■ **OPINION**

# Revising the Tobacco Excise Directive: why harmonized tax rates in the EU are not realistic

## With a mixed ad valorem and specific tax system, the notion of convergence in tax rates risks being a muddled concept – Part I

***Fourth in a series of six papers***

May 2021 *by* Donato Raponi

The European Commission is currently looking at whether the minimum excise rates on cigarettes and other tobacco products need to be increased in the Tobacco Excise Directive, the 'TED', to move towards more convergence in the tax rates applied in Member States.

In the previous paper in my series, I recounted how this was a hard enough – and ultimately fruitless – errand when it came to VAT.

But it shall be even harder when it comes to tobacco excises for two reasons.

First, cigarettes are subject to a mix of specific and ad valorem excise duties (as are some other tobacco products). It is by no means clear what, in a practical setting, fiscal convergence actually means under such a tax system.

Second, true tax convergence would need not only the same excise rates to be levied throughout the Single Market, but also the same excise structure to be adopted by all Member States. Given the experience from VAT, I cannot see this happening any time soon for tobacco products.

In this paper, I focus on the first of these questions – what does tax harmonization actually mean in a mixed excise system?

By law, cigarette excise duties in the European Union must be comprised of an ad valorem and a specific component.

An ad valorem excise, like VAT, is expressed as a percentage of the product's price.

A specific duty, in contrast, is an amount in Euros (or in non-Eurozone countries, in their currency) per unit of consumption. For cigarettes, specific excise is expressed per 1,000 sticks. In the case of loose tobacco, it is an amount per kilogramme.

If the repeated attempts to harmonize VAT rates had succeeded, this would have meant a very different VAT burden in Euros on products across Member States.

A recent study by Eurostat, the Commission's statistical information directorate[1], revealed that the price levels of consumer goods and services in Denmark are 41% higher than the EU average, whilst prices in Bulgaria are 47% lower than the EU average.

Notwithstanding the fact that such vast price differences are, apparently, sustainable without the EU Single Market collapsing, they also mean that if the VAT rate were to be equalised across the union, then people in Denmark would be paying more than two-and-a-half times more VAT in Euros than the people in Bulgaria for identical goods and services.

Cigarette prices vary across Member States, much in the same way as the prices of all consumer goods and services.

The European Commission's Excise Duty Tables from 1st March 2021 show that the average price of cigarettes in Ireland are 157% higher than the EU average, whilst prices in Bulgaria are 44% lower than the EU average.

There is a wide variation in the ad valorem excise duty rates on cigarettes across the EU. If this were harmonized such that all Member States applied a duty equivalent to the average of all current ad valorem cigarette tax rates,

[1] Eurostat, December 2020, Comparative price levels of consumer goods and services, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Comparative_price_levels_of_consumer_goods_and_services

this would imply an EU-wide ad valorem rate of 28% of the price of a pack of cigarettes.

This common EU wide ad valorem rate would collect €1.38 per pack of cigarettes in the EU, on average. But in Ireland, where cigarette prices are highest, it would result in ad valorem duties of €3.54 a pack whilst in Bulgaria, with the lowest cigarette prices, ad valorem duties would be much less at €0.77 a pack.

As in the case of VAT rate equalisation, cross-country price differentials result in harmonized ad valorem taxes generating a *much* different tax burden on the same products from one EU country to the next, in line with cross-border retail price differences.

However, harmonization of specific excise rates would result in a profoundly different outcome.

Like with ad valorem cigarette excise tax rates, there is a large variation in the specific excise duty rates levied across the Member States. If individual country's rates were replaced with a single EU-wide specific cigarette excise tax rate equivalent to the current EU average, this would imply a tax of €1.86 per pack of cigarettes.

But a specific excise of €1.86 per pack would hit consumers in Bulgaria much harder than it would consumers in Ireland. It would represent more than two-thirds of the average price of cigarettes in Bulgaria, but only 15% of the average price of cigarettes in Ireland.

In other words, if you equalise a specific excise across all Member States, you get a *completely different* outcome than if you harmonize an ad valorem excise rate (and, for that matter, harmonizing VAT).

This means that the Commission's talk of convergence in cigarette tax rates is, without further clarification, somewhat of a muddled concept. If you have identical ad valorem tax rates throughout the EU, then the excise levied in Euros on a pack of cigarettes will vary greatly from one country to another, in line with cross-country price differences. But setting the specific excise at the same level throughout the EU will mean that excise as a proportion of the retail price will vary greatly from one country to another, a clear anomaly to what the EU tried to achieve with attempts to converge VAT rates.

One solution that has been mooted as a way of solving this conundrum is harmonising the rate of specific excise duties (and minimum excise rates) not in Euros per se but, instead, at a level that is adjusted across Member States in line with differences in purchasing power parities. This would, by definition, account for the broad price differences in products across countries. And, in doing so, it could go some way to squaring the circle, whilst achieving some greater consistency in cigarette tax rates across Member States.

However, the solution is not without its drawbacks.

It would be potentially complex to administer, requiring annual updates to tax rates as purchasing power parities change over time.

If it were felt desirable to increase taxes over and above inflation (or, for that matter, wage inflation), it would need to be agreed and coordinated annually at EU level. Not an easy process when individual country's budgets take place at different times of the year, notwithstanding the challenges in getting 27 Member States to agree on a single EU-wide tax escalator annually.

And there is a danger that harmonizing specific excise duties on tobacco products in this way will set a precedent that would have to be extended to other products, such as energy and alcohol.

Even if it were felt that the purchasing power parity adjustment is a theoretically elegant solution to the tax harmonization puzzle, there are some material practical considerations that must be carefully thought through.

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