



Policy Note on Tobacco Excise Taxation and the Illegal Market

Institute for Market Economics, May 2019

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Tobacco products in general and cigarettes in particular are the products with the highest taxes within the European Union (EU). Taxes on cigarettes in the EU form 80% of their retail price on average – 85% from the retail price of cigarettes in Bulgaria for 2018-2019. The market for cigarettes in Bulgaria in 2018 is estimated to be around 3.6 billion BGN and trade with cigarettes brings more revenues to the budget than any other good – the revenue from the excise duty and the value-added tax on cigarettes is over 3 billion BGN. Since the market for cigarettes is so big and is taxed so heavily, there is a serious risk from an illegal trade. This is still one of the most profitable criminal activities in Bulgaria even though the illegal market declined in the period after 2015.

In the last 3-4 years, Bulgaria marks serious achievements in the fight with the illegal trade of tobacco products, which at the beginning of 2019 is at a record low levels – the share of the illegal trade is less than 5%. Many factors contribute to the declining of the illegal market. Among them we can include:

- ✓ The initiative against illegal trade by the big tobacco companies in the market, which for many years has presented detailed information about the development of the illegal market;
- ✓ A strong political pressure, as in the past several years the fight against the illegal trade of tobacco products became a top political priority, including in desire to bring more revenues to the state budget;
- ✓ A combination of legislative reforms, the improvement of the work of the control authorities (this includes constant physical monitoring of the factories), and the improvement of the economy as a whole.

¹PMI IMPACT (www.pmi-impact.com) is a grant award initiative of Philip Morris International (PMI). In the performance of its research, IME maintained full independence from PMI. The views and opinions expressed in this document are those of IME and do not necessarily reflect the views of PMI. Responsibility for the information and views expressed in this publication lies entirely with IME.

In the present document we will show the current picture on the market of tobacco products and the developments in the illegal trade as of mid-2019. We will summarize the main arguments from the more comprehensive research on the effects of the excise duty policy conducted in the past 10 years², the analysis of the price elasticity and affordability of tobacco products within the general framework of the excise duty policy in the EU³, and the conclusions from the sociological survey on the attitudes of 5200 smokers in Bulgaria⁴, which was carried out in 2018. Commentaries on the latest changes in regulatory and legislative framework will be presented. These include the implementation of the EU-wide track and trace system towards tobacco products, the introduction of innovative products on the market, and the challenges to the excise duty policy in respect to the novel products.

A Short Summary of the Excise Duty Policy on Tobacco Products

Following the tax shock⁵ of 2010, Bulgaria kept its excise duties on cigarettes unchanged throughout the period between 2011 and 2015. In the last three years (2016 – 2018) steps towards a gradual increase in the excise duties were taken, which aim at achieving the EU-wide minimum excise duty of at least 90 euro per thousand pieces of cigarettes. Putting aside the peculiar change in the excise structure in Bulgaria in 2016, as of 2018 the current taxation framework was put in place, featuring a specific excise of BGN 109 per thousand pieces of cigarettes and an ad valorem excise duty of 25% of the retail price. In comparison with the period between 2011 and 2015, this new framework has both components (specific and ad valorem) of excise duty slightly increased.

The change of the overall excise yield between 2016 and 2018 was gradual and for the duration of the entire period the average price of cigarettes increased by only BGN 0.30-0.40 from BGN 4.70 per pack of cigarettes in 2015 to around BGN 5.00 per pack in 2018. However, the increases in personal incomes in the same period outpaced the rise in cigarettes prices and due to this on the market were observed some positive trends – an increase in the legal consumption and higher revenue for the state budget. These processes were also heavily influenced by the sharp decline of the illegal trade after 2015.

Excise Duties on Cut Tobacco and New Excise Category

There are no changes in the excise duty on the rolling tobacco in the last several years, as the excise duty remains at BGN 152 per kilogram, which was put in place back in 2012. Even though the tobacco market is still heavily dominated by the cigarettes, in the last years there is an increase in the legal consumption of rolling tobacco, which is driven by its lower prices and the corresponding higher affordability to the consumers. In 2017 an excise tax on the so-called heated tobacco products was introduced. At the time of its implementation its rate was equalized with the excise on the smoking tobacco – BGN 152 per kilogram. We will discuss the topic of heated tobacco products in a separate point at the end of this document.

²See [Economic Analysis on the Excise Duty Policy on Tobacco Products in Bulgaria and Its Effects on the Illegal Market \(2007 – 2017\)](#), Institute for Market Economics (January 2018).

³See [Analysis of Price Elasticity and Affordability of Tobacco Products in Bulgaria and Examination of Affordability Issues in Respect to EU Harmonization Policy on Excise Duties \(2007 – 2018\)](#), Institute for Market Economics (December 2018).

