion of low costs relative to high. This relative advantage will vary, either with the length of the tax credit period, or with the extent to which the tax credit exceeds commercial credit. Consequently, the length of the harmonized tax credit period could be a factor in determining what constitutes a fair multiplier.

12.3.8. It was with this factor in mind that the Commission expressed the view (see paragraph 38 of the explanatory memorandum to the proposal for the 3rd stage) that harmonization of these rules could assist the process of convergence towards the final stage of harmonization. The Commission then proposed that examination of this question should begin during the 3rd stage and that a separate directive on the rules of collection should enter into force by 1.1.1985.

12.3.9. As regards the second argument, the Commission would point out that the interest-free loans accruing to producers in the example given arise first, from the fact that the tax credit period exceeds the commercial credit period and secondly, from the differences between commercial credit periods. Harmonization of the tax credit period would not resolve either of these problems. The first problem could of course be removed by fixing a harmonized tax credit period of very short duration, so that the commercial credit period would always be at least equal to the tax credit period. However, unless the commercial credit period were also harmonized - and moreover on the same figure as the tax credit period - the second problem would always be present, and it could even be the case that another distortion would be created due to

commercial credit periods in some Member States being necessarily longer than the tax credit period, thus imposing a financing cost for the tax on the producer.

12.3.10. It would neither be desirable nor practicable to seek to harmonize commercial credit periods throughout the Community. First, any such proposal would lie outside the scope of tax harmonization. Secondly, given the very considerable geographic, demographic and economic differences between the Member States, it is to be expected that commercial credit periods will vary (whether or not taxes are harmonized) to a considerable degree. These variations reflect differing factual and competitive situations and are for this reason desirable on competitive grounds.

12.4. Summary

12.4.1. In these circumstances, the merits of harmonization proposals for the tax credit period lie first, in the certainty they would offer to producers of the extent to which governments of the Member States would be prepared to assume the burden of financing the tax and thus, by removing uncertainty on this account, to facilitate discussions on the multiplier to apply at the final stage. Secondly, a harmonized tax credit period, although sufficiently long adequately to cover the commercial credit period normally found in any Member State, should not be so long as to permit the possibility deliberately to finance producers' capital requirements, thus reducing to the practicable minimum any risk of one producer being favoured relative to another. Harmonization of the tax credit period in accordance with this principle is likely of itself to bring about some convergence between the commercial credit periods. Inevitably, any such harmonized tax credit period could in theory offer some margin of advantage (not on a particular market, but possibly in relation to production overall)

to those producers whose sales, whether domestic or export, are made on markets with relatively shorter commercial credit periods than are the sales of their competitors. However, as stated above, this could only be avoided by harmonization of commercial credit periods.

12.4.2. In its proposals for the 3rd stage, the Commission envisaged adoption of harmonized rules for tax credit periods by 1.1.1985. Even on the basis of the 3rd stage proposals, Member States will at that time have moved only as far as a specific range of 10 to 35% of total tax and will thus be still some way from the final harmonization of the excise structure. In the light of the arguments above, and of the 1981 opinion of the Economic and Social Committee, and without prejudice to the application of Article 37 of the Treaty, this date for adoption of a harmonized tax credit period still appears appropriate.

Table 12.1.

Excise and VAT credit periods

Member State	Excise	VAT
B	15th day of the 3rd month following the order of tax stamps (average 90 days)	15th day of the 3rd month following the order of tax stamps (average 90 days)
LUX	15th day of the 3rd month following the order of tax stamps (average 90 days)	15th day of month following the delivery or importation (average 30 days)
NL	Last day of 3rd month following the order of tax stamps (average 105 days)	Last day of 3rd month following the order of tax stamps (average 105 days)
DK	Within 3 months following delivery of tax stamps (90 days)	One month and 20 days after the end of the 3-monthly accounting period (average 95 days)
GER	Between 28 and 42 days following the delivery of tax stamps (average 35 days)	National production: 10th day of the month following delivery for consumption (average 25 days) Imports: 15th day of month following the importation (average 30 days)
FR	5th day of the second month following production or clearance (average 50 days)	5th day of the second month following production or clearance (average 50 days)
GR	42 days	no VAT
IRL	Last day of the month following the delivery for consumption (average 45 days)	Between the 10th and the 19th day of the month following the end of the bi-monthly tax accounting period (average \pm 45 days)
IT	State production: No credit period Imports: payment within 30 days of purchase of the fiscal stamps	No credit
UK	15th day of month following the delivery for consumption (average 30 days)	In the month following the end of the 3-monthly accounting period (average 90 days)

13. HEALTH CONSIDERATIONS

13.1. Background

13.1.1. The Commission has been active in the field of health aspects of tobacco and cigarette consumption. A recent report (EUR 7531, June 30, 1981) summarises the various measures taken within member countries against tobacco consumption. An extended report on the same topic dealing with prohibitive measures, information measures, educational measures, research and studies, and penalties for infringement of the law, is currently being prepared.

The studies were initiated after the meeting of the Ministers of Health of 16 November 1978 which agreed, as regards smoking:

- to exchange experience concerning the measures taken in the various Member States;
- to establish common methods by which to compare the results and to assess the effectiveness of health education campaigns on smoking;
- to carry out health education campaigns of an experimental nature, in particular to determine the main features of cigarette smoking by young people and to identify their effects on health and the family and socio-economic factors which may play a part in the commencement and development of cigarette smoking;
- to seek a common attitude on advertising.

The question of tobacco smoking has also been included in the multiannual programme of Medical Research and Public Health which will soon be sent to the Council for discussion and approval.

13.1.2. The tax policy of the Commission and of individual Member States has been limited to maintaining high or increased tax incidence on cigarettes in order to discourage consumption of cigarettes as a whole. Tax policy is very relevant to public health since several studies conducted especially in the United Kingdom suggested that cigarette consumption shows a marked responsiveness to price changes.

13.1.3. There is reliable evidence that nicotine and "tar" content of mainstream smoke is an important predictor (though the number of cigarettes smoked per day was a more important variable) of lung cancer mortality and risk of coronary heart disease mortality, as well as of mortality ratio. Other toxic and carcinogenic agents such as carbon monoxide, acrolein, hydrocyanic acid, nitrogen dioxides, nitric oxide phenols and many others are likely to contribute to the health hazards of smoking. However, further research needs to be done to assess whether smokers compensate for lowered "tar" and nicotine concentration by inhaling more deeply, by smoking a greater fraction of the cigarette and by smoking more cigarettes. The effect of passive (or involuntary) smoking on the non-smoker should also be stressed especially in the elderly, in the sick and in infants and children. A study by the services of the Commission showed that children of parents who smoke are more likely to have respiratory tract diseases (bronchitis and pneumonia) during the first year of life.

13.1.4. An additional excise was applied in the United Kingdom for a 2-year experimental period from 1979-1980, on cigarettes with a tar yield of 20 mg or more per cigarette. This tar surcharge had a dramatic effect of eliminating higher tar cigarettes from the market, though it merely accelerated a process which started in the 1970's, i.e. a steady fall in the average tar-yield of cigarettes. A similar trend is being observed in other Member countries where no surcharge was applied.

13.2. Impact on health policies of excise harmonization

13.2.1. As regards the choice between the present and the alternative approach, Annex VII and paragraph 11.5.11 show that, assuming the same multiplier objective, both approaches have much the same effect on prices, so that they are unlikely to differ in their impact on health policy.

13.2.2. As regards the implication for health of the choice of multiplier, it has been argued that a high multiplier, by reason of its downwards pressure on costs, might hinder research and development of less noxious cigarettes. This argument rests on two assumptions:

that research and development of less noxious cigarettes is expensive and that high-quality filters and low-tar tobacco blends are expensive. The argument concludes that a low total multiplier of 2 or less (i.e. a low ad valorem element and conversely a high specific element) is better for health policy, because it allows for larger profit margins on more expensive cigarettes and consequently a higher investment rate to develop them further.

13.2.3. As a general comment, the Commission regards this as a marginal aspect of the debate on health policy and taxation. The crucial tax consideration is to ensure that tax incidence is maintained or increased, so leading to a reduction in smoking overall, rather than a switch from one cigarette to another, the beneficial effects of which (see paragraph 13.1.3. above) are by no means established. Secondly, the present approach will increase some multipliers from about 1.8 to about 3, but in other Member States it will reduce multipliers from about 4.4 down to 3. Consequently, applying the above argument, the present approach will already make it easier for producers in a number of Member States to research and develop less noxious cigarettes.

13.2.4. Moreover, the cost argument is open to question.

- the trend towards lower tar cigarettes has long been established, as has the swing from non-filter to filter throughout the Community as well as in the U.S.;
- as trade publicity demonstrates, competition between cigarettes is now based as much on health considerations as on price. For example, taking an extreme case, consumers would be unlikely to choose a high-tar, untipped cigarette solely on the ground that it was somewhat cheaper than a low-tar filter cigarette;
- a substantial element in the cost difference between a cheap and an expensive cigarette lies in packaging and publicity. If a producer wished to improve research investment, it would be relatively easier to do so by economising on publicity, packaging or by reducing profit, than by economising on the raw materials, which do not vary in price by large margins. In any case, it can hardly be claimed that expensive packaging, for example, makes a cigarette less noxious. Moreover, from the commercial standpoint also, it is likely that tar and nicotine content will in the future outweigh the quality of packaging as a factor in brand image;
- as regards publicity, some sectors of the industry have argued⁽¹⁾ that publicity does not increase demand overall, but merely affects market share. Consequently, a producer devoting a proportion of his (often substantial) publicity budget to producing relatively more acceptable cigarettes from the health standpoint could, even with somewhat reduced publicity, improve market share. For those who believe that publicity in fact increases demand, or at least maintains and encourages the social acceptability of smoking, such a trend would be doubly welcome;

(1) Report on the Relationship between total cigarette advertising and total cigarette consumption in the United Kingdom - Metra Consulting, 1979.

- research on health effects of cigarettes, on tobacco carcinogenesis and on the chemistry and the biophysics of tobacco smoke, is for a large part conducted in universities and in independent research centres which are financed by public and private funds;
- the difference in effect on downwards pressure on costs between a multiplier of 2 and one of 3 is not enormous. Consequently, even if the arguments were valid, the advantage offered by a multiplier of 2 over one of 3 cannot be decisive.

