



EXCISE TAXATION OF TOBACCO PRODUCTS IN BULGARIA – REVIEW AND RECOMMENDATIONS

REVIEW AND ANALYSIS OF EXCISE TAXATION OF TOBACCO PRODUCTS IN
BULGARIA IN THE 2007 – 2013 PERIOD AND RECOMMENDATIONS IN VIEW OF
ACHIEVING NEW EU REQUIREMENTS BY 2018

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Resume

After EU accession Bulgaria was faced with the challenge to harmonize its excise policy with regard to tobacco products and to reach the minimum level of excise duties on tobacco products, as laid down in the respective EU Directive, until the beginning of 2010. In 2007 prices of cigarettes in Bulgaria (weighted average price) were actually lower than the nominal requirement for minimum excise duty in the EU (64 euro per 1000 cigarettes), which illustrates the tough task that our country faced. More specifically, Bulgaria was set to increase excise duties, respectively prices substantially, without distorting the market and avoiding any negative effects for the budget.

Bulgaria failed to develop a long-term strategy and to adopt a timetable for a smooth increase of excise duties on tobacco products, as all changes were made on a case-by-case basis during the regular budget debate at the end of each year. This led to sudden and sharp moves in fiscal policy. Only in 2010 the excise yield, which is the nominal excise burden on cigarettes, increased by 50%, leading to a drastic increase in prices – in 2009 a pack of cigarettes in the most popular price category cost less than BGN 3, while in 2010 the same pack was already sold for more than BGN 4.

The effects arising from the lack of predictability, inconsistency and the sharp increase of excise duties in 2010 were catastrophic – the legal market crashed by 1/3, government revenues declined, and illicit trade boomed. Note that in 2010 one of every three cigarettes smoked was non-domestic – meaning that the volume of illicit trade doubled in comparison to previous years. The EU experience shows that while there is a general tendency towards increasing excise duties on tobacco products, such a boom in illicit trade is seen only in countries, which are implementing sudden and sharp increases in excise duties, while those that manage to have predictable and consistent policy succeed in limiting the negative effects.

At present Bulgaria is faced with the challenge to reach the new EU minimum excise duty by 2018 that is equal to 90 euro per 1000 cigarettes. Building up on our own experience and taking into account good practices in other EU countries, Bulgaria shall take decisive measures to minimize the negative effects, arising from hike of excise duties. Above all, a timetable or else called – an excise duty calendar should be adopted in the legislation (similarly to Romania's practice), where all the steps for future hikes in the excise duty on tobacco products by 2018 will be clearly written in advance. Such a calendar will ensure predictability not only for companies and consumers, but also for the budget. The excise duty can be raised at equal rates, starting from the next fiscal year, so that there is graduality and illicit trade is limited. We see the increase of the minimum excise duty and the specific component by equal rates for the next five fiscal years, starting in 2014, as the simplest and most preferred option.

Such a policy will also contribute to achieving the overall long-term goal of restricting smoking through tax and price measures, which is in line with EU's health objectives. At the same time, it will ensure that government revenues gradually increase year on year, illicit trade does not expand and businesses and consumers act in a predictable environment.

Introduction

The aim of this study is to assess the effects of Bulgaria's taxation of tobacco products after EU accession and discuss further policy options with regard to upcoming tax harmonization within the EU. The study investigates the budgetary and economic implications of the process of harmonization, taking into account consumer behavior and illicit cigarette trade. The state budget in Bulgaria is heavily dependent on the taxation of tobacco products, which highlights the importance of this issue within the broader fiscal debate.

Background information and Tax Harmonization Policy in the EU

Bulgaria as a member of the European Union has signed the EU Treaty mandating compliance with EU Directives and Regulations within the respective timelines and under the conditions set therein. The EU Directive on the structure and rates of excise duty applied to manufactured tobacco¹ lays down general principles for the harmonization of the structure and rates of the excise duty in Member States. The Directive states that the structure of the excise duty on cigarettes must include a specific component calculated per unit of the product, a proportional ad valorem component based on the retail selling price, and in addition, Member States are provided with effective means and thus expected to apply a minimum tax component to all cigarettes.