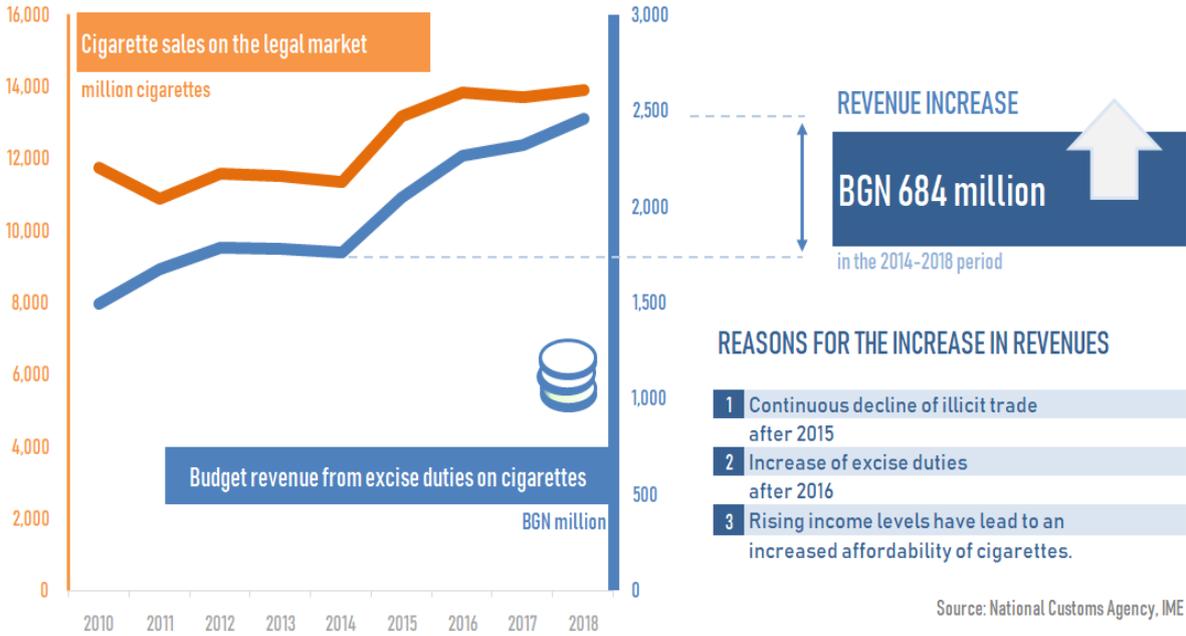
⁴See [Sociological Survey among 5 200 Smokers in Bulgaria](#), IME and Alpha Research (March-April 2018).

⁵The tax shock of 2010 resulted in sharp increase of prices – the price of a pack of cigarettes from the most popular price category on the market increased by 42%. As a result the illegal consumption of cigarettes increased by 1.5 billion pieces (up to 4.8 billion pieces in 2010) and the share of illegal trade doubled to 30.7% from the market in 2010.

Tobacco Consumption and Revenues from Taxes on Tobacco Products

Legal consumption of cigarettes in Bulgaria reached 13.9 billion pieces in 2018. In the last three years, the consumption of legal products remains comparatively unchanged – between 13.7 and 13.9 billion pieces of cigarettes per annum, even though there was an increase in the corresponding excise duties during this period. It is interesting to note that the consumption of legal cigarettes in the last two years is with around 2 billion pieces of cigarettes more than the period prior to 2015, which is due to the notable decrease in the consumption of illegal products. In practice after 2015, there is a migration of consumers from the illegal towards the legal market, which caused the serious growth of the revenues from the excise duties on cigarettes.

Revenue from taxes on tobacco products in Bulgaria reached over BGN 3 billion in 2018 and formed 9.5% of all taxes and social security revenues to the state budget. In this metric Bulgaria occupies a very high position among the other EU members. The sum of the revenue includes both the excise duties and the value-added tax on tobacco products. Revenue from excise duties alone comprises around BGN 2.5 billion and grows constantly after 2015. Nearly 97% of the revenue from the taxes on tobacco products comes from traditional cigarettes, although there is some rise in the consumption of rolling tobacco and a strong performance of heated tobacco products on the market.