13.2.5. The Commission therefore concludes that the choice between the present approach and the alternative approach put forward by the Economic and Social Committee, is of no relevance to health policy. So far as the choice between different multipliers is concerned, this is of doubtful relevance. If of relevance, it can only be marginal, by comparison to the importance of maintaining a generally high tax incidence and thus reducing the overall level of smoking.

14. SYNTHESIS AND CONCLUSIONS

14.1. Developments since 1970

14.1.1. Since the adoption of the Council Resolution of 21 April 1970⁽¹⁾ (see paragraph 4.1.2.) the Community has twice been enlarged, so that the process of transforming into Community law a resolution adopted by a Council of 6, has now to be completed by a Council of 10. In addition, the sustained inflation and unfavourable economic climate since 1973 has brought about major changes in the general economic situation.

14.1.2. The tobacco market and the tobacco industry have by no means been exempt from these economic changes. In particular, the 1970s have been characterised (see Graph 9.1) by frequent falls in tax incidence (due to excise rates failing to adapt to rapid inflation), by price controls (in the context of anti-inflation policies), and by subsequent sharp corrections in both prices and tax incidence, and in some instances by marked increases in tax incidence (see paragraph 4.7.2.).

14.1.3. In addition, the dangers to health of smoking (see Chapter 13) although already known in 1970, had not then been as widely recognized as they are now. Awareness of health risks has led to a radical change in production patterns, with a rapid trend towards filter cigarettes (see Table 7.7) and an increasing preoccupation with lowering tar and nicotine yields. Demand has been generally affected by a variety of anti-smoking measures - in particular, educational campaigns to inform the public of the risks, more or less severe restrictions on cigarette advertising - and a tendency at least to maintain tax incidence over time and in some instances to increase it considerably.

(1) OJ No. L 50, p. 1, 28.4.1970

14.1.4. Community consumption per head of cigarettes in 1980 (see Table 7.6) was about 23% higher than in 1970, but at broadly the same level as that in 1975. In addition, the Community market has followed a world-wide trend towards blond cigarettes, leading to substantial changes in consumer patterns on the markets of those Member States previously dominated by dark cigarettes.

14.1.5. The pattern of the Community cigarette market is therefore one of rapid and sustained change in the product, accompanied by a level of demand which, if not declining, is more or less stagnant. The industry has reacted to these changes by intensifying competition, both in terms of the characteristics of the product (see paragraphs 13.1.3. and 13.1.4.) and in terms of price (paragraph 8.3.1.). This intensification of competition has resulted in the industry becoming increasingly capital-intensive and in particular in rapid technological advance in methods of cigarette production. In addition, the industry has turned increasingly to 3rd country markets and some producers have enjoyed (see Table 7.3) considerable success in compensating for falling demand within the Community by increased third country exports. Consequently, the industry has been able to sustain and even to increase somewhat its total production (see Table 7.1) between 1976 and 1980.

14.1.6. Some producers have also sought to diversify out of tobacco manufacturing, although these efforts have in general been on a limited scale and have tended to encounter opposition from the industry's trade unions (see paragraph 8.4.5.).

14.1.7. During this period (see Chapter 6) the State monopolies in France and Italy have, in accordance with the Council Resolution of 1970, been considerably liberalized. The import monopolies have been legally abolished, and other Community producers now in principle enjoy free access

to these markets. Following examination by the Commission, and subsequent discussions with the French and Italian authorities, the great majority of the discriminatory or restrictive measures have been or will shortly be, removed (see paragraphs 6.2.2. - 6.2.4.).

However, (see paragraph 6.2.6.) the considerable losses incurred by both the French and Italian State producers in recent years have given rise to complaints that the prices of monopoly products may be considered to be subsidized. The Commission is currently investigating whether or not the situation is compatible with Article 37 of the Treaty.

14.1.8. As regards employment, the result has been a general decline over the period 1975 - 1980, by about 9% overall (see paragraph 8.2.8.). In view of the increasing degree of automation in the industry (see paragraph 8.3.1.), this downwards trend in employment is likely to continue.

14.1.9. As regards raw tobacco production, there has been a growing imbalance between the varieties produced by the Community and those required to supply the Community market for manufactured tobacco (see paragraph 5.2.3.). So long as this situation continues, and notwithstanding the fact that the Community imports more than half its total raw tobacco needs, even existing levels of raw tobacco production can be maintained only with difficulty. The situation has been aggravated by the accession of Greece, which is a major producer of tobacco varieties which are not in general in demand within the Community, so that expenditure in support of raw tobacco has almost doubled since Greek accession (see paragraph 5.5.1.). The long-term objective (see paragraph 5.6.1.) must therefore be a radical change in the type of varieties of raw tobacco produced within the Community, and an increase in exports to third countries, so as to maintain existing levels of production and a reduction in imports of raw tobacco from third countries.

14.1.10. The enlargement of the Community has also changed somewhat the overall pattern of tax incidence. Tax incidence in the Community of six ranged from about 60% to rather less than 80%. The accession of Denmark, and subsequent tax increases in that Member State, increased the upper figure to more than 87% and the accession of Greece reduced the lower figure to about 56% (see paragraph 9.1.5.).

On the other hand, the other Member States have shown a markedly convergent trend in recent years, with tax incidence ranging from about 63% to 74% (see paragraph 9.1.6.).

14.1.11. Against this background of change and decline, it is not surprising that progress with excise harmonization has been both slow and difficult. In particular, given that the total tax burden represents so large a proportion of retail price, any tax change is bound to be of great concern to producers of raw and manufactured tobacco alike. However, reports from the Member States on the effects of both the first and second stages of harmonization make it clear that the two harmonization stages have not seriously disturbed either the markets or tax revenues (see paragraphs 4.7.3. and 4.7.4.).

14.1.12. In the case of the United Kingdom and Ireland, considerable market changes did take place following implementation of the second stage, but this seems largely to have been due (see paragraph 4.7.7.) to national decisions to change their tax systems to a greater degree than that required by the harmonization directive. As regards the French and Italian markets, the reduced price ranges arising from harmonization have certainly reinforced the trend observed in both those countries from relatively cheap dark cigarettes towards more expensive blond cigarettes (see paragraph 4.7.4.). However, it has been recognized (see footnote to paragraph 4.7.4.) that this trend is itself due to other factors, not least of which has been a failure of domestic producers to adapt to changing consumer tastes.

14.1.13. The Commission's 3rd stage proposals of course imply further changes which, given existing pressures on the industry, have understandably provoked strong reactions both from those with largely specific taxes, who are concerned at the implications of an increased ad valorem element, and from those with largely ad valorem taxes, faced with an increased specific element.

14.2. Harmonization: the agreed elements

14.2.1. Notwithstanding the acknowledged differences of view over the 3rd stage and the final stage, a considerable degree of consensus has been achieved and maintained over the last 11 years. The desirability of and need for harmonization of taxes on tobacco is still generally accepted. Both the Economic and Social Committee and the Parliament - whatever detailed reservations have been expressed on the Commission's proposals - have consistently endorsed (see Chapter 2) not only the desirability of harmonization but also the major elements in the harmonized system for cigarettes. This is also true of the manufacturing industry, whether private or State producers. In particular, the principle of a mixed specific/ad valorem structure levied on the finished product by reference to the retail price has long been accepted and is not in dispute.

14.2.2. The increase in market interpenetration (see Table 7.4) during this period is also encouraging. It cannot be claimed that this is solely, or even largely, due to tax harmonization, since the process clearly owes much to the trend away from dark and towards blond cigarettes. Moreover, the penetration of the high-specific markets by low-cost producers has been very limited. Nevertheless, it is encouraging that the relatively modest changes in tax structure imposed by the first and second stage do appear to be contributing, albeit slowly, to the establishment of the Community market.

14.2.3. The Member States have also done much to maintain the consensus of view on tax harmonization (see Chapter 4). Denmark, on accession in 1973, accepted the first stage of harmonization as it stood. Ireland and the United Kingdom, although requesting - and being accorded - a 5-year derogation, also accepted the first directive. The enlarged Community of 9 was subsequently able to agree on a second stage which significantly narrowed the permitted range of the specific element and included VAT within the system, and on a directive to define the tobacco products covered by the harmonized excise. Greece, on accession in 1981, accepted all the harmonization directives without any transitional period for adaptation. Moreover, Greece at once introduced a specific element of total tax (currently 11%) which was in excess even of what would be required under the Commission's third stage proposals. Some other Member States have also found it possible to go further than is required under the existing second stage obligations; the Netherlands at present apply a specific element of 10% and Germany, an ad valorem element of 60%.

14.3. The third stage proposals and their context

14.3.1. Seen within this context of slow but consistent convergence, and as Chapter 4 makes clear, the Commission proposal for the 3rd stage cannot be characterized as some radical new initiative, or a departure from agreed policies. On the contrary, it is no more and no less than a relatively modest advance on the two modest stages of harmonization which preceded it, the proposals for which were approved by the Parliament⁽¹⁾⁽²⁾.

(1) Opinion 1st stage OJ C 2 of 11.1.1972

(2) Opinion 2nd stage OJ C 178 of 2.8.1976

14.3.2. Moreover, these proposals are broadly consistent with the line of convergence indicated by the first and second stages, as adopted by the Council (see paragraph 4.8.3.). It should be remembered that the first stage provided a permitted range for the specific element of 5 to 75% of the total excise, and left VAT (a proportional tax) wholly out of account. The second stage permitted a specific range of 5% to 55% of the total tax, including VAT. Moreover, three Member States, as stated above, have already found it possible to go beyond the obligations of the second stage and even, in the case of Greece, beyond what would be required in the third stage as now proposed. Given this orientation, it is of course possible to argue that the proposed range for the third stage of a specific element of 10% - 35% of total tax leans too heavily towards one extreme or the other of the range. It could also be argued that the third stage should advance at a rather slower, or faster, pace. But in the Commission's view, it is not possible to argue that the Council decisions on the first and second stages imply a third stage in which the relative proportions of specific and ad valorem should be radically different from those now proposed.