At the time of Bulgaria's accession to the European Union (2007), the relevant Directive 2002/10/EC stated that the overall excise duty incidence (specific duty and ad valorem duty excluding VAT) on cigarettes shall represent at least 57% of the retail selling price and shall not be less than EUR 64 per 1 000 cigarettes for cigarettes of the price category most in demand (MPPC – most popular price category). The Treaty of Accession of the Republic of Bulgaria and Romania (2005) stated that the two countries may postpone the application of the overall minimum excise duty on the retail selling price (inclusive of all taxes) until 31 December 2009, provided that during this period they gradually adjust their excise duty rates towards the overall minimum excise duty provided for in the Directive.

Back in 2007 the excise duty on cigarettes in Bulgaria was around 35 euro per 1000 cigarettes² on the MPPC, dominated by the ad valorem component. In the next few years Bulgaria was expected to (almost) double the excise yield, which is the nominal excise burden on cigarettes. Prices of cigarettes in Bulgaria in 2007 were even lower than the minimum excise duty in the EU, which was clearly a challenge for the fiscal policy in the country and one that from hindsight could have been tackled in a better manner. There was no clear timetable for reaching the minimum excise duty in 2010 and decisions were made within the budget debates at the end of each year.

In 2009 the excise duty on cigarettes in Bulgaria was around 51 euro on the MPPC, meaning that the remaining portion to achieve the minimum 64 euro as a part of the tax harmonization process was to be covered within the budget debate for 2010. The government made serious amendments to the structure and rates of the excise duty in 2009, effective January 1, 2010. In line with EU-wide practices and tendencies Bulgaria undertook a decrease of the ad valorem component from 40.5% to 23% and a parallel increase of the specific component. Also a minimum excise duty was adopted to ensure a certain nominal level of the excise duty (EUR 75.67) irrespective of the components of the excise duty and the prices of cigarettes – as it is the most secure way to ensure that at least a certain minimum amount of taxation applies throughout the Union not dependent on any price movements.

¹ [Council Directive 2011/64/EU of 21 June 2011](#)

² Excise Duty Tables (2007-2013), European Commission – for example [EXCISE DUTY TABLES 2013](#)

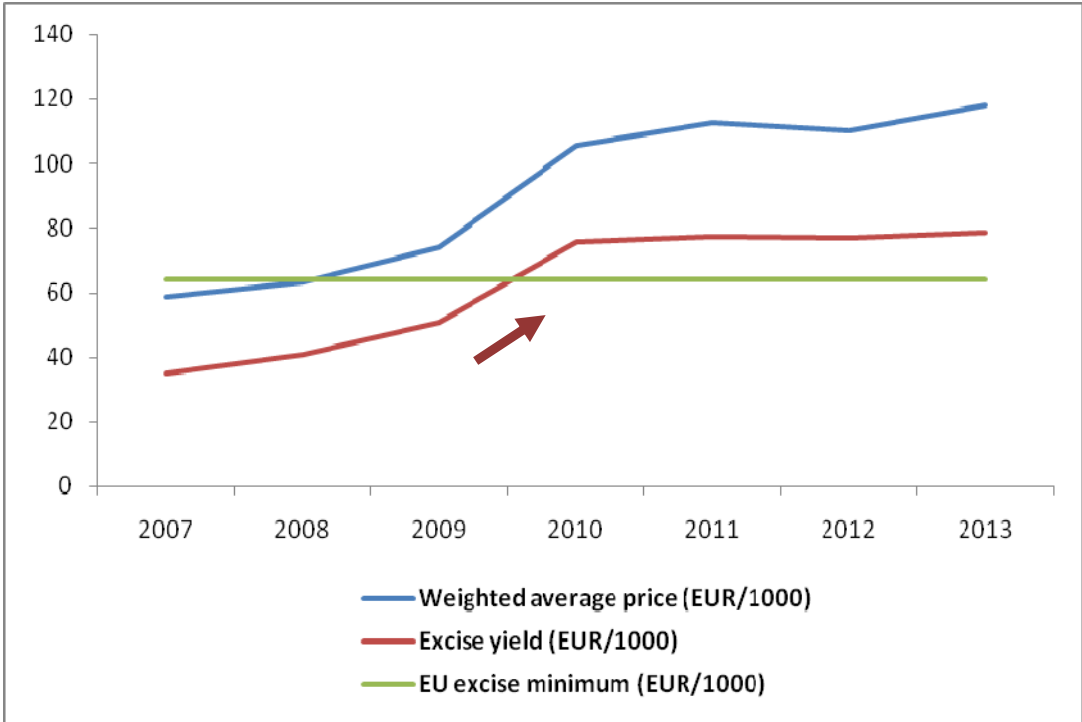
However, instead of simply reaching the minimum requirement of 64 euro per 1000 cigarettes on the MPPC, the increase of the specific component from 21 to almost 52 euro per 1000 cigarettes resulted in a situation in which the excise duty reached almost 76 euro per 1 000 cigarettes on the MPPC. Note that this was a sharp and sudden 50% increase of the excise yield or the nominal excise duty, which resulted in a huge increase in prices and lead immediately to a sharp inflow of illicit cigarettes in the market driven by increased demand for cheaper alternatives (the increase of illicit cigarette trade in 2010 is discussed in another section of this paper).