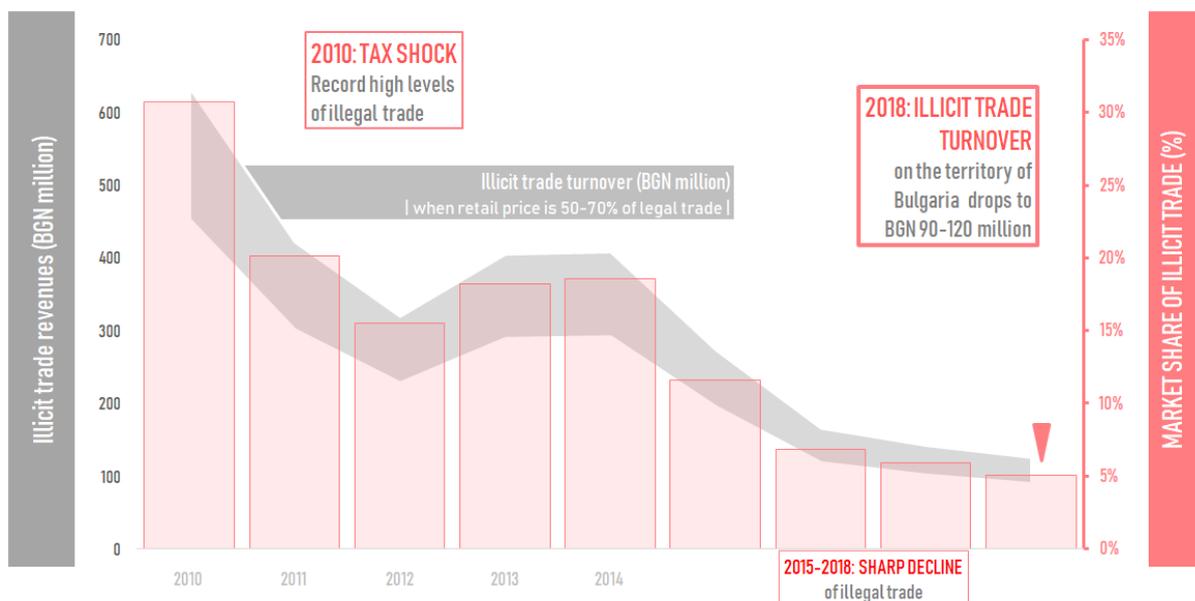
Excise revenues from cigarettes grow strongly after 2015. While in the relatively long period between 2008 and 2014 the revenues from excise duties on cigarettes were between BGN 1.7 and 1.8 billion, currently they have reached over BGN 2.5 billion. This surge (in 2018 the revenues from excise duties on cigarettes were BGN 694 million more than in 2014) is caused by the decrease of the illegal trade after 2015 and the corresponding recovery of the consumption of legal products, as well as by the increase in the excise duties after 2016. It is important also to note the growth of individual income and the rising affordability of cigarettes. The combination of higher excise duties and growing legal consumption brought an increase in excise revenue to the budget of BGN 167 million for the previous year alone (2018 compared with 2017).

Consumption and Revenues from Taxes on Cut Tobacco

In the last two years, a surge in consumption of legal rolling tobacco has been noticed (here we exclude the heated tobacco products), so that in 2018 the quantity of tobacco for which excise duties were paid reached 373 tonnes. Only two years ago its amount was 100 tons less (267 tons of tobacco in 2016). However, cigarettes still dominate the market completely – for comparison those 373 tonnes of smoking tobacco for 2018 equal around 500 million pieces of cigarettes (given there are 0.75 grams of tobacco used for a hand-rolled cigarette) against the market for traditional cigarettes, which is at nearly 14 billion pieces. Revenue from excise duties on smoking tobacco also grows and in 2018 it reached BGN 57 million, which, however, is just slightly more than 2% of the revenue from excise duties on tobacco products as a whole.

Illegal Trade with Tobacco Products

In 2018 the share of illegal cigarettes⁶ on the market in Bulgaria reached a record low level – 5% of the whole market⁷ on average or around 700 million illegal pieces of cigarettes. However, even though the consumption of illegal cigarettes has relatively small share, it should not be neglected – for example, the number of illegal pieces of cigarettes on the market is still significantly greater than both the consumption of rolling tobacco (calculated in terms of number of pieces of hand-rolled cigarettes) and the heated tobacco products (again converted to number of cigarettes). Criminal revenue from the illegal trade of cigarettes for 2018 is estimated by IME at BGN 90-120 million, depending on the price of the illegal products.



Source: IME based on data from "Against Illegal Trade" Initiative & Project SUN. KPMG

A glimpse at the quarterly data for 2018 shows a tendency towards shrinking of the illegal trade. In the last quarter of 2018 the share of the illegal cigarettes, in comparison to the cigarette market as a whole, was 4.4%, which is the lowest share ever recorded by the empty pack survey in Bulgaria. Illegal cigarettes vary in origin – around half of them are found to be in packs, which are “duty-free” labeled, while the other half consists of either packs with untraceable origins or packs, smuggled

⁶The methodologically correct term is “share of non-domestic pack of cigarettes”.