14.3.3. The Commission has also indicated that, were harmonization to be continued in the direction put forward in its third stage proposals, the implied specific element at the final stage would be of the order of 20% of total tax, which in turn implies an average total multiplier of about 3.

14.4. Differences over objectives and over possible approaches

14.4.1. This implied final objective is the source of divergent views within the Community. On the one hand, there are low-cost producers who wish to retain the highest possible total multiplier (currently of the order of 4.5 or more). On the other hand, there are high-cost producers who wish the total multiplier to remain at a level of about 1.8 and in any case not to exceed 2.

14.4.2. In addition, the Economic and Social Committee (see Annex I) has suggested that consideration be given to an alternative approach, consisting of harmonizing the ad valorem components as a percentage of total tax. This view has attracted some support from the Economic and Monetary Affairs Committee of the Parliament. The Economic and Social Committee does not go so far as to propose a specific figure on which the ad valorem tax components should be harmonized. However, the private sector producers have made it clear, not only that they would support such an approach, but that in their view the ad valorem tax components should not exceed 40% of retail price.

14.4.3. The Commission has sought in its work to examine the implications, both of differing multipliers at the final stage and of harmonization of the excise structure following, either the present approach, or the alternative approach, in order to arrive at that final stage. In fact, although these two issues have, as far as possible, been separately examined, they are inevitably inter-related to a considerable degree by the fact that the alternative approach explicitly seeks to achieve both harmonization of the excise structure and a partial harmonization of the tax rates. As tax incidence is one of the functions which determines the multiplier, the two issues are thus linked.

14.4.4. Chapter 8 examines the implications for employment of both approaches, and of differing multipliers. It is concluded (see paragraph 8.6.1.) that employment in the industry is likely to continue to decline in the future, irrespective of further structural harmonization. The major factors in this decline are found to be increasing automation of the industry, the tendency for tax incidence to be maintained or increased for reasons of health policy and the impact of increasing awareness of the health risks of smoking. The chapter concludes (see paragraph 8.6.3.) that the impact on this process of the present approach and of the alternative approach would not significantly differ.

As regards multipliers, the chapter concludes that the theory according to which a low multiplier, exercising a lower pressure on costs, would make it relatively easier for certain producers to make provisions for redundancy, retraining etc., is no more than an assumption.

14.4.5. Chapter 13 concludes (see paragraph 13.2.5.) that the choice between the present and the alternative approach is of no relevance to health policy. As regards differing multipliers, the effect of a lower multiplier could be, as claimed by some producers, to facilitate commercial research and development of less noxious cigarettes via reduced pressure on their costs. However, as is pointed out in paragraph 13.2.4., much of the research effort is conducted by independent and academic research centres. In addition, it is not certain that reductions in tar and nicotine content do not bring about changes in smokers' way of smoking, or an increase in their tobacco consumption. Moreover, given the increasing importance of low tar and nicotine yields in the marketing of cigarettes, it seems likely that the incentives to develop such cigarettes are already very considerable. Finally, the possibilities for economising in areas of production costs which are unrelated to the smoking characteristics of the cigarettes (in particular, packaging) are probably considerable and possibly greater than those in relation to the materials from which the cigarettes are made.

14.4.6. Turning to competition, Chapter 11 examines, not only the implications of different multipliers, but also the relative merits of the present and alternative approaches. The principal conclusions of that chapter and of its related Annexes V, VI, VII and VIII are as follows:

- (i) the major contribution made by tax harmonization in reducing distortions of competition is that offered by the establishment of a single tax structure (see paragraph 11.2.3. and Annex V);

- (ii) the application of a tax with a significant multiplier effect is desirable if a satisfactory range of retail prices is to be possible (paragraph 11.2.6.);
- (iii) the inevitable effect of any mixed excise structure, whatever the relative proportions of ad valorem and specific components and whether the structure is based on the present or the alternative approach, is to benefit one price category of cigarettes at the expense of another (see paragraph 11.2.9. and Annex V);
- (iv) the effect of the mixed system in favouring certain price categories relative to others is unaffected by harmonization of tax rates (see paragraph 11.2.10.).

The effects of harmonization of tax rates on competitive neutrality is dubious and in any case marginal (see Annex V).

Harmonization of tax rates, or a mechanism for anticipating such harmonization - such as the alternative approach - merely ensures the uniform application of the effect of the mixed excise in favouring certain price categories relative to others (see paragraph 11.2.10. and Annex V);

- (v) the alternative approach would not therefore add to competitive neutrality, particularly because of the inherent bias in the mixed system (see (iii) above) in favour of certain price categories relative to others (11.2.10., Annex V);
- (vi) the Commission fully accepts the effect of a predominantly ad valorem system in encouraging producers to reduce ex-tax prices to a minimum (paragraph 11.3.4.);
- (vii) there is insufficient evidence to support a view that a total multiplier of the order of 3 must result in revenue instability (paragraph 11.3.11.);

- (viii) no "causal link" has been established between a total multiplier of the order of 3, and restrictive competitive practices (section 11.4.);
- (ix) the present approach - assuming a 20% specific - would give, at the final stage of structural harmonization, an average total multiplier at present tax rates of about three, an average tax multiplier of about 2.3, with some variation on either side of these averages, and a harmonized tax multiplier at the time of harmonization of tax rates, the multiplier figure then depending on the harmonized tax rate (paragraphs 11.1.3., 11.1.4., Annex II);
- (x) the alternative approach would give a harmonized tax multiplier (at a figure yet to be proposed) at the final stage of structural harmonization and whether or not tax rates are harmonized (paragraphs 11.1.3., 11.1.4., Annex II);
- (xi) whichever of the two approaches is followed, the degree of adaptation for the Member States in order to arrive at a third stage or at a given final stage objective is broadly the same (paragraphs 11.5.11., 11.7.1., Annex VII);
- (xii) whichever of the two approaches were followed, and even assuming harmonized tax rates, the total multiplier will continue to vary somewhat, because of differences in distribution margins (Annex II, paragraph 7);
- (xiii) both approaches become identical in all respects at the time of harmonization of tax rates (section 11.6.);
- (xiv) the essential difference between the two approaches is one of timing, in that the alternative approach (at the final stage of structural harmonization) would fix a harmonized tax multiplier, independently of harmonization of tax rates, and the present approach uses the multiplier only as a broad guide and leaves the final figure to be determined by harmonization of the excise rate (paragraphs 11.5.6., 11.6.2.);

- (xv) in view of (iv) and (v) above, this difference in timing is of no importance from the standpoint of competition, but does offer the advantage of certainty, in that the tax multiplier, once fixed under the alternative approach, is unaffected by future changes in tax rates (paragraph 11.5.6.);
- (xvi) any change in the final objective from a total multiplier of about 3 (i.e. from a 20% specific or 56% ad valorem rate) could as well be expressed in terms of a different specific element (e.g. a specific element of about 44% of total tax, broadly equal to a 40% ad valorem rate) (paragraph 11.7.2., Annex VII);
- (xvii) in terms of "fairness" the present approach satisfies a wider range of degrees of reflection in retail prices of relative differences in ex-tax costs, over a wider range of tax incidence, than does the alternative approach (paragraph 11.8.5., Annex VIII, Graph 2);
- (xviii) whichever of the two approaches is followed, an increase in tax incidence will invariably improve the relative competitive position of high-cost producers. This effect will be relatively greater if the alternative approach is followed (paragraph 11.8.4., Annex VIII, Graph 2);
- (xix) in view of (iv), (v), (xii), (xvi), (xvii) and (xviii) above, the Commission is of the view that adoption of the alternative approach for the establishment of future stages is undesirable, and is likely to make agreement on further stages more, rather than less, difficult (paragraph 11.9.5., 11.9.6.);
- (xx) in view of (xv) above, the Commission would not rule out the possibility, once the final stage of structural harmonization has been reached, of "freezing" the multiplier by then converting the specific/ad valorem ratio into a harmonized ad valorem element. However, whether it would be desirable

to do so at that time - and without excluding other possibilities - would depend in particular on the differences in tax incidence then obtaining and on the agreed period of tax credit.

14.4.7. As regards tax credit, and in the light of the 1981 opinion of the Economic and Social Committee, the Commission is of the view that adoption of harmonized rules for tax credit by 1.1.1985 remains an appropriate target (paragraph 12.4.2.). The period of tax credit should be governed by the principle of it being sufficiently long to cover normal commercial credit periods, but not so long as to permit financing of producers' capital requirements (paragraph 12.4.1.).

1976 AND 1980 OPINIONS OF THE ECONOMIC AND SOCIAL COMMITTEE

1981 OPINION OF THE ECONOMIC AND MONETARY AFFAIRS COMMITTEE
OF THE EUROPEAN PARLIAMENT

In 1976, the Economic and Social Committee (see CES 691/76)

"3.3.2. ... noted that a specific excise duty (i.e. a fixed amount per cigarette) merely determines the level of retail prices over and above the pre-tax manufacturers' price and trade margin. Differences in manufacturers' pre-tax delivery prices are not enlarged by a specific duty at retail level. On the other hand, proportional (or ad valorem) taxes based on the final retail price multiply differences in the manufacturers' pre-tax selling prices into larger differences in retail prices. Trade margins, which are generally expressed as a percentage of retail prices, further add to this multiplication effect. It was also noted that as the incidence of the proportional elements of the retail price structure (i.e. proportional taxation plus trade percentage margin) increases above 50% of the total retail price, the increments in the multiplication effect rise dramatically faster than each successive increase in the incidence of the proportional elements of the retail price.

3.3.3. Because of this multiplication effect, the conditions of competition induced by the taxation system are thus determined by the rates of proportional taxation on retail prices and not by the ratio relationship between the incidence of specific and proportional taxation. In fact, significant differences exist between Member States in the incidence of the total taxation burden on cigarettes. The achievement of a fixed relationship between the specific duty and proportional taxes on the most popular price class in all Member States, which is envisaged as the final stage of the harmonization of structure under the 1972 Directive, would therefore only go some way towards, but would still fall short of, achieving uniform conditions of competition within the Community.

This would be achieved only when a subsequent harmonization programme of the rates of taxation on cigarettes would also have been completed and when other distortions of competition will have been removed. Obviously, the impact of such a harmonization programme upon government revenues and expenditure, and the consequential social policy effects, must be carefully examined.