Table 1: Excise duty on cigarettes in Bulgaria

	2007	2008	2009	2010	2011	2012	2013
Minimum excise duty (EUR/1000)	N/A	N/A	N/A	75.67	75.67	75.67	75.67
Ad valorem (%)	54%	35%	40.5%	23%	23%	23%	23%
Specific (EUR/1000)	3.32	18.91	20.96	51.64	51.64	51.64	51.64
Weighted average price (EUR/1000)	58.80	63.29	74.01	105.33	112.49	109.93	117.85
Excise yield (EUR/1000)	35.07	41.07	50.93	75.87	77.52	76.93	78.75

Source: Excise Duty Tables (2007-2013), European Commission

Graph 1: Cigarettes excise yield in Bulgaria



Source: Excise Duty Tables (2007-2013), European Commission

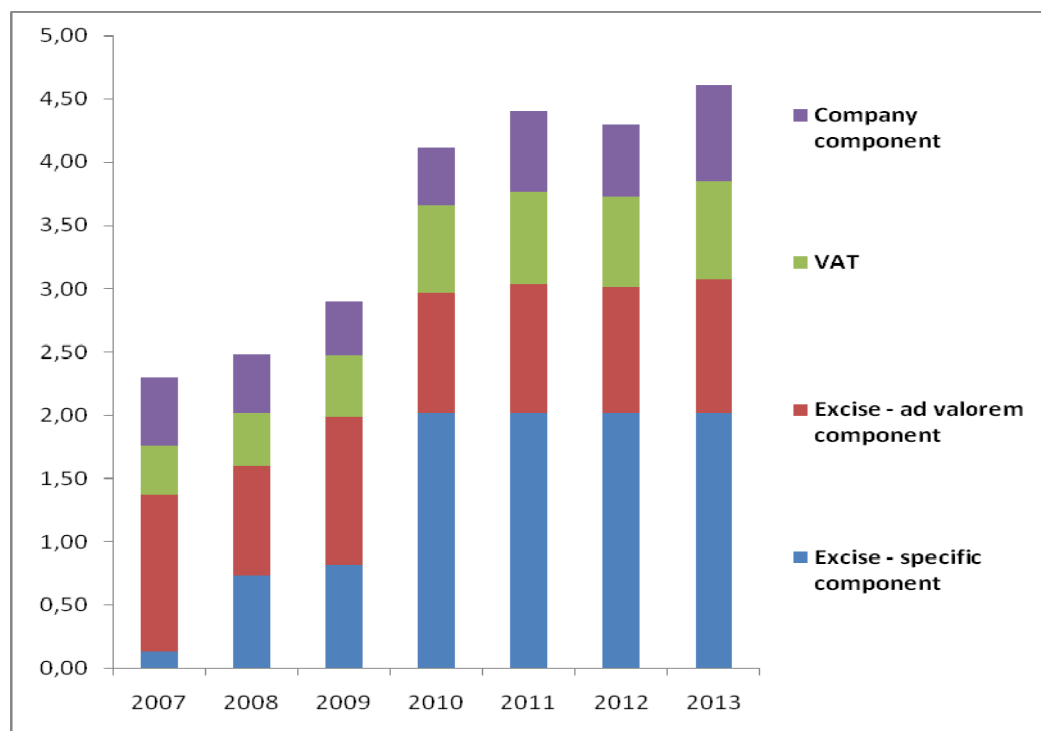
Following the adoption of a revised EU Directive in 2011, setting new rules and minimum requirements, at the end of 2013 Bulgaria is once again in the position to pursue another European target. As written in the revised Directive, effective from 1 January 2014, the overall excise duty on cigarettes shall represent at least 60% of the weighted average retail selling price (WAP) of cigarettes released for consumption during the previous year and the excise duty shall not be less than EUR 90 per 1 000 cigarettes for all cigarettes irrespective of the weighted average retail selling price. Bulgaria, Estonia, Greece, Latvia, Lithuania, Hungary, Poland and Romania are allowed a transitional period until 31 December 2017, meaning that Bulgaria has five fiscal years to reach the new minimum level.