⁷The data is from the latest Empty Pack Survey in Bulgaria, which covers the fourth quarter of 2018.

from the neighboring countries. It is important to note the constant appearance during the years of new illegal “illicit whites”⁸, which come as a sudden substitute for former “illicit whites” on the market. This means that the presence of those products is not an accident and signals for well-organized criminal activity.

Positive trends are also observed on the regional level, even though the differences between various cities in Bulgaria are preserved. As of the end of 2018 the highest share of non-domestic packs of cigarettes is observed in Svilengrad (29%), which traditionally is the leader. Among the district capital cities, the highest share of illegal packs was found in Haskovo (12%), Pleven (11%), and Pernik (9%). The lowest share of illegal packages was observed in Gabrovo and Dobrich, both with 1.3%, but even in those cases there are some “seasonal adjustments” to the demand on the illegal market. Changes in the quarterly regional data show that the illegal trade is cyclical and depends on factors, which cannot be always observed from the snap shot of the illegal market, given by the empty packs survey.

Survey among 5 200 Smokers and Definition of the Risk Group

The survey, conducted by the Institute for Market Economics and Alpha Research among 5 200 smokers in Bulgaria⁹ at the beginning of 2018, allows us to point out several interesting characteristics of the illegal trade, which cannot be observed solely by the analysis of the empty packs. Interviewing the smokers in the period of March-April 2018 to a greater extent confirmed the scope of the illegal market, which was hitherto estimated by the regular empty packs survey. An important moment in our survey was that, while the level of consumption of illegal cigarettes was between 5-6% of the whole market, up to 11.7% of the smokers shared that they have consumed illegal cigarettes in the past 2-3 years. This means that the group with the greatest risk of switching to illegal products, if there is a supply in the market, consists of around 250 thousand people.

Over 90% of those 250 thousand people said that the main reason for them to look for illegal cigarettes is their price. Asked where they acquire illegal cigarettes from, the people in this group gave several answers each, the most popular being from friends or relatives (37.8%), on the street (35.7%), and on an open market (25.9%). Almost half of them shared that in the last one to two years the price of illegal cigarettes has increased – the average price on the non-domestic packs of cigarettes analyzed was BGN 3.50 (as of March-April 2018), which is around 70% of the weighted average price per pack of cigarettes on the legal market. This data was used for the calculation of the criminal revenue from the illegal trade.

The Illegal Trade of Cut Tobacco

An in-depth research¹⁰ of the illegal market of cut or bulk tobacco in Bulgaria was carried out in 2016. A very important element on this market is that Bulgaria is the biggest producer of raw tobacco in the region, which increases the risk for illegal trade of cut tobacco. The data confirms the huge share of the illegal cut tobacco in Bulgaria – up to 74.6% of the whole market, which means that ¾ of all tobacco for hand-rolled cigarettes is traded with no excise duties being paid. The so called bulk

⁸The term “illicit whites” is used to describe illegal cigarettes, which do not have analogue in the domestic market. These cigarettes have their own brands and are produced and intended solely for illegal trade.

⁹See [Sociological Survey among 5 200 smokers in Bulgaria](#), IME & Alpha Research, March-April 2018

¹⁰The research was conducted in 15 European countries across Europe by Crime&Tech Srl, a satellite company of Universita Cattolica. It is based on the methodology by the Research Center on Transnational Crime Transcrime.

tobacco dominates the illegal trade in this category and 86.2% of it is of local origin. Bulk tobacco is defined as cut tobacco, which is distributed beyond the legal selling locations and is sold on kilogram in packages without any tags or information.

These findings were confirmed by the field study of IME and Alpha Research from the beginning of 2018. The snap shot, established by what the interviewed smokers showed in terms of packages of cut tobacco, shows a very high share of the illegal products, which reaches 70%. According to the smokers interviewed, they buy packages of between 30 and 1000 grams of bulk tobacco, which often have no label. The price difference between the legal and illegal cut tobacco is huge – while the legal cut tobacco is sold on the market for BGN 12.5 for 50 grams on average, the illegal counterpart costs just BGN 2 or six times less (as of 2018). Due to the extremely low price of the illegal bulk tobacco, revenues from its illicit trade are more or less confined to around BGN 20 million per year.

