

EUROPEAN PARLIAMENT

# Working Documents

1980 - 1981

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13 February 1981

DOCUMENT 1-871/80

## Report

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

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

**Rapporteur: Mr B. BEUMER**



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

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

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

It considered this proposal from the Commission at its meetings of 28 October 1980, 25 November 1980, 20 January and 30 January 1981 and at this last meeting adopted the motion for a resolution and the explanatory statement by 8 votes to 1 with 6 abstentions.

Present: ~~Mr~~ Delors, chairman; Mr Deleau, vice-chairman; Mr Beumer, rapporteur; Mrs Baduel Glorioso (deputizing for Mr Piquet), Mr Beazley, Mr Bonaccini, Mr Caborn, Miss Forster, Mr Herman, Mr Lange (deputizing for Mr Walter), Mr Leonardi, Mr Markozanis, Mr Purvis (deputizing for Mr Hopper), Mr Seal (deputizing for Mr Rogers) and Mr von Wogau.

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

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

MOTION FOR A RESOLUTION

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

The European Parliament,

- having regard to the proposal from the Commission to the Council<sup>1</sup>
  - having been consulted by the Council pursuant to Articles 99 and 100 of the EEC Treaty (Doc. 1-328/80),
  - having regard to the report of the Committee on Economic and Monetary Affairs and the opinions of the Committee on Budgets and the Committee on Agriculture (Doc. 1-871/80),
1. Notes that there is still relatively little overall interpenetration of the national tobacco markets and still a considerable difference in prices;
  2. Deplores the slow rate of progress on harmonization of excise duty, in particular on cigarettes; recalls the objectives set by the Council in 1970<sup>2</sup> according to which the final stage of harmonization was to have begun at the start of 1980;
  3. Notes that the proposed third stage of harmonization of excise duty on cigarettes is still far short of the final stage and that the Commission judges that it could prove premature to lay down the details of this final stage at the present time;
  4. Points out that it is important for industry to have definite information about the final stage of harmonization as otherwise medium and long-term planning is made unnecessarily difficult; believes that the indication by the Commission of what form this final stage could take, without however making a proposal to the Council on this point, does nothing to dispel this uncertainty;

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

<sup>2</sup>OJ No. C 50, 28.4.1970

5. Emphasizes that the taxation structure to emerge from harmonization must also be as neutral as possible from the point of view of competition; wonders, however, whether the method of harmonization laid down by the Council in Directive 72/464/EEC, whose ultimate goal is to establish a fixed relationship between the specific and proportional components of the duty, is the best way of achieving this goal;
6. Requests the Commission therefore to investigate as soon as possible, whether as regards the final stage it would not be more neutral from the point of view of competition to determine the effect of proportional taxation on retail prices than to fix the relationship between the specific and proportional components of duty;
7. Disagrees with the proposals for a third stage of harmonization and urges a prolongation of the second stage pending the submission at the earliest possible date of final proposals that take into account all aspects of this harmonization issue, including the rules governing collection of excise duty;
8. Considers that the proposal for reducing the minimum excise duty is premature;
9. Notes that, according to the Commission, use has not yet been made of the possibility of excluding customs duties from the basis of assessment of ad valorem excise duty on cigarettes so that removal of this option can have no major repercussions; agrees therefore with the proposal that inclusion of customs duties in the basis of assessment of excise duty on cigarettes should be obligatory;
10. Points out that the calculation of the financial implications for the EEC budget is incomplete and based on static hypotheses;
11. Asks the Commission to submit as soon as possible the proposal on the harmonization of the rules governing collection of the excise duty referred to in Article 2 of its proposal which is to be adopted by the Council before 31 December 1983.

EXPLANATORY STATEMENT

1. The structures of the national markets for tobacco products differ widely. Efforts to create a common market for tobacco products have inevitably come up against the divergent excise systems in the Member States. Partly as a result of high rates, these excise systems have a considerable influence on the pattern of consumption and their divergence makes them an obstacle to the realization of the common market. It was for this reason that in 1967 the Commission submitted a proposal for the harmonization of excise duties on manufactured tobacco<sup>1</sup>.