3.3.4. The Committee suggests that the Commission's examination of relevant approaches to the final stage of this harmonization programme might include an examination of proposals, which might fix the incidence (i.e. the rates) of proportional taxation on maximum retail prices, rather than the ratio relationship between the specific and the proportional elements of taxation. This would involve a departure from the approach envisaged in Article 1 of the draft Directive but it would ensure the earlier realization of uniform conditions of competition in the Community as a unified market, leaving Member States free to levy a variable specific excise duty until such time as harmonization of excise rates overall can also be agreed upon."

In 1976, the Parliament, whilst noting the opinion of the Economic and Social Committee, did not take up its suggestions. Parliament approved the second stage proposals, recalling only the principles which it had put forward in its 1969 opinion:-

"that the aim must be a tax system that is neutral in its effects on competition and promotes market interpenetration, optimum utilization of the tax source, while maintaining the same quality and range of products". (paragraph 3, PE 44.665).

In 1980, in its proposals for the third stage, the Commission confined its comments (paragraph 27 of COM(80)69) to the legal and political implications of following this approach:-

"... an approach of this kind is not consistent with the method laid down by the Council in Article 4 of Directive 72/464/EEC: and it is this method which is still the keystone of the harmonization process. In any case, while a solution along these lines could be attractive for tobacco manufacturers, provided the tax multiplier was small (less than 2, i.e. with the sum of the proportional components being less than 50%) it would hardly smooth the way to agreement between the Member States, who hold quite different views as to what the common multiplier should be."

In 1981 (paragraph 13 - 1 of CES 242/81) the Economic and Social Committee repeated its 1976 proposal, as follows:-

"13. ... In all ten Member States, taxation absorbs 57% or more of the price of cigarettes; in seven of them, more than 70%; and in one (Denmark) as much as 88%. At these very high levels of tax, the rate of ad valorem taxation has a greater influence on the conditions of competition than any other element in the fiscal structure. This is because of the very strong "multiplier" effect of high ad valorem taxation on manufacturers' delivery prices. Any change in the ex-factory price is multiplied up several times in working through into retail prices.

14. Since the objective is to eliminate those elements in the fiscal system which lead to distortions or restrictions on competition, it is desirable to move towards harmonizing the element of ad valorem taxation rather than continue to follow the present approach of trying to harmonize the ratio between the ad valorem and the specific elements.

15. The ad valorem element consists in part of the ad valorem excise duty and in part of value added tax. Harmonizing it would imply that the combined rate of these two taxes would become the same on cigarettes throughout the Community. Member States would remain free to fix their own rate of value added tax but would then have to fix the rate of the ad valorem excise duty so that the combined rate of the two taxes would be at the level agreed for the Community as a whole. Member States would also remain free to fix their own rate of specific excise duty, and this degree of freedom would enable them to impose taxation on cigarettes at whatever overall level they judged necessary to meet their national fiscal needs.

16. Although not disposing of all the problems which have so far impeded agreement about the final stage, this approach would be better than the present attempt to harmonize the ad valorem/specific ratio. Among other things, it seems likely to provide a more flexible approach in the conditions of an enlarged Community.

17. The Committee therefore recommends that Article 4.3 of the first Directive should be amended, to read as follows:

"At the final stage of harmonization of structures, the combined rate of proportional taxation (that is to say, the sum of the rates of the proportional excise duty and the turnover tax calculated on the retail selling price) shall be the same on cigarettes in all Member States, and shall be such as will not distort conditions of competition in national markets nor impede the free movement of cigarettes within the Community."

The Committee went on to propose certain studies.

"19. Any proposal leading towards such a solution must be based on a full social and economic study such as the Committee called for in 1976.

This study ought to take into account at least the following aspects:

- (a) The effect of different mixture of ad valorem and specific taxation
 - on the pattern of employment in cigarette manufacturing and distribution
 - on the conditions of competition and the profitability of these activities in national markets, and
 - on competition in intra-Community trade bearing in mind the development of competition policy at Community level in relation to the cigarette industry.
- (b) The influence of the excise tax structure on the range of consumer choice.
- (c) The special problem of import penetration in France and Italy, and its consequences for tobacco farming in the Community including Greece, bearing in mind the existence of surplus stocks of certain varieties of Community-grown tobacco.
- (d) The relationship between tax increases and price increases on cigarettes under different mixtures of ad valorem and specific taxation; the taxation structure which would be most appropriate to provide Government with a stable revenue in a price competitive market; and the effect of inflation on this aspect of excise taxation policy."

Subsequently, the Economic and Monetary Affairs Committee of the Parliament, in its report of January 1981 on the third stage proposals, stated (page 11 of PE 66.992/Fin):

"14. The purpose of harmonization must be to arrive at a taxation structure which is as neutral as possible from the point of view of competition. Every effort must be made to avoid limiting or distorting competition. It was for this reason that in the preparatory work for the

second period of harmonization the Economic and Social Committee asked whether a fixed relationship between the specific and the proportional tax components was really the most neutral of solutions from the point of view of competition. The Commission was asked to conduct a thorough inquiry into whether it would not be better to base harmonization on a different method. However, the Commission never carried out the inquiry on the grounds that the principle of the harmonization process was laid down in paragraph 4 of the Council Directive 72/464/EEC which did not provide for any alternative.

Previously the Economic and Social Committee had suggested that instead of establishing a fixed relationship between the specific and proportional components of taxation on the extent to which proportional taxation increased retail selling prices should be harmonized. This proposal implies applying the same fiscal multiplier⁽¹⁾ but does not rule out differing rates of taxation. Following the results of the third harmonization period, this proposal was reiterated by tobacco manufacturers' organizations. In this connection, the explanatory memorandum attached to the Commission's proposal quotes a proportional tax rate of 50% or less of the retail selling price which implies a low multiplier (less than 2). Experience has shown that a low multiplier permits healthy price competition. This is the yardstick against which the tax system will ultimately have to be measured."

The Committee went on (point 6 of the draft resolution in PE 66.992/Fin) to request the Commission

"to investigate ... 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".

THE MULTIPLIER AND THE TAXATION OF CIGARETTES

1. Council Directive 72/464/EEC of 19 December 1972 stipulates that the tax on cigarettes shall have three components:

- a specific excise;
- a proportional excise;
- a VAT portion.

The specific component is expressed as a fixed amount per unit of product (normally 1 000 cigarettes), while the proportional (or ad valorem) component is expressed as a percentage of the retail price.

2. In the first stage of harmonization the rule was that the specific component was to be fixed, at the discretion of each Member State, between 5 % and 75 % of the total excise charged on cigarettes in the most popular price category. At present, i.e. during the second stage, the specific component must be fixed at between 5 % and 55 % of the total tax burden (including VAT) on cigarettes in the most popular price category in each Member State. Accordingly, the sum of the proportional component and VAT must lie between 95 % and 45 % of the total tax burden.

3. The basis of assessment for the proportional component is the retail price inclusive of all taxes, that is to say the price to the consumer inclusive of the specific components, the proportional component itself and VAT.

Like the proportional component, VAT, which is normally calculated on a price net of VAT, is in practice calculated on a price inclusive of all taxes (by transposing the rates).

This means that, in the taxation of cigarettes, all proportional charges are calculated on the retail prices, with the charges themselves entering into the calculation. This system of taxation is unique.

4. The excise is payable by the manufacturer or by the importer and, for reasons of tax administration and control, it is collected in most Member States by means of tax labels affixed to the cigarette packets.

5. VAT, which is normally paid in portions at each marketing stage, is in some Member States charged only once, "at source", i.e. it is levied on the manufacturer or the importer, like the excise, whether or not it is included in the price shown on the tax label.

It is to be noted that, even where the arrangements for collecting VAT are not exactly the same as those for collecting the excise, the proportional component and the VAT portion, which are both calculated on retail prices, have the same effect, namely to multiply manufacturers' delivery prices. The same is true of the distributor's margin, which, in accordance with commercial practice, is also calculated as a percentage of the retail price.

The examples below illustrate the system for taxing cigarettes.

Examples

Assumptions (a) total tax burden equal to 70 % (of which 10 % is VAT) of the retail price;

(b) distributor's margin equal to 10 % of the retail price.

I. Minimum specific component = 5 % of total tax burden

	Cigarette in the most popular price category	Other cigarette
Retail price	100	120
Specific component (5 % of 70)	3.5	Specific component x 3.5
Proportional component ((95% of 70) - 10 = 56.5% of 100)	56.5	Proportional component (56.5% of 120) 67.8
VAT (10 % of 100)	10	VAT (10 % of 120) 12
Distributor (10 % of 100)	10	Distributor (10 % of 120) 12
Manufacturer	20	Manufacturer 24.7
	} Tax portion = 70	} 83.3
	} Non tax portion = 30	} 36.7

II. Maximum specific component = 55 % of total tax burden

	Cigarette in the most popular price category	Other cigarette
Retail price	100	120
Specific component (55 % of 70)	38.5	Specific component 38.5
Proportional component ((45 % of 70) - 10 = 21.5 % of 100)	21.5	Proportional component (21.5 % of 120) 25.8
VAT (10 % of 100)	10	VAT (10 % of 120) 12
Distributor (10 % of 100)	10	Distributor (10 % of 120) 12
Manufacturer	20	Manufacturer 31.7
	} Tax portion = 70	} 76.3
	} Non-tax portion = 30	} 43.7

The multiplier

(a) The total multiplier

6. It will be seen from Example I that an increase of 4.7 units in the manufacturer's delivery price produces an increase of 20 units in the retail price. Example II shows that the same increase of 20 units in the retail price increases the return to the manufacturer by 11.7 units.

In the first case, the difference between the manufacturers' delivery prices is multiplied by $\frac{20}{4.7} = 4.255$

In the second case, the difference between the manufacturers' delivery prices is multiplied by $\frac{20}{11.7} = 1.709$

This multiplier effect can be expressed as follows:

$$M = \frac{\text{retail selling price of cigarette x} - \text{retail price of cigarette y}}{\text{ex-works price exclusive of tax of cigarette x} - \text{ex-works price exclusive of tax of cigarette y}}$$

7. The total multiplier thus reflects, to use the words of Article 4(3) of Directive 72/464/EEC, the ratio of the differences (range) in retail prices to the differences in the delivery prices of cigarettes.