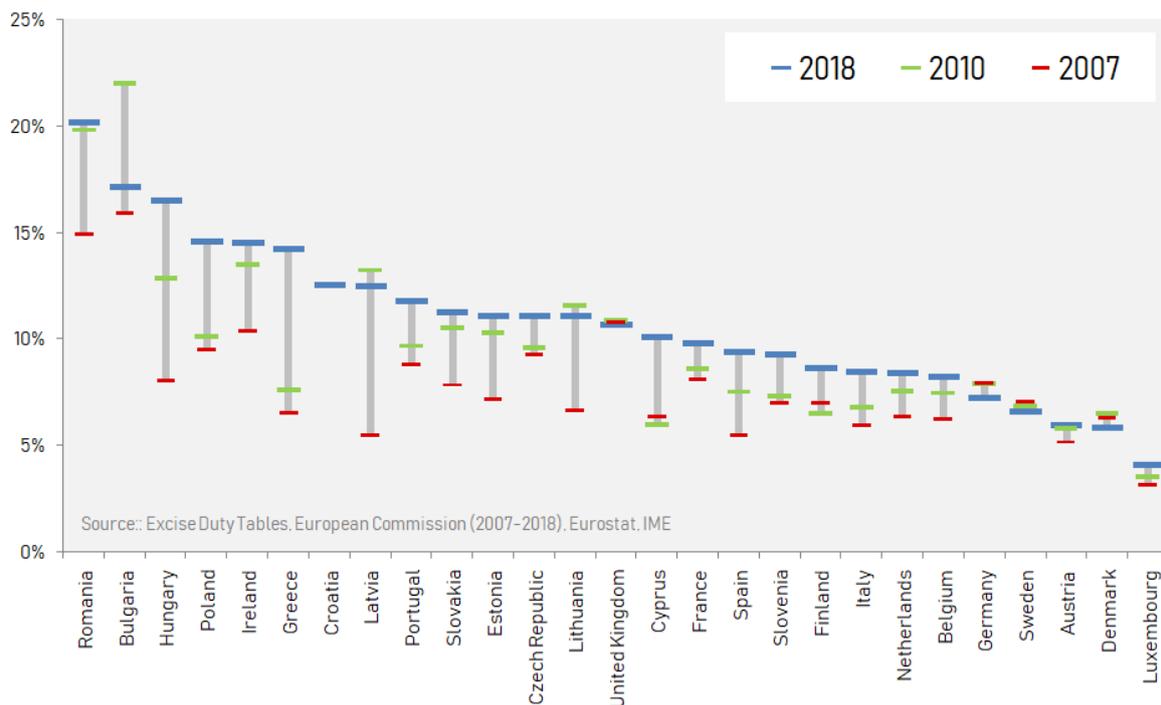
Prices and Affordability to Cigarettes

As of the beginning of 2019, a pack of cigarettes in Bulgaria costs BGN 5.00 on average, which is the lowest price among all EU members. In the last 5 years (between 2014 and 2019), as a result of the slight increase in the excise duties, the weighted average price for a pack of cigarettes increased with around 8% or BGN 0.40 per pack – reaching slightly more than BGN 5.00 per pack in 2019. The weighted average price of a pack of cigarettes in Bulgaria is half the EU average prices and 20-25% less than the prices in the new member states. It is important, however, to take into account also the difference in income across the EU. That is why one should not only look at the nominal price, but to analyze price affordability, which compares the price of the product, on the one hand, with income levels in the different countries, on the other. This indicator shows that the price affordability of cigarettes in Bulgaria is among the lowest in the entire European Union.

Calculating price affordability can be done using various methods. By applying three of the most popular methods we reached similar results, namely that price affordability of cigarettes in Bulgaria is between 1.6 and 1.7 times lower than the EU average. For example, in 2018 with the net daily disposable income per person in Bulgaria could be acquired 5.8 packs of cigarettes, while the EU average net daily disposable income per person covers 9.3 packs of cigarettes. In other words, the price of a pack of cigarettes in Bulgaria in 2018 was 17% of the daily disposable income per person in comparison to the average of 11% for the EU. In short, even though the net price of a pack of cigarettes in Bulgaria is lower, the price affordability of cigarettes in the country is far behind the one in the more developed European countries.

It is interesting to note that in the last 3-4 years the affordability of cigarettes in Bulgaria is improving, even though the excise duties were increased in the period between 2016 and 2018. The reason for this is that in the same period the disposable income increased faster than the tax hikes and eventually made cigarettes more affordable to the local consumers. This is true for the current 2019 as well. The excise duties will not be increased this year, while the disposable income continues to rise due to the high level of employment and the growth in wages.

Retail price of pack of cigarettes as a share of daily disposable income per person (%)



As a whole, among the 28 EU member states in the last 10 years there is a decrease in the affordability of cigarettes, which can most notably be seen in the new member states. Price affordability of cigarettes remains between 1.4-1.5 times higher in the older member states in comparison with the new ones. After 2015, however, this trend reversed and many of the member states managed to stabilize or even to improve price affordability of cigarettes. In some of the new member states – Bulgaria included – there is a clear tendency for price affordability to improve, which is a result of the better economic conditions in the past 3-4 years and the strong growth in disposable income.