Bulgaria is already meeting the requirement that the overall excise duty on cigarettes should represent at least 60% of the weighted average retail selling price of cigarettes released for consumption. As for reaching the minimum excise duty of EUR 90 per 1 000 cigarettes, Bulgaria should not repeat the experience of previous years with no predictability and sudden sharp increases (like in 2010), that led to an array of negative effects, as discussed in this paper.

Consumer and Economic Considerations

The Bulgarian market for cigarettes is traditionally characterized by high price elasticity of demand – meaning both that consumption is reacting substantially to price changes and that it is mainly focused on the cheaper price category. Bulgaria is one of the few countries in the EU where the most popular price category is below or equal to the weighted average price. The official data also shows that prices of cigarettes in Bulgaria are the lowest within the EU, which is to be expected as the country is the poorest member and also the one with the lowest overall price level in comparative terms.

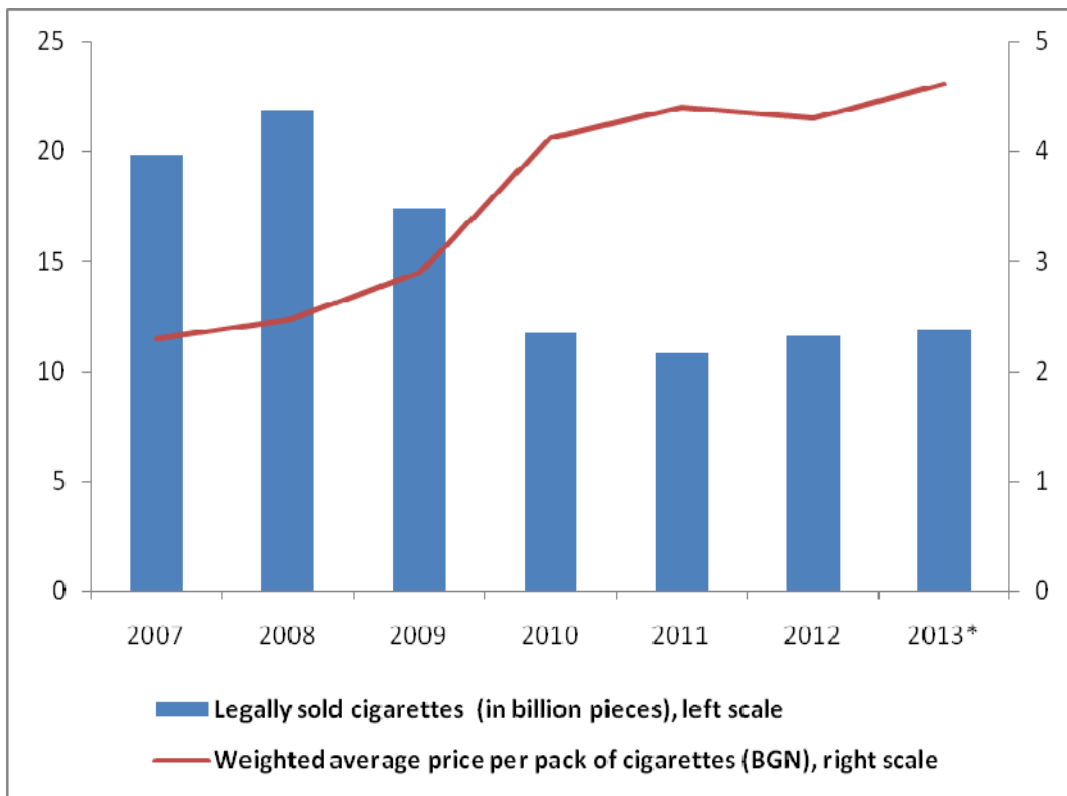
Graph 2: Weighted average price of a pack of cigarettes – main components