The multiplier may also be defined as follows:

$$M = \frac{P}{p + s}$$

where

P = retail selling price

p = manufacturer's delivery price

s = amount of specific component

The value of M may also be calculated using the most common method :

$$M = \frac{1}{1 - \frac{x}{100}} \quad (1)$$

where x is the sum of the proportional components: (a) the proportional excise;
(b) VAT;
(c) the distributor's margin,

these components being expressed as percentages of the retail price.

The total multiplier thus takes into account all the proportional components, including the non-tax proportional component, which is the distributor's margin.

However, this margin is not fixed and is a matter lying outside the tax sphere. Consequently, if a new harmonization method were adopted, based no longer on the ratio of the specific tax component to the total tax burden but rather on harmonization of the multipliers, introduction of a common total multiplier would not bring about harmonization of tax rates. As the total multiplier is partly a function of the distributor's margin and since, under the Treaty's competition rules, a fixed level may not be set for this margin, the fixing of a common total multiplier is excluded.

(b) Tax multiplier

8. On the other hand, the tax multiplier takes into account only the proportional components induced by the proportional excise and VAT.

(1) If P is the retail price $P = p + s + P \frac{x}{100}$

p is the manufacturer's delivery price : $1 = \frac{p + s}{P} + \frac{x}{100}$

s is the amount of the specific element : $1 - \frac{x}{100} = \frac{p + s}{P}$

x is the sum of the proportional components : $\frac{1}{1 - \frac{x}{100}} = \frac{P}{p + s} = M$

As a result, the figure given for the tax multiplier will always be lower than that for the total multiplier.

It is self-evident that, for a given specific component/total tax ratio, the multiplier (whether the total or the tax multiplier), which is a function of the sum of the proportional components levied on the retail price, is also influenced by the total level of taxation. Returning to Example I above and assuming that the level of taxation, instead of being 70 %, is 80 %:

the total multiplier rises from $1 - \frac{1}{\frac{76.5}{100}} = 4,255$ to $\frac{1}{1 - \frac{86}{100}} = 7.143$

while the tax multiplier rises from $1 - \frac{1}{\frac{66.5}{100}} = 2,985$ to $\frac{1}{1 - \frac{76}{100}} = 4.167$

9. Regardless of the tax structure, the effect of any percentage increase in the distributor's margin and in the proportional tax components is to amplify the multiplier effect, with a smaller share of the retail price remaining for the manufacturer.

10. Assuming a total tax burden of 70 % and a distributor's margin of 10 %, the relationship between the mixed tax structure and the multiplier is as follows:

Specific component in total tax burden	Sum of the ad valorem <u>tax</u> components levied on retail price	Tax multiplier	Total multiplier
5 %	66.5 %	2.985	4.255
10 %	63 %	2.702	3.703
20 %	56 %	2.272	2.941
35 %	45.5 %	1.834	2.247
55 %	31.5 %	1.459	1.709

11. At 1 August 1981 the multipliers arising from the tax systems in force in the Member States were as follows:

	Tax multiplier	Total multiplier
Belgium	3.13	4.45
Denmark	1.66	1.85
Germany	1.71	2.06
France	3.21	4.32
Greece	2.01	2.51
Ireland	1.47	1.69
Italy	3.50	4.87
Luxembourg	2.47	3.35
Netherlands	2.89	4.07
United Kingdom	1.52	1.74

THE TARIFFS ON UNMANUFACTURED TOBACCO AND MANUFACTURED
PRODUCTS IN THE COMMON CUSTOMS TARIFF AND THE SUSPENSION
OF TARIFFS GRANTED TO DEVELOPING COUNTRIES

1. Unmanufactured tobacco and tobacco waste (CCT heading No 24.01) are subject to a mixed customs duty: an ad valorem rate subject to a specific minimum and maximum charge (see table at the end of the Annex).
2. The autonomous ad valorem rate of 30% was set by the Treaty (Article 19(4) in conjunction with Annex I, List F). The autonomous specific rates of 29 EUA minimum and 70 EUA maximum per 100 kg net were introduced to correct the extreme effects of the ad valorem rate at either end of the price range, thereby reconciling various requirements. These requirements included the protection of Community production (low-priced tobacco) and reducing the extent of protection against tobaccos from the United States (high-priced tobaccos).
3. Similar considerations lay for the most part behind the conventional rates. These have been substantially reduced in successive GATT negotiations. The present bound GATT rates are shown in the table to this Annex.
4. Raw Virginia type tobacco originating in developing countries and Yugoslavia is covered by the generalized system of tariff preferences (GSP). The special arrangements provide for a reduced rate of duty on this product within a Community tariff quota (61.200 tonnes for 1981). Within this quota, the duty is suspended at 7% with a minimum charge of 13 EUA and a maximum of 45 EUA per 100 kg net, and is totally suspended on tobacco originating in the least developed countries (Council Regulation No 3321/80 of 16 December 1980, OJ No L 354).
5. Raw or unmanufactured tobacco, other than Virginia-type, from developing countries and Yugoslavia is also admitted at a reduced rate of duty up to a Community ceiling (in 1981, 2.550 tonnes.) Up to this ceiling

duty is suspended at the rate of 7%, with a minimum charge of 33 EUA and a maximum of 45 EUA per 100 kg net and totally suspended for the least developed countries (Council Regulation No 3321 of 16 December 1980, OJ No L 354).

A Community tariff quota (of 1.500 tonnes in 1981) has been opened for "Prilep"-type tobacco originating in and imported from Yugoslavia, within which the CCT duty is suspended at the rate of 7% ad valorem with a minimum charge of 13 EUA and a maximum of 45 EUA per 100 kg net (Council Regulation No 3504/80 of 22 December 1980, OJ No L 367).

6. There is a complete exemption from duties for raw or unmanufactured tobacco and tobacco waste originating in Turkey (Regulation No 2760/72, OJ No L 293) and in the African, Caribbean and Pacific States (ACP) and the overseas countries and territories ("PTOM") (Council Regulation No 435/80, of 18 February 1980, OJ No L 55).

7. Fixing the CCT duties for manufactured tobacco (CCT heading No 24.02) presented a number of difficulties, arising from the problem of customs duties of a fiscal nature, the existence of State monopolies and the internal taxation systems in the Member States.

8. In France and Italy tobacco imports were the preserve of the State monopoly and were free of duty. However, to consider the rate of duty in those two countries as zero for the purposes of calculating the arithmetical average provided for by Article 19 of the Treaty ignored the protection actually afforded by the existence of the monopoly.

9. It was therefore thought better not to calculate the duties on manufactured tobacco strictly according to Article 19 but to fix them by a unanimous Council Decision under Article 28.

10. A further major difficulty was the basic difference in internal taxation systems. Whilst in France and Italy a State monopoly operated, in the Benelux countries manufactured tobacco products were subject to excise duties based on their retail prices. This system greatly magnified the impact of customs duties. Hence, an ad valorem rate of customs duty on cigarettes in the Benelux countries of 45% belied an actual effect that was much greater because of the internal tax structure. Had the Benelux countries accepted as high a rate as that of other Member States, the result would have been sharply to increase the overall tax burden on tobacco products from outside the Community, thereby significantly increasing their retail prices and thus limiting their importation.

11. To overcome these difficulties and allow the Benelux countries temporarily to maintain their customs duties at their previous rate, it was necessary to authorize them, under Article 26 of the Treaty, to postpone bringing the rates of duty on manufactured tobacco into line with those in the Common Customs Tariff. Account also had to be taken, when fixing the rates of duty in the CCT, of the requirements of other members of GATT. The possibility of introducing specific duties on manufactured tobacco was raised during the discussions in the Community but was not taken up.

12. The autonomous rates of duty on manufactured tobacco were finally set at the figures shown in the Table to the Annex.

13.. The Commission and the Member States agreed that the decision taken on the rates of CCT duty should not dictate the outcome of the talks then taking place on the harmonization of taxation. Indeed, the Commission stated that if the studies in this area then under way resulted in an agreement on a harmonized tax system which was incompatible with the level of duties proposed for manufactured tobacco, those duties should be revised in line with the new internal tax arrangements that had been decided upon (Doc. III/COM(62)6 of 12 January 1962, p. 9).

ANNEX III

14. Again in 1972 (see OJ No L 166, p. 5) the Commission stated that if the harmonization of the internal tax structures for manufactured tobacco proceeded as advocated in the proposed Regulation on taxes other than turnover taxes affecting the consumption of manufactured tobacco (subsequently issued as a Directive in OJ No L 303 of 31 December 1972), the Council would probably be led to make significant changes to the CCT duties on these products.

15. The Commission's remarks concerned only the autonomous rates of CCT duty (for cigarettes, 180% ad valorem). Later on, manufactured tobacco was the subject of GATT negotiations and conventional rates of duty were introduced (see, inter alia, Regulation No 2999/79, OJ No L 341), halving the tariff on cigarettes to its present level of 90% ad valorem.

16. The Commission does not have any plans at present for negotiating or renegotiating the customs duties on raw or manufactured tobacco. However, it is worth noting that some products falling within CCT headings 24.01 and 24.02 are on the Federal Register, which means that the United States Government could enter into a negotiation or renegotiation of the tariff rates (Section 124).

17. Under the generalized system of preferences the rates of ad valorem duty on manufactured tobacco are (1981) as follows:

A. Cigarettes	87%
B. Cigars	42%
C. Smoking tobacco	110%
D. Chewing tobacco and snuff	45%
E. Other, including agglomerated tobacco in form of sheets of strip	19%

The partial suspension of duties at the above rates also applies in 1981 to manufactured tobacco originating in Turkey.

A total exemption from customs duties is granted on manufactured tobacco originating in the African, Caribbean and Pacific (ACP) States (Council Regulation No 3225/80, OJ No L 347) and the overseas countries and territories ("PTOM") (Council Decision of 31 December 1980, OJ No L 361).

