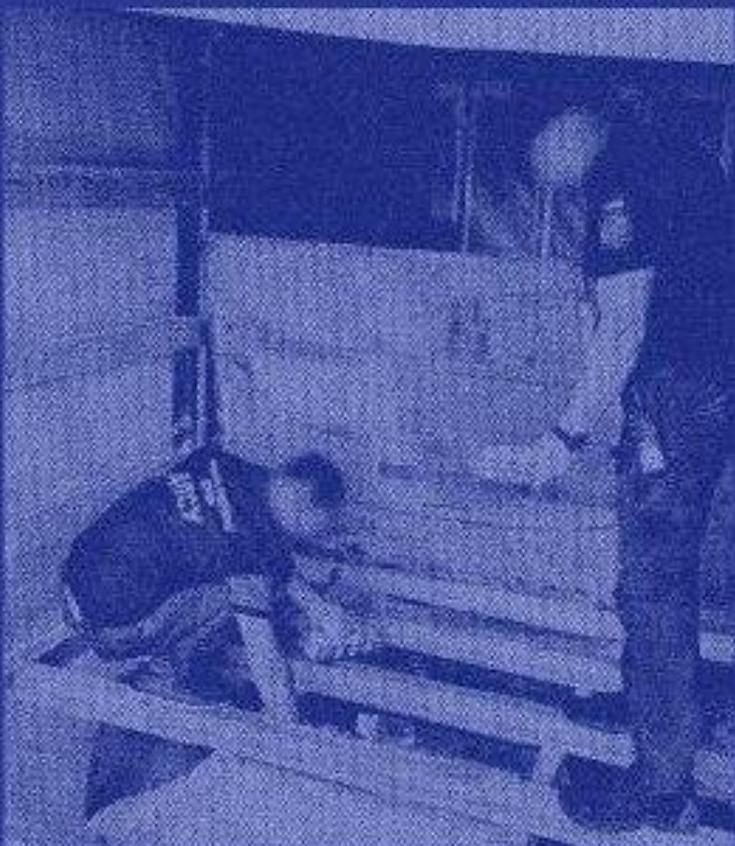


TOBACCO EXCISE TAX: REALITIES OF MAXIMIZING REVENUE

Analytical note



General context

In today's environment, the need to increase tax revenues in order to adequately finance programs to strengthen the state's defense capability is becoming more urgent. One of these areas is the further increase of excise tax rates on tobacco products. It should be noted that this measure is a classic tool for filling the state treasury in many countries, including those involved in military conflicts¹. A full-scale invasion requires additional solutions from the state to cover at least part of the unprecedented fiscal gap. Increased excise tax revenues will strengthen the state's ability to fulfill its tasks and functions.

At the same time, the increase in the excise tax should not only be aimed at ensuring the growth of budget revenues, but also be consistent with the goal of minimizing the volume of the illegal tobacco market, which continues to be a significant problem for the state. Despite the decline in its share to 14.6% in July 2024, the annual loss of tax revenues will amount to about UAH 23 billion, which is unacceptable in a period of acute financial shortages.

In 2022-2024, the budget shortfall from the illegal cigarette market is estimated at more than UAH 64 billion (EUR 1.4 billion). As the price of legal products increases, the benefits of participants in illegal schemes will grow and budget losses will increase. Obviously, demand for cheaper tobacco products creates supply.

The empirical experience of the EU member states and other developed G-7 countries shows that countering the growing illegal markets for excisable goods requires additional budgetary allocations, coordinated efforts of government agencies, and time.

So what should we do, given all this?

Let's pay attention to another fundamental point. The excise policy should also take into account the fact that the *cigarette market will gradually decline*. Not only because the prevalence of smoking will decrease. This would be an ideal, but unfortunately difficult to implement scenario. The best thing is for young people not to start, and for smokers to stop. However, there is no perfect life; it is not easy to keep everyone from becoming addicted to nicotine, which in turn has fashionable trends. We live in a time when *more and more consumers are opting for the latest nicotine consumption products*: heat-not-burn or heated tobacco products (HTPs) and electronic cigarettes (also called vapes). The question is, how should they be taxed? And if this is a "promising pair" that will gradually replace CCs, are there any threats to tax revenues associated with the formation of their illegal markets?