Source: Excise Duty Tables (2007-2013), European Commission; IME calculations

Prices of cigarettes are dominated by the excise duties, thus are highly dependent on the policy of reaching the minimum excise duty in the EU. In the period 2007-2010 prices of cigarettes in Bulgaria increased by approx. 80% on average, mainly due to the sharp increase in the total excise yield in 2010. The overall effect on consumption of cigarettes for sale on the domestic market was severe, as consumers turned to illegal cigarettes, cheaper brands and substitute products, and legal market sales steeply declined. There was a sharp increase in the consumption of fine-cut tobacco, taxed lower than cigarettes, in 2010 (by more than 5 times), while before joining the EU consumption of fine-cut tobacco in Bulgaria was symbolic. The biggest change in the market of cigarettes happened in 2010 following a sharp last-minute increase in the excise duty and a collapse of the legal market from 17.4 billion pieces to 11.7 billion pieces of cigarettes.

Graph 3: Price (WAP) of cigarettes and volume of legally sold cigarettes



Source: Excise Duty Tables (2007-2013), European Commission & Ministry of Finance, Bulgaria

The data on legally sold cigarettes in the European market clearly shows that such sharp movements are mainly due to sudden changes in excise duties and are not or to a lesser extent due to other factors or policies aimed at restricting smoking. While there is a tendency towards less smoking in Europe in the last 10 years³, the general picture is changing gradually – for instance in 2010 legal sales of cigarettes in Europe (EU-27) decreased by 4.5%, while in Bulgaria legal sales of cigarettes decreased by 33% or 1/3 of the legal market disappeared in just one year due to the sharp increase in excise duties.

There are several cases in Europe that replicate the Bulgarian experience in 2010. Romania had a similar experience also in 2010 with a sharp increase in excise duties and a severe impact on legal products sales – the latter also fell by 1/3 in just one year. Poland also went through a similar experience in 2009, when the excise duty on cigarettes was raised and legal sales, respectively the consumption of legally sold products, shrank by half – partly because of artificially high sales reported in 2008 due to forestalling in anticipation of the higher excise duty the next year. The European experience clearly shows that while there is a recommendation for a gradual increase of excise duties towards achieving the minimum required levels, there have been several cases of sudden tax increases that have shown a disastrous effect on the markets – extreme consumer reaction, increased illicit trade, and difficulties with planning tax revenues. Romania, however, has managed to overcome quickly the increase in illicit trade in 2010 by implementing an 8-year schedule for a gradual increase of the excise duty in the 2011-2018 period. This approach has proven to have a timely positive effect on reducing non-domestic cigarettes consumption from around 20% in 2010 to less than 10% in 2012⁴.

³ [Releases for consumption of cigarettes 2002-2012](#), European Commission, Taxation and Customs Union

⁴ 2013 KPMG - Project [STAR Report](#)

In its tax legislation, Romania has written explicitly the specific steps for increasing the minimum excise duty by 2.5 EUR per year, and also the steps for gradually decrease of the ad valorem component by 1 percentage point each year until it reaches 14% in 2018. Due to the dependence of the specific component on exchange rate movements, Romania has set a clear excise yield for each year and the specific component is calculated in a way to obtain that yield.

Germany, as one of the most developed countries in the EU and also one that is heavily taxing tobacco products, has also implemented in 2010 a 5-year plan for its excise duty increases in order to avoid any side effects on the market. Nevertheless, Germany is taxing tobacco products way above EU minimum requirements, and implementing a clear timetable is generally viewed as the best policy to ensure a stable perspective for businesses, consumers and the government. One should note that the German timetable sets a pace of increase for the minimum excise duty by 4.5 EUR per year.

Over the medium to long run, Bulgaria should follow the example of countries that have set in their legislations a clear and pre-defined plan for future increases of excise duties that rests on a moderate and step-by-step approach.