Price Elasticity of Demand and Consumer Behavior

Price elasticity of demand measures the change in the quantity demanded (the consumption) of a given product as a result of changes in the price of the same product. In general, there is an inverse relationship between the price fluctuations and the demanded quantity of any given good, which means that elasticity most often is negative. Two effects should be taken into account when we discuss price elasticity of demand as far as tobacco products are concerned. The first effect is the income effect – the quantity demanded decreases as a result of the price increase; the second is the substitution effect – consumers migrating towards cheaper substitutes, including illegal products.

The Institute for Market Economics conducted the first research of its kind on the price elasticity of demand for cigarettes in 2018. Data for the past 10 years shows that the elasticity of demand for cigarettes in Bulgaria is relatively high, which means that price fluctuations lead to significant changes in the consumption of legal tobacco products. Many events happened in the period between 2007 and 2017 including the tax shock on cigarettes (predominantly in 2010), the turbulent economic environment (a crisis in the beginning of the period and the recovery that followed), and the effective measures against illegal trade (mainly after 2015).

IME calculations for the period 2007-2017 show that the price elasticity of demand of cigarettes is - 0.95, which is a relatively high number as far as the available relevant literature on the matter is concerned. This means that the changes in the price of cigarettes and the decrease in affordability for the consumers lead to a corresponding drop in the consumption of legal products. The research, conducted among 5 200 smokers, to a large extent confirms this calculation and clearly reveals that differences in social status and level of personal income should be kept in mind since different groups of consumers react to changes in the prices of cigarettes in varying ways.

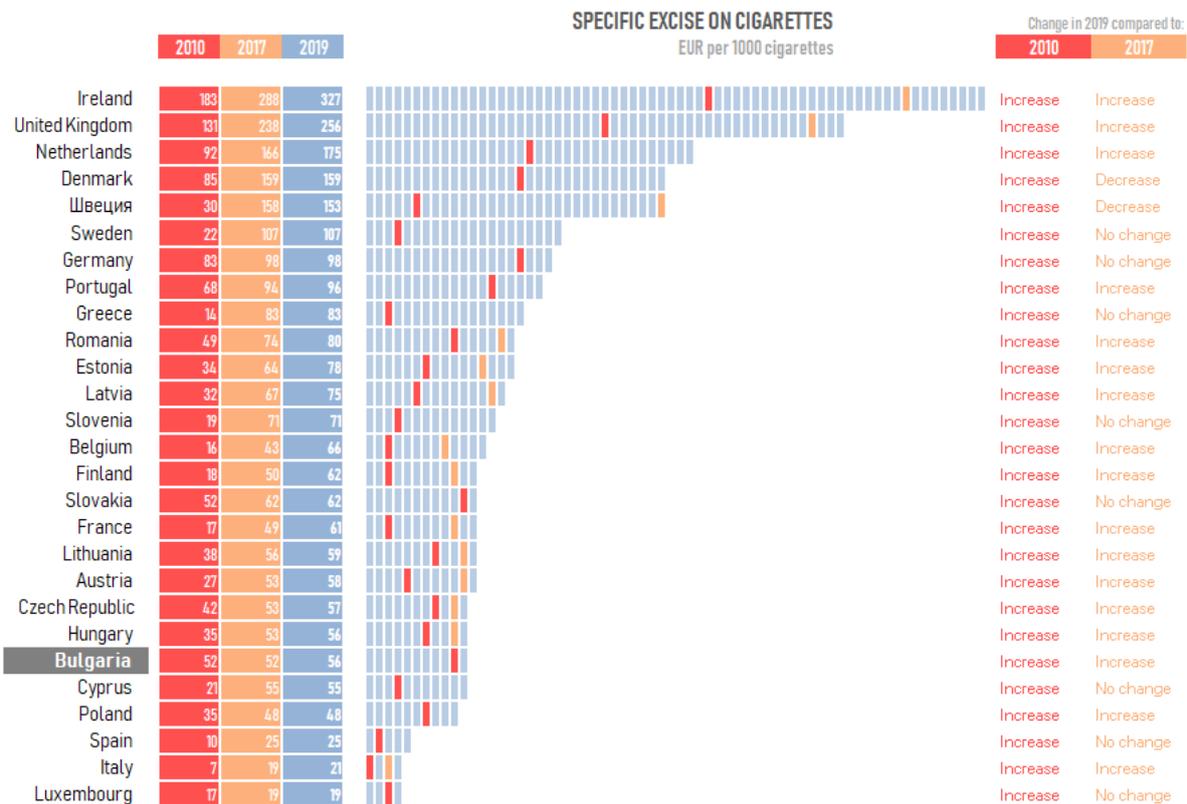
Detailed data for the consumption shows that the changes in the affordability of cigarettes in Bulgaria lead to both – income effects (changes in consumption) and substitution effects (redirection of consumption). A leading alternative for the consumers is the market for illegal cigarettes, meaning that the illegal trade of tobacco products directly corresponds with their affordability on the legal market. From 2015 on the redirection of consumers from the illegal towards the legal market is happening not only due to the increased efforts of the control authorities, but also because of the improved economic environment and the increase in affordability of cigarettes.