¹ Mehrotra, A. K. (2010). The Price of Conflict: War, Taxes, and the Politics of Fiscal Citizenship. Michigan Law Review, 108(6), 1053-1078

We have tried to study all these aspects by examining the latest developments in world science, the practice of European and other countries, and the realities of the formation and implementation of excise policy in Ukraine, and we provide answers to the burning questions in this policy brief.

An overview of current foreign research

Primarily, let's pay attention to the scientific works of recent years, which confirm the *existence of a link between the increase in excise tax on tobacco products and the growth of their illegal market*.

The European Anti-Fraud Office (OLAF), based on the results of a study that included a survey of 27,672 respondents in all EU countries, states that *respondents see the main problem of the illegal cigarette market in the loss of tax revenues*. These losses are estimated at tens of billions of euros annually. In addition, the money from the sale of illegal tobacco products can be used to finance other illegal schemes, which is a national security issue. *The lower affordability of illegal cigarettes is a major factor in their consumption*².

In their study of tax regulation of the³ tobacco market, Philippe DeCissa, Donald Kenkel and Michael Loewenheim concluded that the issue of optimal tax rates is central to the excise policy of even developed countries. When the volume of the illegal cigarette market is significant, *it leads to irrecoverable fiscal losses*.

Alberto Asiani, Francesco Calderoni, and Marco Dugato have studied the main factors that influence the consumption of illegal cigarettes in 247 regions of the EU, dividing them into 2 categories: price and non-price ones. The price increase is primarily due to an increase in excise tax rates. The non-price factors included: inequality of national income, higher population density, proximity to low-cost production centers, and the level of illicit trade in neighboring regions and countries⁴.

Matija Kajic and Stanislav Tosha determined that the illicit trade in tobacco products in the United States is primarily caused by higher excise tax rates in the sample of states compared to other states and neighboring countries, *as well as the existence of significant benefits for counterfeiters and smugglers*⁵.

² Public perception of illicit tobacco trade. OLAF (European Anti-Fraud Office). URL: https://anti-fraud.ec.europa.eu/public-perception-illicit-tobacco-trade_en

³ DeCicca, P., Kenkel, D., & Loewenheim, M. F. (2022). The economics of tobacco regulation: a comprehensive review. *Journal of economic literature*, 60(3), 883-970. URL: https://www.nber.org/system/files/working_papers/w26923/w26923.pdf

⁴ Aziani, A., Calderoni, F., & Dugato, M. (2021). Explaining the consumption of illicit cigarettes. *Journal of Quantitative Criminology*, 37, 751-789.

⁵ Kajić, M., & Tosza, S. (2022). Trends and Challenges in Combating Illicit Trade in Tobacco Products in the US. *Combating Illicit Trade in Tobacco Products: In Search of Optimal Enforcement*, 537-593.

The study by *the A&M* consulting company is dedicated to identifying the preconditions for the illicit trade in tobacco products⁶. The analysis covered 32 countries, including the United States, 16 EU countries, Ukraine, and others. Using econometric research methods, the authors found that *an increase in taxation is the main factor in the existence of the illegal tobacco market*. Increasing excise rates reduces the affordability of cigarettes for consumers, who are forced to look for cheaper products on the market, which in most cases are illegal. Experts emphasize the need to improve the validity of tax policy and ensure its consistency. The shortcomings of tax policy development primarily affect the rapid increase in the volume of illicit trade in tobacco products, especially cigarettes. The consequences of this growth can only be overcome in the medium and long term. After all, measures to counter illicit trafficking require proper coordination, significant amounts of public financial resources and time spent by regulatory and law enforcement agencies.

Research papers on the taxation of new nicotine products are also beginning to appear. In particular, Malgorzata Szejnkowska notes that in the EU, *Heated Tobacco Products* (we use the term HTPs) are not subject to the *Tobacco Directive (TBD)*. Therefore, each EU country is free to apply excise tax rates for HTPs that are lower than for cigarettes. The researcher concluded that *the use of moderate excise tax rates on HTPs by European governments is sufficient to generate stable budget revenues; And this is fully consistent with other state goals in the social and economic sphere*⁷.