CHAPTER 24

TOBACCO

Heading number	Description	Rate of duty	
		Autonomous % or levy (L)	Conventional %
1	2	3	4
24.01	Unmanufactured tobacco; tobacco refuse:		
	A. Flue cured Virginia type and light air cured Burley type tobacco (including Burley hybrids); light air cured Maryland type and fire cured tobacco (a)	30 with a min. of 29 EUA and a max. of 70 EUA per 100 kg net	23 with a min. of 28 EUA and a max. of 30 EUA per 100 kg net
	B. Other	30 with a min. of 29 EUA and a max. of 70 EUA per 100 kg net	14 with a min. of 28 EUA and a max. of 70 EUA per 100 kg net
24.02	Manufactured tobacco; tobacco extracts and essences:		
	A. Cigarettes	180	90
	B. Cigars	80	52
	C. Smoking tobacco	180	117
	D. Chewing tobacco and snuff	100	65
	E. Other, including agglomerated tobacco in the form of sheets or strip	40	26
(a) Entry under this subheading is subject to conditions to be determined by the competent authorities.			

RAW TOBACCO: STATISTICS

Table 1. Breakdown by variety

Variety	PRODUCTION (t)						CONSUMPTION (t)
	1980						
	I	F	GR	D	B	Total	
Flue cured	18649	288	58	402		19397	360000
Light air cured	48784	4	13927	2457		65172	90000
Sun cured	21854		88151			110005	55000
Dark air cured	11505	37246		2875	1008	52634	100000
Fire cured	8606					8606	15000
Other	282			9		291	10000
TOTAL	109680	37538	102136	5743	1008	256105	630000

Baled tobacco: Source Commission

Table 2. Area by Member State

	AREA (in hectares)					
	D	F	I	B	GR	TOTAL
1975	3 832	20 485	56 193	490	97 090	178 090
1976	3 912	21 822	63 756	460	114 190	204 140
1977	3 760	22 181	55 173	469	104 610	186 193
1978	3 589	20 509	57 871	479	101 340	183 788
1979	3 422	20 016	59 668	527	93 250	176 883
1980	3 363	18 701	60 684	423	89 306	172 476

Source: Commission

Table 3. Tobacco growers by Member State

	GROWERS					
	D	F	I	B	GR	TOTAL
1975	5 640	36 130	93 650	767	118 500	254 687
1976	5 260	36 020	103 020	703	129 900	274 903
1977	4 770	35 360	96 170	659	124 900	261 859
1978	4 333	31 903	85 600	619	115 692	238 147
1979	3 728	29 870	83 693	601	106 784	224 666
1980	3 567		83 393	559	106 059	

Source : Commission

Table 4. Average area per grower by Member State

	HECTARES/GROWERS					
	D	F	I	B	GR	TOTAL
1975	0,67	0,56	0,60	0,63	0,81	0,69
1976	0,74	0,60	0,61	0,65	0,87	0,74
1977	0,78	0,62	0,57	0,71	0,83	0,71
1978	0,82	0,64	0,67	0,77	0,87	0,77
1979	0,91	0,67	0,71	0,87	0,87	0,78
1980	0,93		0,74	0,78	0,84	

Source : Commission

Table 5. Income per hectare and by variety
1980

	FR	IT	B	D	GR
	ECU	ECU	ECU	ECU	ECU
1a Bad. Geudertheimer	8077	6088		6902	
2 Bad. Burley	6017			7242	
3 Virgin	5517			4217	
4a Paraguay	6558	3809			
b Philippin					
5 Nijkerk	3180				
6a Misionero	5953				
b Rio Grande					
7 Bright		5874			
8 Burley		7709			
9 Maryland		7560			
10a Kentucky		3756			
11a Nostrano		3698			
12a Beneventano		1644			
b Brasile Selvag.		3354			
13 Xanti-Yakà		3521			
14 Perustitza		3828			
15 Erzegovina		3203			
16a Round Tip	18.160	21.710		27.308	
17 Basma					4253
18 Katerini					4818
19 Kabakoulak classic					3914
20a Kabakoulak non classic					1699
20b Elassona, Myrodata Smyrne					2734
21 Myreradata agrinion					4346
22 Zichomyrodata					5038
23 Tsebelia					4608
24 Mavra					2771
25 Burley (Gr)					4737
26 Virginia (Gr)					3566
Total	6517	5312	7864	6781	4008

Table 6. Raw tobacco : calculation of premium

Number	Community varieties	Total cost price *	Competing prices non-member countries		Difference		1981 premium (baled tobacco)
			Min.	Max	(1 - 2)	(1 - 3)	
		1	2	3	4	5	6
4	Paraguay	4.072	1.225	1.789	2.847	2.283	2.355
10	Kentucky	3.182	1.518	2.487	1.664	0.695	1.560
8	Burley	3.356	1.538	2.344	1.818	1.012	1.512
7	Bright	4.342	1.437	2.506	2.905	1.836	2.119
13	Xanti-Yaka	4.746	2.302	3.062	2.444	1.684	2.551
23	Tsebelia	5.757	2.101	2.503	3.656	3.254	3.254

* Total cost price = norm price x coefficient (specific for each variety) + processing costs.

ANNEX IV contd.

Table 7. Raw tobacco : breakdown of expenditure (million ECU)

	Expenditure 1979	Expenditure 1980	Approps 81 2nd amend- ing budget	Approps 82 letter of amendments
Refunds	3.7	4.4	5	19
Premiums	208.7	274.9	280	587
Storage	13.0	30.0	42	42
TOTAL	225.4	309.3	327	648
% of Guarantee Section expenditure	2.2 %	2.7 %	2.8 %	4.8 %

EFFECTS ON COMPETITION OF THE INTRODUCTION OF
A HARMONIZED EXCISE

1. Assume two excise systems for cigarettes: on market A, taxes are levied as a proportion of retail price; on market B, the tax is a fixed amount by cigarette, irrespective of price, size, weight or other factors (for control purposes, a maximum cigarette size would have to be fixed). In both instances, although the tax incidence differs, it is relatively high.
2. All other things being equal, the price range on market A will show a more or less even distribution from the cheapest up to the most expensive cigarettes, the tax being proportional to retail price. On market B, all cigarette price categories will be found at or close to the maximum cigarette size.
3. It is apparent that producers on market A, whose product range covers a wide range of prices, will be obliged to limit their exports to B to only part of their range. Producers on market B, if they wish to export to market A, will be obliged, either to limit their competition to one sector of the market, or to increase their product range beyond what is required for their own market B.
4. The major tax distortion to competition arising from this situation lies in the fact that all the producers concerned, although well able to supply both markets, are obliged to adapt their products and prices separately to each of them, and are thus denied the possibility of competing on a single market AB. Whatever excise system is chosen to apply on both markets A and B (whether systems A, B, or some other system), this particular distortion is removed.
5. If the structure chosen is a combination of systems A and B, the effect of combining a specific amount with an ad valorem rate will be to produce a tax incidence which, although different for each price category,

nevertheless varies more or less in proportion with the differences in price. The degree of variation in incidence will be less (i.e. the closer the approach to price proportionality) the smaller the specific part in the total tax mix. Conversely, the larger the specific part, the greater the variation in tax incidence between price categories. However, whatever the specific/ad valorem mix chosen for system AB, it is bound to favour certain price categories relative to others. So far as the Commission is aware, there is no objective basis on which any one mix could be said to be more neutral in terms of competition than any other.

6. It should be stressed here that the alternative approach is favoured by the Economic and Social Committee because, by harmonizing the tax multiplier, it anticipates the harmonization of tax rates (although only to some extent, since the specific element will continue to vary between Member States until excise rates are harmonized). The benefits of this, in terms of improved competition, are doubtful.
7. The relative contribution to be made to competitive neutrality by a harmonized structure on the one hand and by harmonized tax rates on the other depends on a variety of factors (all of which inter-act) and on differences between these factors. The factors concerned are the differences between the original tax structures, the differences between the tax rates (in this case, on cigarettes) and the differences between those tax rates and the taxes levied on other goods and services. Fully to evaluate the relative importance of each of these factors on the Community scale would require an unusually complex model, taking into account degrees of substitution and price elasticity, and would in any case depend on a variety of starting assumptions (e.g. on demand price elasticities) for which little reliable data exists, and none on a Community-wide basis.
8. However, some qualitative assessment of the further contribution to competitive neutrality of harmonization of cigarette excise rates can be given. First, it should be noted that the excise is charged on the

destination principle - that is, exports are wholly tax-free and imports charged at the same rate as domestic products. Consequently, even with widely different rates, and provided always that the tax structure is itself harmonized, competition between imports and national products within market A and within market B will be neutral. Secondly, although differences in the excise rates may tend to differentiate markets A and B (e.g. high rates in A, low rates in B, could lead to different parts of consumption going to cigarettes in A and B, to different price ranges, to market A declining whilst market B expands etc.) most of these differences could also arise from a variety of factors external to the cigarette excise (e.g. differences in other tax rates, differences in economic growth rates, changes in consumer tastes). Thirdly, although there are significant differences in the levels of cigarette tax rates between the Member States (between 56% and 87% of retail price) the level of taxation of cigarettes is generally high, relative to taxes on most other consumer items, and the differences in rates in reality reflect differences in the indirect tax systems as a whole. Consequently, the extent to which harmonization of cigarette excises alone is likely to improve competition, over and above the improvement gained by a harmonized structure, is certainly doubtful and probably marginal⁽¹⁾.

9. In any case, even assuming a harmonized structure and harmonized tax rates, and whatever the proportions of specific and ad valorem elements in the total tax, the mixed system will invariably result in a relatively greater tax incidence on certain price categories than on others. This effect is inherent in the mixed system and is unaffected, either by harmonization of the tax rates, or by devices to anticipate rates harmonization to a greater or lesser degree.

(1) Harmonization of indirect tax rates is, however, a pre-condition of the abolition of fiscal frontiers, which remains a major, if long-term, political objective of the Community.

10. The degree of adaptation to be made by manufacturers based in A and B will of course depend crucially on the extent to which the harmonized structure and rate departs from the system under which they previously operated. Harmonization on the basis of (say) a system A B tending more towards A than to B could therefore tend to confer an initial advantage on producers based in A. Once-for-all advantages of this kind are an unavoidable consequence of any harmonization process, although it might be regarded, in political terms, as initially unfair to producers based in B.