Government Revenues, Stability, Graduality and Predictability

Bulgaria's state budget is mainly dependent on taxing consumption (indirect taxation) and not so much on direct taxation of personal income and corporate profits – this is not the case in most of the wealthier European countries. In recent years for instance, revenues from excise duties only are greater than the combined revenues from taxes on personal income and corporate profits. This is showing the key importance of excise duties for the budget and fiscal policy of the country.

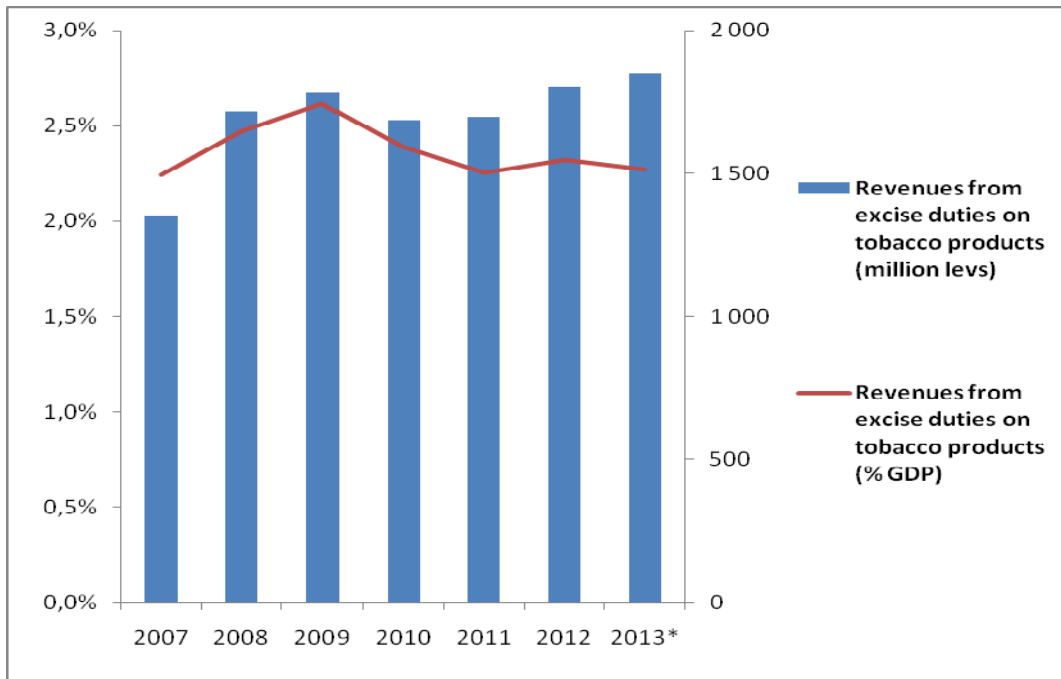
Revenues from excise duties on tobacco products in Bulgaria are almost 1.8 billion levs in 2012, which is 2.3% of GDP. Despite of the big increase in excise duties on cigarettes in 2010 the government is not collecting more revenues. The budget revenue from excise duties on cigarettes actually fell in 2010 and has been gradually recovering since then. This is a classical example of policies that are not adequate to the economic and social realities and are doing more harm than good – prices of cigarettes have almost doubled since 2007 due to the higher excise duty, but the State Budget has been collecting less money due to the collapse of the legal market.

Table 2: Revenues from excise duties on tobacco products

	2007	2008	2009	2010	2011	2012	2013*
Revenues from excise duties on tobacco products (million levs)	1 348	1 715	1 784	1 685	1 697	1 803	1 850
% all tax revenues	7.0%	7.7%	8.8%	8.9%	8.2%	8.4%	7.9%
% GDP	2.2%	2.5%	2.6%	2.4%	2.3%	2.3%	2.3%

Source: Ministry of Finance, Bulgaria & National Statistical Institute, Bulgaria

Graph 4: Revenues from excise duties on tobacco products



Source: Ministry of Finance, Bulgaria & National Statistical Institute, Bulgaria

As regards the structure of the excise duty on cigarettes, in 2008/2009 Bulgaria decided to follow the EU tendency and practice of lowering the proportional (ad valorem) component and have a tax dominated by the specific (nominal) component. This approach was in a way inevitable for Bulgaria, as the country has the lowest prices in the EU and as long as the proportional component depends on prices, it cannot be relied on to ensure the nominal minimum level of excise duty in EU. This also seems to be the general tendency in Europe – to have a higher weight of the specific component that in some cases covers alone the nominal minimum requirement of an excise duty in the EU and reduce the proportional component. EU data for the period 2010 – 2013 show that all Member states increased their specific component (except Bulgaria) and 20 Member states further decreased their proportional component.