Threats of illegal markets: the EU's mistakes and the realities of Ukraine

Without limiting ourselves to the conclusions of modern world science, we will give examples from the experience of EU countries, when a sharp increase in excise tax led not to an increase in tax revenues, but to the expansion of the illegal cigarette market with accompanying losses for the budget.

In *Bulgaria*, in 2008-2010, the minimum excise tax liability (METL) on cigarettes increased from EUR 35.08 to 75.67 per thousand units, or 2.2 times (in 2010 – by 48.5% compared to 2009). As a result, in 2010 the share of the illegal cigarette market in the country exceeded 30% and there was a decline in budget revenues. The government's response to this development was to freeze the excise tax for 5 years. Its rate was increased by 8.8% only in 2016, and further regulation of the excise tax on cigarettes took into account the dynamics of household income and the tobacco product affordability index. These measures have led to a gradual decrease

⁶ Alvarez & Marsal. Causes and Control of Illicit Tobacco. Second Edition, 2019. URL: https://www.alvarezandmarsal.com/sites/default/files/causes_and_control_of_illicit_tobacco_report_ed_2.pdf

⁷ Szejnkowska, M. (2022). Heated Tobacco as a Novelty Tobacco Product Subject to Excise Duty: A Cross-country Comparison. *Teka Komisji Prawniczej PAN Oddział w Lublinie*, 15(2), 355-364.

in the share of illicit cigarette trade and an increase in excise tax revenues to the state budget.

In *Latvia* in 2008-2009. The METL increased 3.2 times to EUR 67.73 per thousand cigarettes, which was immediately reflected in a significant drop in sales of legal products and budget revenues. Revenues from the excise tax on tobacco products have declined by more than 20% for two consecutive years, and the share of the illegal cigarette market reached 37% in 2010. These effects of the changes in the excise tax burden led to the suspension of the cigarette excise tax increase in 2010-2011 and a moderate increase in its rates in 2012-2013. In general, over the four years, excise tax growth was about 10%, and consumer inflation in the country was 5.7%. Since 2011, the share of the illicit tobacco market has been gradually decreasing and excise tax revenues from these products have been increasing.

In three years in *Lithuania*, as a result of the excise tax shock (the rate tripled to EUR 64 per thousand cigarettes in 2010), the illegal tobacco market exceeded 40%, and excise tax revenues from these products decreased by 20.1%. The government was forced to adapt to this situation. For the next two years, the excise tax rate on cigarettes was not revised at all, and in 2013 and 2014 it gradually increased to a level close to 5%. In Lithuania, consumer inflation was 12.5% in 2011-2014. After the excise tax rate increased too rapidly in 2008-2010, it was not indexed even to inflation in the next four years. However, the suspension of the growth of the tax burden on cigarettes resulted in a gradual and significant reduction in the rate of illegal circulation and an increase in the fiscal efficiency of the excise tax.

In *Hungary* in 2008-2009. The METL increased by 31.9% to EUR 62.8 per thousand cigarettes; Due to the growth of the illicit market, tobacco excise revenues decreased by 25.4% in 2010. In response to this, the authorities have significantly slowed the growth of the cigarette excise tax. In 2010-2012, the rate increased by only 5.5%, while consumer inflation in the period amounted to 15.1%. However, Hungary later made the same mistake. Without taking into account the experience of the excise tax shock and the dynamics of the cigarette affordability index, but taking into account the position of certain segments of society on the need to index the excise tax to a level higher than consumer inflation in 2013. The METL increased by 32% at once. The consequence of this step was a drop in excise tax revenues from tobacco products for two consecutive years in 2013 and 2014, and a rapid increase in the share of the illegal cigarette market to 8.8%. Therefore, the government decided to freeze the excise tax rate again in 2014-2015. This measure allowed to resume the growth of budget revenues since 2015 and halved the turnover of illegal products to 4.3%.

Most EU countries have taken their lesson from the surge in illicit trade into account when planning a new excise tax increase. Others learned from the mistakes

of others. At the same time, all those who fought the illegal cigarette market implemented a balanced excise policy during the period of its largest scale.