2. Taking this proposal as a basis, Parliament held an exhaustive debate on the principles of the harmonization of excise duties on manufactured tobacco<sup>2</sup>. It is not the purpose of this report to examine these principles in depth once again, since the proposal under discussion is concerned with the third stage of harmonization, harmonization having begun on 1 July 1973. As this third stage is due to begin on 1 January 1981, little time remains for the adoption of the proposal for a directive. At the same time, it should be noted that Article 1(3) of the first Council directive of 19 December 1972<sup>3</sup> stated that: 'On the basis of Articles 99 and 100 of the Treaty, the Council shall, at least one year before the expiry of the period provided for in Article 7(1), adopt a directive laying down the special criteria applicable during the following stage or stages'. This was valid for the transition from the first to the second stage. As regards transition to the third stage, the period was limited to six months.

It is therefore somewhat surprising that the Commission has submitted this proposal for a third stage barely six months before the end of the present second stage. By that time, the Council should in fact have already acknowledged the imminence of the third stage. The consequence of this is that the proposal will have to be dealt with in great haste if the third stage of harmonization is in fact to begin on 1 January 1981 and the Committee on Economic and Monetary Affairs accordingly takes exception to the Commission's tardy submission of its proposal.

The Committee on Economic and Monetary Affairs nevertheless attaches great importance to the fact that progress should be made with harmonization and would be very sorry if it proved impossible to introduce the third stage of harmonization on 1 January 1981. It will therefore do its utmost to deal with this proposal for a directive as quickly as possible.

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<sup>1</sup> Doc. 122/67-II

<sup>2</sup> Doc. 224/69 of 10 March 1969

<sup>3</sup> OJ No. L 303, 31.12.1972

3. The main factor in the harmonization of excise duties on manufactured tobacco is the duty on cigarettes since this is the largest source of revenue. Work on harmonization has so far therefore concentrated mainly on cigarettes. As far as other manufactured tobacco is concerned, harmonization has been limited to a common definition of the various groups of products<sup>1</sup>. The present proposal is again concerned with cigarettes and particularly with the third stage of harmonization of excise duties on cigarettes.

4. Before a start was made on harmonization, it was possible to divide the Member States into two groups: on the one hand, the Member States in which excise duty was almost exclusively levied in the form of a fixed amount per cigarette (the specific component) and, on the other hand, the Member States in which excise duty was principally a percentage of the retail price (the proportional or ad valorem component). The accession of the United Kingdom and Ireland added a third system based on the weight of the raw tobacco, which, after a transitional period, has since been abolished.

5. In its resolution of 21 April 1970<sup>2</sup> the Council set itself the aim of harmonizing excise duty on cigarettes in these terms:

'With regard to excise duty on cigarettes, a proportional element will be combined with a specific element so that at the final stage, beginning on 1 January 1980, the relationship between the proportional component and the specific component should be established to ensure that the range of retail prices freely fixed by manufacturers fairly reflects the difference in the manufacturers' supply prices'.

6. This principle was reaffirmed in the first Council directive of 19 December 1972<sup>3</sup> which laid down general principles for the harmonization of taxes other than turnover taxes which affect the consumption of manufactured tobacco and also initiated the first stage of harmonization.

7. Without wishing to go into further detail about these general principles, one ought nevertheless to recall the conditions and principles with which the harmonized excise duty system must comply and to which attention has repeatedly been drawn by Parliament<sup>4</sup>:

- the tax system must be neutral in its effects on competition;
- the tax system must promote market interpenetration;

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<sup>1</sup> Council Directive 79/32/EEC in OJ No. L 10, 16.1.1979

<sup>2</sup> OJ No. C 50, 28.4.1970

<sup>3</sup> OJ No. L 303, 31.12.1972

<sup>4</sup> Doc. 224/68 and Doc. 128/76



- the tax system must allow optimum utilization of the tax source;
- the tax system must not lead to a narrowing of the price range, but quality must be maintained and product diversity promoted.

8. How much progress has now been made with the harmonization of excise duties on cigarettes which began with the abovementioned first Council directive of 18 December 1972? As stated above this first directive laid down the provisions for the first stage of harmonization.

The first stage of harmonization was originally planned to run for two years from 1 July 1973. During this period the specific component of the excise was to be situated between 5 and 75% of the aggregate amount of the proportional and specific components of the duty.

9. This first stage of harmonization, which was to have lasted for two years, was later prolonged on four occasions and in fact ran on until 30 June 1978 instead of 30 June 1975, i.e. exactly twice as long as originally intended. The second stage of harmonization was introduced on 1 July 1978<sup>1</sup>.