When it comes to stability and predictability of government revenues from excise duties on tobacco products, the specific component is playing a key role, as it ensures a certain amount of the excise duty that is not dependent on price movements or consumer choice of cheaper or more expensive cigarettes. The specific component, moreover, provides for the same burden on both cheap and expensive cigarettes, which is in line with the utmost health objective of the EU to limit smoking, without distorting the market and shifting preferences between different price categories.

Still, apart from the structure of the excise duty on cigarettes, any big movements in the overall tax burden are leading to fiscal problems, as they distort the market in the short term and trigger illicit trade – recent Bulgarian experience in 2010 is proving just that. When there is a set target for a higher excise duty on cigarettes, as is the obligation of Bulgaria to achieve the minimum excise duty on all cigarettes by January 1, 2018, the best way to overcome the negative effects is to do it in a predictable and gradual way.

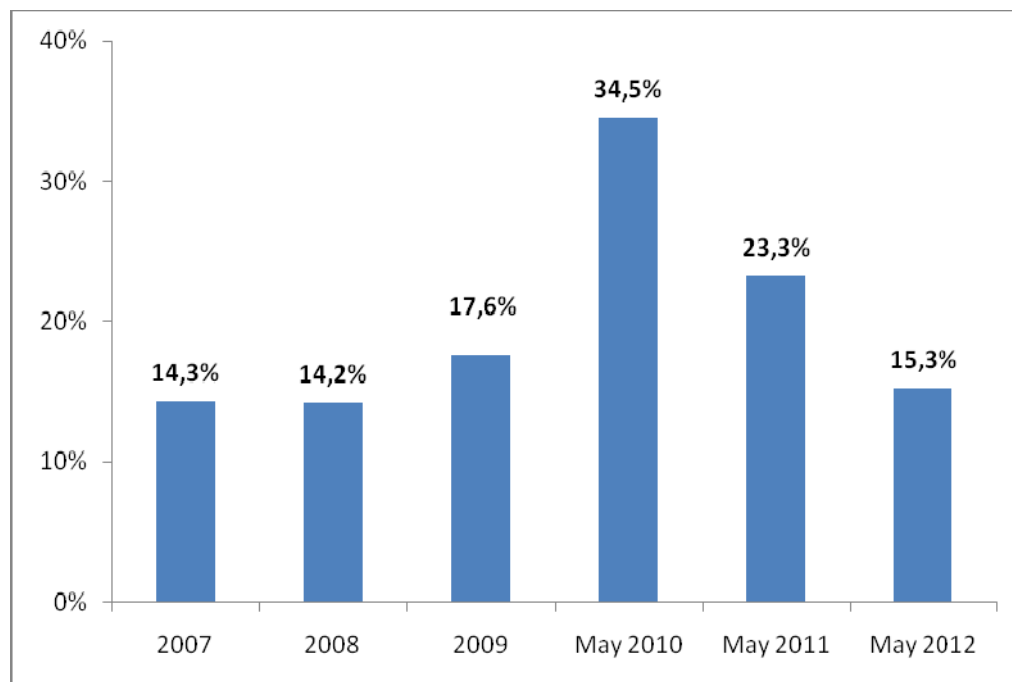
This means that the excise duty target shall be reached step by step, with a timetable adopted in the legislation in advance, so that market participants are informed in advance and are not faced with sudden changes affecting prices and consumer behavior. In view of the clearly fixed minimum of the excise duty of 90 euro per 1000 (BGN 176) on all cigarettes that Bulgaria is obliged to achieve, a clear plan for the increase of the minimum excise duty from BGN 148 per 1000 pcs. to BGN 176 per 1000 pcs. in equal steps each year in the next five fiscal years could be established in the law, with reference to the EU Directive.