And we think that this happened in the EU countries, but it is definitely not possible in Ukraine, because we can easily overcome the illegal market? Let's just introduce a few more new measures, make some more personnel decisions, and then we can forget about illegal cigarettes? Unfortunately, economic laws in Ukraine do not operate in a special way in the context of an increase in the excise tax rate against the backdrop of a decrease in the purchasing power of the population. Tobacco criminals, seeing future (and increasingly greater) benefits with the increase in excise tax, revive their "business" again and again even after seemingly crushing blows...

Let us remember how in the second half of 2022 the activities of a large manufacturer of illegal cigarettes causing damage to the budget in the amount of over UAH 6.5 billion were stopped⁸. It took the intervention of the President of Ukraine to close the factory. But the positive effect did not last long. According to Kantar⁹, the level of illicit trade in tobacco products in November 2022 decreased to 17.8% compared to 21.9% in August. However, in October 2023, this figure reached its all-time high of 25.7%. Everything indicates that the vacated niche was quickly filled.

On May 14, 2024, searches began at the five largest cigarette manufacturers, where information about their illegal activities was confirmed. The results of the searches were made public by Viktor Lysenko, Head of the ESB's Crime Detectives Unit for the Protection of the Economy in the Field of Circulation of Excisable Goods. A number of expert examinations were ordered, the State Tax Service of Ukraine conducted an inspection and revoked the licenses for the production of tobacco products for some of the companies involved.

Law enforcement officers seized two cigarette production lines and 18 tons of tobacco raw materials in an unlicensed warehouse of one of the manufacturers, one line for processing tobacco raw materials in a warehouse not officially indicated by the manufacturer, about 5 tons of tobacco stored in the warehouse of one of the manufacturers without a license, and samples of cigarettes for which comparative examinations were ordered, etc¹⁰.

These investigative actions resulted in a decrease in the level of illicit trade in tobacco products from 18.0% in April to 14.6% in July 2024, as recorded by *Kantar*. However, as soon as these operational measures were disbanded, we again saw

⁸ Law enforcers have been unable to close an illegal tobacco factory in Zhovti Vody for years, Hetmantsev says. Business.Censor. 04.10.2022. URL: https://biz.censor.net/news/3371413/pravoohorontsi_rokamy_ne_mogly_zakryty_nelegalnu_tyutyunovu_fabryku_u_jovtyh_vodah_getmantsev

⁹ Monitoring of illicit trade in tobacco products in Ukraine, 2024. Wave 3. URL: <https://www.kantar.com/ua/Inspiration/AIT/AIT-WAVE-3>

¹⁰ After large-scale searches by the ESB at tobacco factories, one of the manufacturers lost its license. Business.Censor. 16.07.2024. URL: https://biz.censor.net/news/3499970/biznesasotsiatsiyi_zavyavly_pro_pidvyschennya_efektyvnosti_roboty_byuro_ekonomichnoyi_bezpeky

alarming reports of the resumption of illegal cigarette production¹¹. Assessing this, Danylo Hetmantsev, Chairman of the Parliamentary Tax Committee, stated frankly: "It happens that a disease that was almost cured relapses, which must be treated again, but it must be treated, and not given up. Otherwise, it's death"¹².

Only those who have never done it and have not studied the European and domestic experience in retrospect can believe that fighting the illegal tobacco market is easy. And only those involved in the actual counteraction to the illicit trade in tobacco products know how difficult it is to "recapture even the smallest pieces of territory captured by the enemy on this path of the war of good and evil." Increasing the excise tax makes the fight more difficult, and it is important to remember this. There will always be those who fall for the illusion that the higher the excise tax rate, the more "full the rivers of tax revenues" will be. But we have to be realistic. We need to understand the full responsibility for decisions made in a full-scale war. Today, mistakes are particularly costly for the state.