Excise Policy towards Tobacco Products in Europe

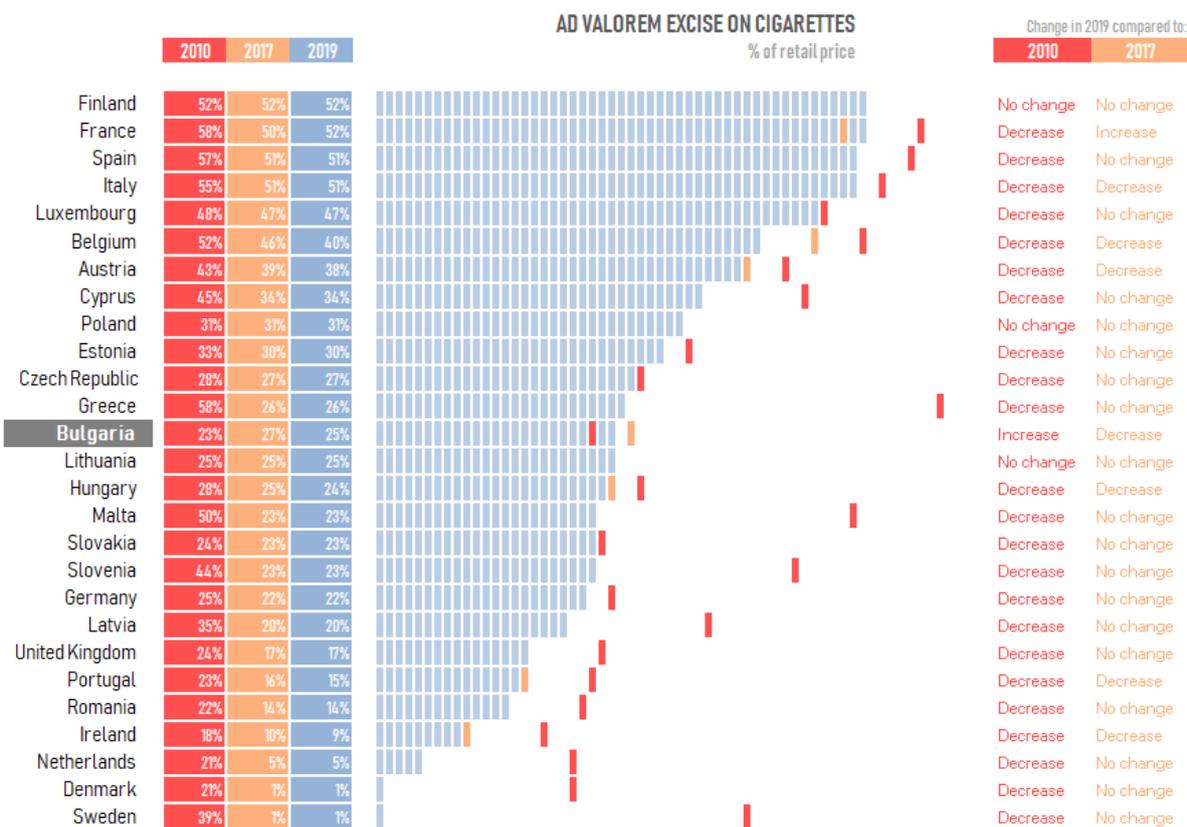
The European Union experience in the field of taxation of tobacco products in general and of cigarettes in particular, is extremely interesting since there are coordination and general rules applying in a big number of developed countries as far as excise tax policy is concerned, on the one side, and because this is the region with highest excise duties on tobacco products in the whole world, on the other. All EU member states apply a mixed structure of excise duties on cigarettes with specific and ad valorem components, which traditionally leads to a higher level of taxation as a whole.

The different member states have various excise tax structures. The specific component is dominating in 18 countries, including Bulgaria, while in the other 10 countries the greater levy comes predominantly from the ad valorem component. In the past 10 years, however, the trend in excise policy is obvious. During the period between 2010 and 2019, all member states have increased the specific component of the excise on cigarettes, since it guarantees results to a greater degree and because it does not depend upon decisions on prices by the tobacco companies. Even in the last two years (2018 and 2019) more than half of the member states have taken steps towards an increase in the specific component of the excise.