**EXTRACT FROM THE DECISION OF THE COURT OF JUSTICE
IN CASES NO. 209-215/78 AND 217-218/78**

- 127 In that respect it is necessary to observe in the first place, as the parties agree, that in a system of basically proportional excise duty, as applicable in Belgium, any alteration in the manufacturers' or importers' share contained in the retail price involves an alteration several times greater in the tax and therefore in the retail price itself where the said alteration is adjusted so as to be recovered in the price. That multiplier effect in principle works as regards both increases and reductions. Nevertheless in the latter case the decreasing effect of the multiplier which works in favour of the consumer is limited by the minimum excise duty laid down by the Belgian State pursuant to Council Directives Nos 72/464 and 77/805 by reason of the fact that the excise duty is fixed at 90% of the aggregate amount of the proportional and the specific excise duty levied by the Belgian State on cigarettes in the most popular price category.
- 128 It follows from this multiplier effect in conjunction with the minimum excise duty levied by the Belgian State to guarantee its revenue that any competitive effort in relation to profit margins by the manufacturer or the importer having a repercussion on the retail price is limited.
- 129 Further, although in principle the Belgian rules on consumer taxes and price controls do not prevent the manufacturer or importer from choosing the retail price desired by him for each of his products, such liberty of choice is in practice subject to various constraints. As has already been shown it seems that the practical application in the manufactured tobacco sector of the price control measures in which the revenue authorities in particular take part encourages joint negotiations with the trade associations representing the various branches of the sector even if the system does not exclude the possibility of separate undertakings' giving individual notifications especially in the case of the introduction of a new brand. During such negotiations great influence on the fixing of the retail price is exercised by the revenue authorities whose concern is above all to guarantee the revenue arising from the taxation of the products in question. It also appeared during the proceedings that the Belgian State is able by using the range of tax bands to restrict the freedom of undertakings as regards the choice of the retail prices for their products. In that respect the applicant BAT stated that after introducing a new brand of cigarettes it was forced to increase the price by Bfr 6 per packet in order to market them at a price corresponding to the lowest tax band available from the authorities, who had abolished the tax bands for lower prices.
- 130 It follows from all the considerations set forth above that in the manufactured tobacco sector the Belgian rules on consumer taxes and price controls and their application pursuant to the revenue policy pursued by the State have the effect of making it practically impossible for manufacturers and importers to compete in such a way that there would be an effect upon the amount of the retail selling price.

EFFECTS ON RETAIL PRICES OF MOVING FROM THE PRESENT TAX STRUCTURE TO DIFFERENT THIRD STAGE AND FINAL STAGE STRUCTURES (SEE PARAGRAPH 11.5.10)

Hypothesis	% price change = p	% of market where prices change									
		B	DK	D	F	GR	IRL	IT ¹⁾	LUX	NL	UK
I. Specific duty not less than 10% and not more than 35% of total tax (3rd stage present approach)	p < 2%	96,8	98	100	60,5	96,8	98,1	49,0	97,5	99,1	97,8
	2% ≤ p < 5%	1,2	0	0	30,4	0	1,2	27,0	1,3	0	2,1
	5% ≤ p < 10%	0	2	0	7,1	0	0	15,9	0	0	0
	10% ≤ p < 20%	0	0	0	0	0	0	1,8	0	0	0
	20% ≤ p	0	0	0	0	0	0	3,3	0	0	0
Market share taken into account ²⁾		98,0	100	100	98,0	96,8	99,3	97	98,8	99,1	99,9
II. Specific duty 20% of total tax (final stage present approach)	p < 2%	82,9	94,7	56,3	60,5	74,5	91,9	45,1	69,2	96,6	89,8
	2% ≤ p < 5%	13,9	3,3	43,7	0	22,3	7,4	5,8	28,3	2,5	8
	5% ≤ p < 10%	1,2	0	0	30,4	0	0	0	1,3	0	0
	10% ≤ p < 20%	0	0	0	7,1	0	0	39,7	0	0	2,1
	20% ≤ p	0	2	0	0	0	0	6,4	0	0	0
Market share taken into account ²⁾		98,0	100	100	98,0	96,8	99,3	97	98,8	99,1	99,9
III. Ad valorem duty not less than 44% and not more than 66% of retail price (3rd stage alternative app)	p < 2%	96,8	100	100	60,5	96,8	99,3	50,9	98,8	99,1	97,8
	2% ≤ p < 5%	1,2	0	0	37,5	0	0	39,7	0	0	2,1
	5% ≤ p < 10%	0	0	0	0	0	0	1,3	0	0	0
	10% ≤ p < 20%	0	0	0	0	0	0	1,8	0	0	0
	20% ≤ p	0	0	0	0	0	0	3,3	0	0	0
Market share taken into account ²⁾		98,0	100	100	98,0	96,8	99,3	97	98,8	99,1	99,9
IV. Ad valorem duty 56% of retail price (Final stage alternative approach)	p < 2%	82,9	98	56,3	60,5	72,7	91,9	42,9	97,5	83,2	94,2
	2% ≤ p < 5%	13,9	0	43,7	0	23,1	7,4	6,1	1,3	15,0	3,6
	5% ≤ p < 10%	1,2	2	0	30,4	1,0	0	1,9	0	0,9	2,1
	10% ≤ p < 20%	0	0	0	7,1	0	0	39,7	0	0	0
	20% ≤ p	0	0	0	0	0	0	6,4	0	0	0
Market share taken into account ²⁾		98,0	100	100	98,0	96,8	99,3	97	98,8	99,1	99,9
V. Ad valorem duty 40% of retail price (Final stage alternative approach)	p < 2%	81,2	100	100	43,5	66,8	99,3	42,9	62,2	73,9	99,9
	2% ≤ p < 5%	2,7	0	0	17,0	11,8	0	2,2	32,5	22,7	0
	5% ≤ p < 10%	12,9	0	0	0	18,2	0	5,8	2,8	1,6	0
	10% ≤ p < 20%	1,2	0	0	30,4	0	0	25,1	1,3	0,9	0
	20% ≤ p	0	0	0	7,1	0	0	21,0	0	0	0
Market share taken into account ²⁾		98,0	100	100	98,0	96,8	99,3	97	98,8	99,1	99,9

¹⁾ Based on 5% specific duty applied to-day.

²⁾ Price categories which represent less than 1% of market not taken into account.

Source: Member States

FAIRNESS GRAPH

A substantial excise duty will in one way or another influence competition between products. A pure specific duty tends to favour the most expensive products: the absolute difference in ex-factory prices remains unchanged at retail level, but the relative difference in ex-factory prices is very substantially compressed at retail level. On the other hand, a pure ad valorem system tends to favour the cheapest products - the relative price difference at producer level remains the same at retail level, whereas the absolute price difference is considerably multiplied.

It is possible to postulate a point between these two extremes, where neither high-cost nor low-cost products enjoy a competitive advantage.

A rough balance could be struck by choosing a point where half of the relative price difference between the producer price of the most popular price category and those of a high-cost and a low-cost product is reflected in retail price. To reach such a solution means that the specific duty should be the same as the ex-factory price of the most popular product. The ad valorem rate in such a case would then be determined by the level of total taxation.

To show the present position in the Member States, Table 1 gives the "proportionality coefficients" for the lowest and highest price category compared with the most popular price category. The "proportionality coefficient" is the % figure by which the relative difference in ex-factory prices is reflected in the relative difference in retail prices as: -

$$\text{proportionality coefficient} = \frac{\text{relative difference in retail prices}}{\text{relative difference in ex-factory prices}} \times 100$$

PROPORTIONALITY COEFFICIENT

Relative difference in retail price on most popular price category and another¹⁾

" " " ex-factory " " " " " " "

	Most popular relative to lowest price	Most popular relative to highest price	Average
BELGIUM	∞	89,0	89,0
LUXEMBOURG	86,9	86,9	86,9
NETHERLANDS	70,4	70,4	70,4
FRANCE	-	84,3	84,3
F.R. GERMANY	50,8	50,8	50,8
ITALY	92,8	95,2	94,0
DENMARK	19,4	23,5	21,5
UNITED KINGDOM	36,6	29,3	33,0
IRELAND	36,8	37,4	37,1
GREECE	84,7	92,3	88,5

∞ Minimum excise duty

1) Example:

Ex-factory price most popular price category $x = 1$
 Ex-factory price highest price category $y = 1,5$
 Retail price most popular price category $x_r = 5$
 Retail price highest price category $y_r = 7$