It is equally important to realize that *cigarettes are not "kings for life" on the tobacco market*. Over time, their consumption may be significantly replaced by newer alternatives, and the threat of new illegal markets will increase. The fight against the latter will have its own peculiarities. But the impact of the excise tax increase on the level of illicit trade in nicotine products will remain unchanged. It is important to observe where consumer demand flows and whether the relevant markets have an illegal component. This has an impact on budget revenues. It is short-sighted to think that this is only a problem of the future. It's better to take preventive measures than to "treat severe stages of the disease." Modern excise policy determines future trends!

The importance of avoiding substitution with undesirable alternatives

After a number of negative cases, here is a positive example of the implementation of *the German* excise policy. There was a period in the country when smokers started switching to pipe tobacco (which was much cheaper due to relatively low excise tax rates), which even intensified price wars in the cigarette market. Both changes in consumer preferences and aggressive dumping by some cigarette manufacturers caused the budget to lose money. With this in mind, Germany implemented changes in 2010-2015 that included: 1) Increase of the specific (from EUR 82.7 to 98.2 per thousand pcs.) and reduction of the ad valorem (from 24.66 to 21.69%) excise tax on cigarettes; 2) Increase of the specific (from EUR 34.06 to 48.49 per kg) and reduction of the ad valorem (from 18.57 to 14.76%) excise taxes on finely

¹¹ Illegal tobacco factories have resumed operations despite law enforcement raids. RBC. 07.10.2024. URL: <https://www.rbc.ua/rus/news/nelegalni-tyutyunovi-fabriki-vidnovili-svoyu-1728301105.html>

¹² Telegram channel of Danylo Hetmantsev. 05.10.2024. URL: <https://t.me/getmantsevdanil/7892?comment=84973>

cut tobacco; 3) Anti-dumping measures. We emphasize that the rate of increase in the excise tax on cigarettes was no more than 5% per year, while the excise tax on pipe tobacco grew somewhat faster. And all this was done in a balanced manner to prevent the transition to undesirable alternatives. In the end, the goals were achieved.

In contrast, there have been cases in *Georgia* where a significant increase in cigarette excise taxes has provoked spikes in loose tobacco consumption. In particular, in 2018-2019, cigarettes rose in price by almost two and a half times as a result of the excise tax increase. Since the excise tax on loose tobacco in the country was much lower than on cigarettes, it was more affordable for consumers, a significant number of whom switched to hand-rolled cigarettes. If about 2% of smokers smoked hand-rolled cigarettes in 2018, then in 2019 the number of their consumers increased to almost 21%¹³. As a result of the replacement of cigarettes with these alternatives, excise revenues decreased.

Of course, in our time, the threats of consumers switching to hand-rolled cigarettes (we give these examples to illustrate the conditions for replacing one tobacco product with another and the speed with which such undesirable processes can occur) are not as relevant as the risks of losing tax revenues due to the replacement of conventional cigarettes with electronic ones. As noted above, the dynamics of excise tax revenues will increasingly be determined by the ratio of the markets of the “promising pair” – HTPs and e-cigarettes.

According to our estimates, there is currently no *illegal market for HTPs in Ukraine*¹⁴. An obstacle to its formation is the complex technological process of producing heating sticks and limited access to expensive equipment. This makes it virtually impossible to produce counterfeit HTPs. Similar conclusions were reached in a study by *NielsenQ*: 99.9% of HTP packs have labeling that fully complies with Ukrainian legislation¹⁵.

At the same time, *the domestic illegal market for e-liquids* after the ban on flavored liquids in the summer of 2023, according to our estimates, *reached 99%*¹⁶. At the same time, the prevalence of consumption of these products has increased slightly. And this is not a mistake of the EU countries, or a "Georgian lesson", but a painful warning against radicalism for our budget...