Quite the opposite is true of the ad valorem component of the excise. Between 2010 and 2019 it was decreased, in practice, by almost all EU member states, significantly in some cases. There are some examples also, where the excise structure was basically completely reversed in favor of the specific excise. Bulgaria actually is the only member of the European Union where the ad valorem excise in 2019 is slightly higher than it was in 2010. In the last two years (2018 and 2019) on an EU-wide level, there are comparatively fewer changes in the ad valorem component. There are some countries which have reduced it but in general most of them have left it unchanged.



Source: Excise Duty Tables, Manufactured Tobacco, European Commission (2010-2019)



Source: Excise Duty Tables, Manufactured Tobacco, European Commission (2010-2019)

The general conclusion is that within the European Union the specific excise is gaining popularity. It is a fact that even in Bulgaria the increase of the excise yield in the last 10 years became possible due to the reversal of the excise structure in favor of the specific component. In general, it should be noted that the excise structure in Bulgaria is in a way creating parity between the weights of the specific component, on the one side, and the sum of the proportional components – the ad valorem excise and the value-added tax, on the other. This is something like an unwritten rule around which the excise structure on cigarettes in Bulgaria gravitates.

A Glimpse at the Innovative Tobacco Products

In 2017 Bulgaria introduced an excise framework regarding the heated smokeless tobacco products, which is in line with the best practices in the EU. A precise definition of the heated tobacco products was introduced, thus separating them from the other products, already present on the local market. It was rightfully considered that the different character of the heated tobacco products does not allow for a tax base to be upon “pieces of cigarettes” and thus they are currently taxed based on the quantity of tobacco used for them.

The key question about the tax rate was also solved in one of the most widespread ways in Europe – an excise duty equal to the excise on the cut tobacco, which in our case was BGN 152 per kilogram of tobacco. In 2018 the legislation was reconsidered and a wide discussion on the taxation of the new products was carried out, which included even ideas for a total change of the excise framework, which, if implemented, could have had very negative effects on this market segment. In the end a generally balanced decision was agreed upon, which left the tax base unchanged but increased the tax rate to BGN 233 per kilogram of tobacco.

The question of taxing the heated smokeless tobacco products is an important one since the new products entered very successfully the local market. According to the data available, in 2018 in the form of heated tobacco products were released a total of 148 tonnes of tobacco, which is equal to around 486 million pieces of heated smokeless tobacco products on the market. Budget revenue from the excise duty on the innovative tobacco products in 2018 was BGN 23 million. This number will definitely be significantly higher in 2019, since for the most of the last year the former tax rate of BGN 152 per kilogram of tobacco was in force.

In the future, an important aspect of taxing the heated tobacco products will be not only to preserve the tax basis on the quantity of tobacco but the difference in taxing the innovative products in comparison with conventional cigarettes. Currently, the most popular practice in Europe is to have a noticeable difference between the excise taxes on cigarettes and on heated tobacco products. As of 2018, the average excise duty on heated tobacco products is around 30% of the excise duty on classical cigarettes and in the new EU member states the spread is even greater. In 2019 the excise tax on heated tobacco products in Bulgaria is around 40% of the excise on classical cigarettes.

Normative Novelties and Challenges

A few new regulatory and legislative changes in 2019 concern both the market of tobacco products and the illegal trade. Among the key changes is the incrimination of production and distribution of illegal tobacco products and the creation of a register of people who are involved in the production and sale of machines and equipment for the production of tobacco products. Both measures aim to

strengthen the legislative framework by giving more instruments for not only limiting the illegal trade but decreasing the illegal production of tobacco products in the country as well.

On May 20, 2019, the new system for monitoring and tracking of movement of tobacco products was put into service in the entire European Union. In practice, this means that all cigarette packs already have a unique identification code, which allows the entire route of a pack from the factory to the final consumer to be traced. Even though this system caused many discussions on the European level (due to the new administrative overload upon the producers of legal cigarettes), it should be beneficial for the purposes of limiting the illegal trade. This should be especially true in the cases when classic smuggling occurs – i.e. when packs of cigarettes, produced in one country, are imported illegally in another one.

An interesting measure was the removal of the price of cigarettes from the excise label and putting it on the box itself instead. This measure aims to reduce the administrative burden on the producers of legal cigarettes and to help increase the flexibility on the market – printing of excise label will no longer be connected with the pricing decisions of the companies. In the same time, having the price printed on the box itself guarantees that the consumers will remain fully protected against all sorts of unscrupulous practices.

In conclusion, we could point out that the normative changes regarding the tobacco products follow two main directions. On the one hand, there are stricter rules against the illegal trade – with tracking of cigarette packs, registry of manufacturing machines, and incrimination of illegal production. On the other, there is the implementation of regulations, which aim to support the developments on the legal market. Among them is the new excise framework regarding the innovative products and the removal of the price from the excise label. These changes should further foster both the solid development of the legal market of tobacco products from the past several years and to allow for the illegal trade of tobacco products in the country to remain at its record low levels.