During this second stage of harmonization, the ratio between the specific excise duty component and the total tax charged (including VAT) must lie between 5 and 55%. By contrast with the first directive, the specific component is now set in relation to the total amount of taxation including VAT.

10. The present proposal is for a third stage of harmonization to run from 1 January 1981 to 31 December 1986 and providing for a gradual narrowing of the band within which the specific component must lie in relation to the total tax burden:

- from 1.1.1981 to 31.12.1982 within the existing bracket of 5-55%;
- from 1.1.1983 to 31.12.1984 within the bracket 7.5-42.5%;
- from 1.1.1985 to 31.12.1986 within the bracket 10-35%.

11. In view of the aim set in the Council resolution of 1970 to reach the final stage on 1 January 1980, this proposal for a directive immediately prompts the comment that, even though this deadline has been passed, the objective remains a long way off. Although the target date was put back by one year in the second directive, it was still envisaged at that time that the final stage would follow on from the second stage. This final stage has now been replaced by a third stage of harmonization which will require another five years and only after that might the final phase be introduced.

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<sup>1</sup> Council directive of 19 December 1977 in OJ No. L 338, 28.12.1977

A number of comments in the Commission's explanatory memorandum indicate how remote the final stage still is and how little of the original objective has been accomplished. It says: 'Notwithstanding the first two stages, price ranges still differ considerably, and the degree of market interpenetration overall is not great. Even if the final objective were fixed now, experience with the first two stages has shown that a lengthy period of adaptation will be required before that objective can be attained'.

Does this mean that, after the third stage of harmonization, a fourth stage will be needed before the final stage can be attained?

12. At all events, the Commission states that: 'To fix the final objective definitively at this stage could prove to be premature', and this despite Parliament's appeal, when commenting on the Commission's proposal for the second stage of harmonization, for 'strenuous efforts to find a solution for the final stage of harmonization'. The explanatory statement of Parliament's report (Doc. 128/76) said that it was no longer possible to avoid taking a decision in favour of one particular structure of excise duty on cigarettes after the expiry of the second stage since: 'The uncertainty regarding the final result obstructs any medium and long-term planning'.

13. In view of its own uncertainty, but faced with industry's need for some certainty about the final stage, the Commission has simply calculated the specific component for the final stage, a figure that will however serve merely as a reference point. The Council is not asked to approve this figure so that in fact the uncertainty about the final stage will remain.

Calculation of the relative component of the specific excise duty to apply during the final phase should be directed towards the objective set in Article 4(3) of the first directive 72/464/EEC<sup>1</sup>, namely that the range of retail selling prices should reflect fairly the difference in the manufacturer's delivery prices. The Commission is right in saying that, with this end in view, the ideal way of fixing the final stage would be to measure the extent to which changes in the structure and level of taxation would affect the relationship between the retail selling price and the price exclusive of tax. However, since it is clearly impossible to predict how producers and governments will react to changes in the structure of taxation, this ideal approach cannot be used.

The Commission has therefore chosen to assume that the tax burden on cigarettes in the most popular price category will not change. It then calculates that the ratio between the specific component of the excise duty and the total tax burden to apply at the final stage should be 20%. As

<sup>1</sup> OJ No. L 303, 31.12.1972

mentioned above, this figure can serve only as a reference point and there is no certainty whatsoever that it would in fact apply at the final stage.

14. However, opinions differ as regards the final objective. 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<sup>1</sup> 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.

In view of the advantages which it clearly offers, a system which lays down the rate by which proportional taxation may increase retail selling prices is worth serious consideration. The Commission should thoroughly investigate this alternative. The basic principle laid down in Article 4 of the Directive 72/464/EEC does not preclude such an inquiry. If the inquiry should confirm that a different principle is in fact more suitable from the point of view of competition, then the Commission should draw up appropriate proposals.

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<sup>1</sup> Relationship between the difference in the retail price of two brands of cigarettes and the difference in prices exclusive of tax.