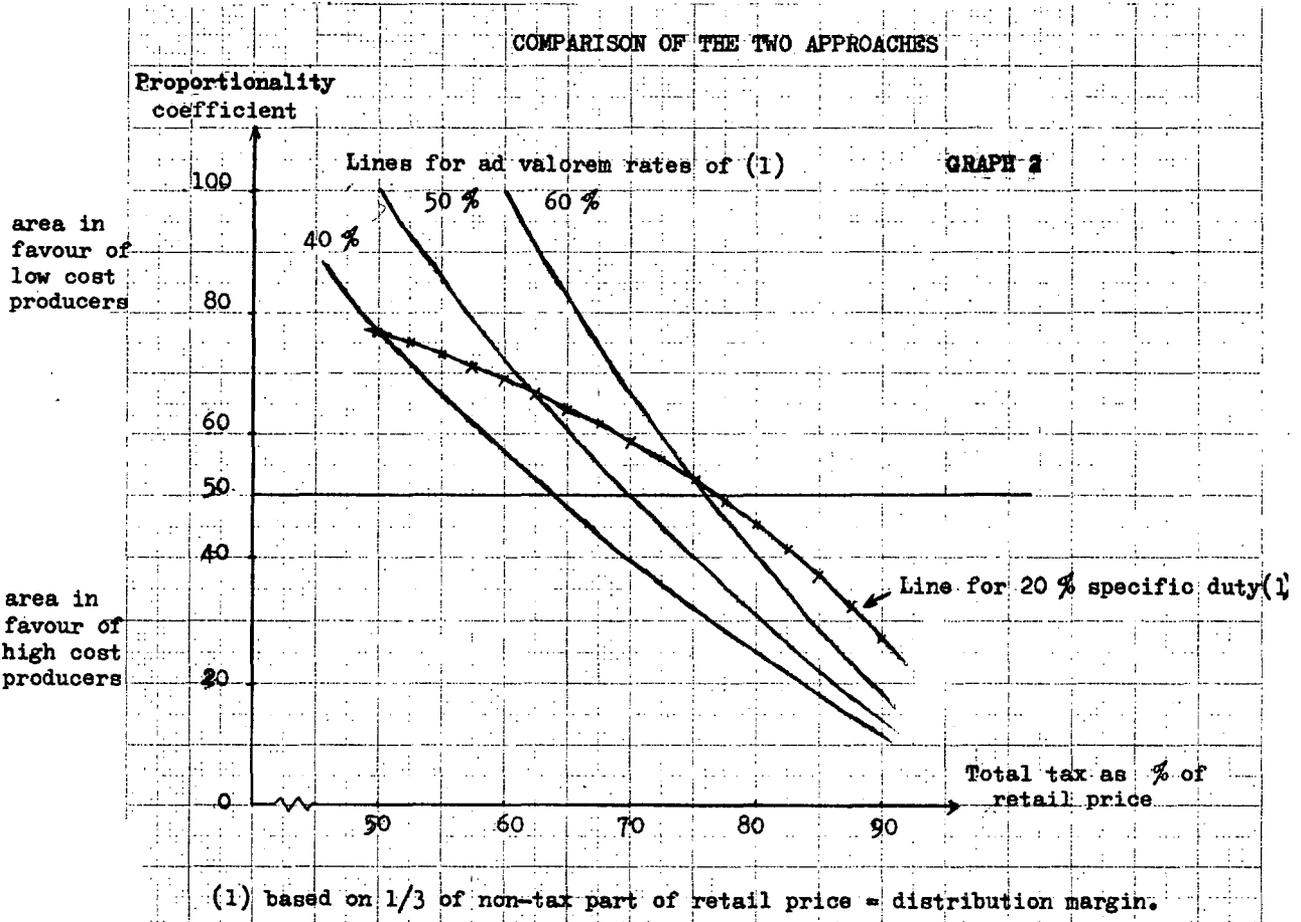
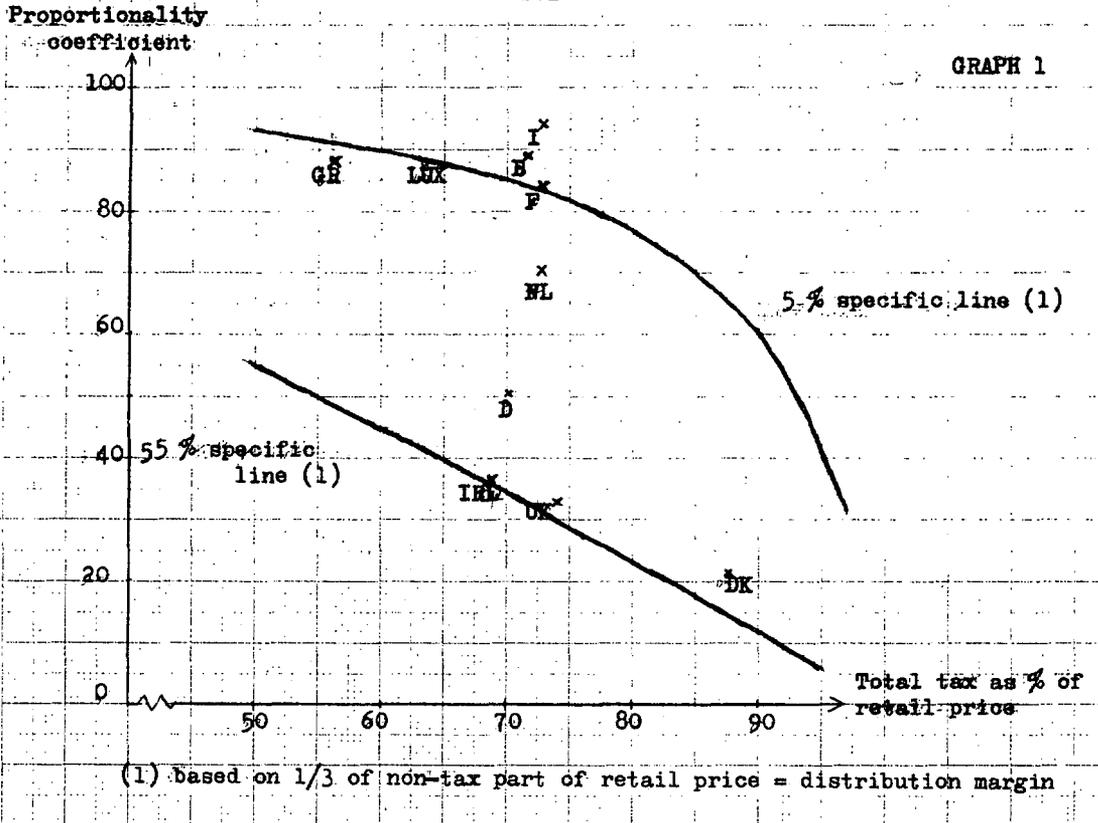
$$\text{Proportionality coefficient} = \frac{\frac{y_r - x_r}{x_r}}{\frac{y - x}{x}} \times 100 = \frac{\frac{7 - 5}{5}}{\frac{1,5 - 1}{1}} \times 100 = 80$$

The level where a Member State is placed is determined by the incidence of total tax (the higher the tax incidence, the lower the coefficient) and the % of the total tax which is specific (the lower the %, the higher the coefficient).

The alternative approach proposed by the Economic and Social Committee would oblige the Member States to have a total tax incidence at least equal to the fixed ad valorem duty. In a theoretical case of a Member State choosing this minimum level of taxation, the above-mentioned coefficients, because of a zero specific element, would be 100. If the total tax is increased (which can then only take place by the addition of a specific duty), the coefficient will go down. For example, with a total tax incidence of 71.25%, a fixed ad valorem rate of 50% of retail price, and a 7.5% distribution margin, the coefficient is 50. But if the total tax incidence is 85% of the retail price (the ad valorem rate unchanged at 50%) the coefficient is 17.6.

The present approach, with the specific element fixed as a proportion of total tax, will also give variations in the coefficient when the total tax incidence is changed, but to a lesser extent than the alternative approach.

Graph 1 shows the area between the 5% and 55% specific lines, which are roughly the limits at present fixed by the second stage of harmonization. In the same graph is indicated where the Member States have placed themselves at 1.8.81. This graph clearly shows that the proportionality coefficient in a Member State can be more than 3 times the coefficient in another Member State even at the same level of total taxation or, put in another way, the retail prices in the Member States reflect the ex-factory prices in quite different ways from each other and therefore give the producers very different competitive conditions.



The present situation, with the possibility of varying proportionality coefficients at the same level of taxation, will become uniform when structural harmonization reaches its final stage. But no matter what approach is followed - fixed specific proportion of total tax or fixed ad valorem rate - the proportionality coefficient will invariably differ in accordance with the tax incidence. In graph 2, two examples show the correlation between total tax incidence and proportionality coefficient both in a system with 20% of specific duty and in a system with fixed ad valorem rates of 40, 50 and 60%. In all cases, the proportionality coefficient will go down as total tax incidence increases.

Whichever approach is followed, the effect of an increase in tax incidence will invariably be to improve the relative competitive position of high-cost producers, because the degree of reflection in retail prices of differences in pre-tax costs will fall. Conversely, a reduction in tax incidence will improve the relative competitive position of low-cost producers, because the degree of reflection in retail prices of differences in pre-tax costs will rise. Consequently, a substantial up or down movement in tax incidence will alter the competitive situation in favour of high- or low-cost producers⁽¹⁾, the degree of the alteration being relatively greater if the alternative approach is followed.

(1) A harmonized tax structure consisting of a fixed specific amount and a variable ad valorem rate would avoid this situation. The competitive situation would then be insensitive to changes in tax incidence.

Tobacco Report COM(82) 61 - New Table 7.6

Cigarette consumption per head

	1970	1975	1980
B & LUX	1830 ¹⁾	2030	1920
DK	1310	1420	1370
D	1950	2040	2080
F	1370	1610	1590
GR	1700 ²⁾	2010 ²⁾	2320
IRL	1730	2360	2210
IT	1300	1600	1730
NL	1430	1750	1620
UK	2300	2370	2180
Weighted average	1720	1910	1900

1) Only Belgium.

2) Estimated from the weight of manufactured cigarette tobacco.

Sources: Manufacturers' statistics; Member States tax statistics.

REPORT TO THE EUROPEAN PARLIAMENT
ON THE IMPLICATION OF FURTHER HARMONISATION
OF THE EXCISES ON MANUFACTURED TOBACCO

CORRIGENDUM

- Page 3 Paragraph 1.1.4. Line 8. Amend "p 5" to read "p 135".
- Page 42 Paragraph 7.1.1. Line 4. Amend "25 %" to read "15 %".
Paragraph 7.1.1. Line 8. Amend "22.9 %" to read "7.5 %".
- Page 43 Table 7.1. Line "IRL". Amend "5600" to read "5900 ²⁾", "9600 ¹⁾"
to read "8000 ²⁾" and "-22.9" to read
"-7.5".
Table 7.1. Line "UK" Amend "111.100" to read "147.500 ²⁾".
Table 7.1. Line "ALL MS" Amend "457.100" to read "493.800" and
"564557" to read "562957".
Table 7.1 Add footnote "2) Fedetab".
- Page 48 Paragraph 7.3.2. Line 4-5 Delete the phrase in brackets
Paragraph 7.3.2. Line 6-9 Delete the final sentence of the
paragraph "It is striking tax
incidence (see chapter 9)."
- Page 50 Table 7.6. Delete the table and insert the new table 7.6 attached.
- Page 54 In column "UK" in the table : Amend "47.900" to read "37900".
- Page 57 Paragraph 8.3.2 Line 2 - 3 : Amend "by 23,5 %" to read
"by about 15 %".
- Page 118 Paragraph 14.1.4 Line 2 : Delete "about 23 %".