Illicit Trade Considerations

When it comes to consumption of tobacco products (mainly cigarettes) and the respective policies to increase excise duties on cigarettes one should consider consumption of the so-called non-domestic cigarettes or in other words, the issue of illicit trade. This causes problems in several different directions: health and quality concerns for the consumers, loss of revenues for the state budget and source of funding for organized crime. Any fiscal policy that may lead to a sudden increase in illicit trade is problematic for all the above reasons and therefore should be debated in search of a proper solution.

The available data for Bulgaria shows that there was a sharp increase in the illicit trade of cigarettes in 2010, when consumption of non-domestic cigarettes reached 34.5% of the total market of cigarettes. The data presented here are not based on theoretical calculations, but is referring to an empty pack survey conducted regularly in the country since 2007 (using data about empty packs found on the streets and in public bins – indicative of the trends of non-domestic cigarettes, consumed in the market).

Graph 5: Non-domestic cigarettes market or illicit trade (% of all consumption)



Source: A survey conducted by ACNielsen upon the assignment of British American Tobacco Bulgaria, Bulgartabac Holding, Imperial Tobacco Bulgaria, Japan Tobacco International Bulgaria, Philip Morris Bulgaria

The data shows that this sharp increase of non-domestic incidence (34.5% of all empty packs collected) is indisputably a direct result of the big increase in the excise duty and respectively, in the prices of cigarettes. Other local studies show that in 2010 the illegal market for cigarettes was the fastest growing market for criminal activity in Bulgaria⁵. The negative budget effect due to illicit trade just in 2010 is estimated at around BGN 250 million lost revenues⁶.

⁵ CSD [Crime Assessment Report 2010-2011](#)

⁶ IME estimations

After 2010 the share of non-domestic cigarettes started to decrease mainly due to the decision to maintain excise duties unchanged over the next few years. The illicit trade effect due to sudden changes in tax policy is usually immediate, but the recovery of legal market sales is taking more time. In other words, if tax policy ensures tackling the mandatory increase gradually, such an extreme reaction and the observed large-scale negative effects on both government revenues and the tobacco industry are avoidable.

Policy Implications

As clearly seen in the data Bulgaria did not succeed in tailoring properly its excise duty policy in respect to tobacco products after joining the EU. With no clear roadmap, the sharp and sudden increase in the excise duty in 2010, unnecessarily exceeding the minimum required level, had a disastrous effect on the market, leading to much higher prices than consumers could afford, a collapse in legal consumption, less revenue for the state budget and a jump in illicit trade. Now Bulgaria is facing another deadline to meet newly required minimum excise levels and this time fiscal policy should be better designed in order to avoid all those negative effects.

Bulgaria needs to adopt a clear roadmap for all the required actions concerning the excise duty on tobacco products up until 2018. This will ensure predictability that is crucial to a successful fiscal policy – such a roadmap enacted into law for instance is in place in Romania, which is facing the same challenges to meet the EU requirements.

Conclusions

In order to avoid distortions of the market, Bulgaria's authorities should ensure predictability and integrate a timetable for the gradual increase in excise yields, which are the nominal excise burden on cigarettes, in domestic legislation. This timetable should set a clear plan for the upcoming increases every year until 2018. The best way to do that is by gradually increasing the specific component, which is more adequate for Bulgaria (having the lowest prices) and not artificially tilting consumer choice between cigarettes of different price categories. Equal steps for increasing the specific component for each of the next five fiscal years, starting in 2014, is the simplest and preferable option.

Recognizing the price sensitivity of consumers and the social acceptability of illicit products that are widely available, excise duty increases should be as moderate as possible, enabling prices to adapt to the real wages and not outrun them. This can be achieved with the help of a clear timetable with the smallest increases possible. Therefore there should be no delay in the process of moving towards the minimum EU levels and the gradual increase should start by taking the first step as early as possible, namely in 2014 (January 1, 2014 or mid next year – July 1, 2014).

Such a policy will also contribute to achieving the overall long-term goal of restricting smoking through tax and price measures, which is in line with the EU health objectives. At the same time, it will ensure that government revenues gradually increase year on year, illicit trade does not expand and businesses and consumers act in a predictable environment.