15. What is the situation as regards the proposal that in the third stage of harmonization the margin of fluctuation of the specific components should be narrowed? On closer inspection it appears that this third stage of harmonization will not predetermine what the final structure will be. Calculations have revealed that the third stage will lead to a convergence of various national taxation structures towards a taxation structure where the specific component will constitute approximately 20% of total taxation and where proportional taxation will account for 50% of retail selling prices. The proposed third stage will mean a step towards harmonization even if only a modest one. In view of the fact that this third stage still leaves all the options open as regards the final stage, the Committee on Economic and Monetary Affairs is able to lend its support to the proposal for this stage.

16. Article 9 of the first Directive 72/464/EEC of 19 December 1972 and Article 10 of the Second Directive granted Member States the right to exclude customs duties from the basis of calculation of the proportional excise duty on cigarettes. The Commission is now suggesting that this derogation be abolished and that customs duties on imports be taken fully into account when fixing the basis of assessment on which the ad valorem excise duty is charged. Since the customs duty on cigarettes specified in the Common Customs Tariff is 90% of the value for customs purposes, and with domestic taxes accounting for between 61% and 88% of the retail selling price, the incidence of the customs duties will amount to 150% or more of the value for customs purposes.

Before the committee can appreciate the effect of this measure, it will need to be informed of the use made at present of the derogation, the volume of imports, the breakdown of imports according to country of origin, price category and quality, the type of consumer of these foreign cigarettes, etc.

17. Article 10 of the first directive also gave Member States the right to levy on cigarettes a minimum excise duty the amount of which might not be higher than 90% of the aggregate amount of the proportional excise duty and the specific excise duty levied on the cigarettes in the most popular price category. Five Member States have exercised this right.

The reason for this minimum limit is the multiplier effect of a high ad valorem excise duty. Since excise duty rates are high, small differences in factory prices will produce large differences in retail selling prices where the ad valorem component predominates. This means that there is a danger, in countries with a proportionately high ad valorem excise duty, that opening up the market will lead to its being overrun by cigarettes in the lower price category. This distortion of the market can be prevented by placing a minimum limit on excise duties. As the specific component increases as a result of harmonization, this multiplier effect will become less. The Commission there-

fore proposes that during the next stage of harmonization this minimum should be no greater than 80% of the total excise duty on cigarettes of the most popular price category. The suggested ceiling should create no difficulties if the proportion of the specific excise duty in the total tax burden is set at 10%. At the present time only Belgium and Germany have a ceiling of approximately 90%.

The proposed lowering of the ceiling for the minimum excise duty will make a wider range of prices possible and increase opportunities for competition without it being fixed so low as to disturb certain national markets for cigarettes.

18. The first Council directive of 19 December 1972 (72/464/EEC) held out the prospect of harmonization, in the final stage, of the rules governing collection. The need to harmonize the method of collecting excise duty as well as its structure is clear. Now Article 2 provides for the Council to adopt common rules governing collection of the excise duty before 31 December 1983. These rules would enter into force from 1 January 1985. The Committee on Economic and Monetary Affairs considers it extremely important that the method of collection of excise duty should be harmonized as soon as possible since it is an essential element of harmonization. The Commission is therefore urged to submit the necessary proposals as early as possible.

19. An estimate of the financial implications of the present proposal is set out in the financial record. The forecasts are based on various hypotheses concerning prices (retail and producer prices), tax yield, development of the market structure etc. Using these static hypotheses which take no account of general shifts in the tobacco market, the Commission has made an estimate of the effect on expenditure, i.e. the additional intervention purchases and the additional refunds for exports of raw tobacco which together will cost 2.94 million EUA. The extra customs duty revenue accruing from increased imports of raw tobacco into the Community is estimated at 0.4 million EUA. Although the Commission's analysis pertains exclusively to the situation in Italy and France, these countries do provide 95% of the Community's raw tobacco production. A change in intra-Community patterns of trade following harmonization is, however, not to be excluded and this would also have financial consequences which the Commission has completely ignored. This evaluation of the financial consequences, based on static hypotheses, is thus incomplete and this point is stressed in the opinion of the Committee on Budgets.

OPINION OF THE COMMITTEE ON BUDGETS

Draftsman : Mr NOTENBOOM

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

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

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

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

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

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

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

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

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

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

The receipts arise from:

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

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

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

#### 8. Conclusion

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



OPINION OF THE COMMITTEE ON AGRICULTURE

Draftsman: Mrs Barbara CASTLE

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

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

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

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

Delete paragraph 2.

Add the following new paragraphs:

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

#### Justification

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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