¹³ Deaths and prices vs. a bad habit – how is the fight against tobacco in Georgia going? 27.09.2019. URL: <https://sputnik-georgia.ru/reviews/20190927/246611504/Opravdala-li-sebya-antitabachnaya-politika-v-Gruzii.html>

¹⁴ Excise policy and the illicit trade in tobacco products: in search of balanced solutions. T. Koshchuk, M. Pasichnyi / edited by T. Koshchuk, Growford Institute, K: 2024. URL: <https://www.growford.org.ua/research/aktyzna-polityka-i-nelegalna-torgivlya-tyutyunovymy-vyrobamy-u-poshu-kah-zbalansovanyh-rishen/>

¹⁵ HTP Empty Packs Survey. NIQ. March 2024. URL: <https://eba.com.ua/wp-content/uploads/2024/03/Clients-file-2-charts.pdf>

¹⁶ E-liquid illicit trade: prerequisites, trends, countermeasures. Koshchuk T., Pasichnyi M. / edited by T. Koshchuk, Growford Institute, K: 2024 URL: <https://www.growford.org.ua/research/nelegalna-torgivlya-ridynamy-dlya-el-ektronnyh-sygaret-peredumovy-tendentsiyi-zahody-protydyi/>

Thus, *while the transition to e-cigarettes in the domestic reality means a concomitant loss of tax revenues, the transition to fully legal HTPs ensures that taxes are paid on each pack purchased.* In this context, HTP consumption has advantages over smoking conventional cigarettes, the market for which remains 14.6% illegal.

How then is it better to tax HTP? What does the EU experience suggest? Unfortunately, it is too late to think about the optimal taxation of vapes.

Excise tax on HTP in EU countries: current practice and prospects

Council Directive 2011/64/EU of 21.06.2011. The Law of Ukraine "On the Structure and Rates of Excise Duties Applicable to Tobacco Products (Codification)"¹⁷ establishes the principles of harmonization of the structure and rates of excise duty on tobacco products (processed tobacco) – cigarettes, cigars and cigarillos, smoking tobacco, but does not regulate the taxation of heat-not-burn products. The reason is obvious: such products appeared after the directive was adopted.

This means that EU countries can determine the taxation of HTP at their own discretion, taking into account, among other things, that such products, unlike conventional cigarettes, do not burn but are heated to a certain temperature, which results in less carcinogenic substances entering the human body. There are already studies that confirm this fact¹⁸. However, there is no medical evidence on the long-term effects of their use. Discussions are ongoing, and HTPs are often referred to as products with potentially reduced health risks. This has an impact on their taxation.

In its turn, the European Commission, fearing that countries would introduce excise taxation systems for HTPs that differ too much from each other, recommended that such products be taxed at the rates applied to the excisable category "other smoking tobacco", which are the lowest among all tobacco products¹⁹. In most EU countries, such rates are set per unit weight in kilograms. This had a decisive impact on the development of the European practice of taxation of the HTPs.

We would also like to emphasize that Council Directive 2011/64/EU contains the principle that different excise rates should be applied to different categories of tobacco products. The highest is for the most popular category, which is cigarettes. And if new products appear on the market that do not fall within the existing "narrow" definitions of tobacco products, the broadest definition is "other smoking tobacco". Since HTPs consumed only with the use of a special heating device cannot

¹⁷ On the structure and rates of excise duties applicable to tobacco products (codification). EU Council Directive of June 21, 2011. 2011/64/EU. URL: <http://www.minjust.gov.ua/45885>

¹⁸ FDA permits of IQOS Tobacco Heating System through premarket tobacco product application pathway. 30.04.2019 URL: <https://www.fda.gov/news-events/press-announcements/fda-permits-sale-iqos-tobacco-heating-system-through-premarket-tobacco-product-application-pathway>

¹⁹ Report from the Commission to the Council on Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco. 12.01.2018. URL: https://ec.europa.eu/taxation_customs/sites/taxation/files/report_excise_duty_manufactured_tobacco_12012018_en.pdf

be classified as cigarettes, cigars or cigarillos, we can agree with the European Commission that the weight of tobacco in HTP sticks should be excised and the rate for them should be equal to the excise rate for loose tobacco. Later, as HTPs spread on the market, some EU countries introduced slightly higher excise taxes for HTPs compared to other smoking tobacco, which at the same time remain significantly lower than for cigarettes.

As of April 1, 2024, 10 EU countries (Belgium, Greece, Denmark, Estonia, Spain, Cyprus, the Netherlands, France, Czech Republic and Sweden) have set the same excise rates for HTPs and other smoking tobacco. In Austria, Bulgaria, Croatia, Finland, Latvia, Romania, Slovakia, Slovenia, and Finland, the excise tax on HTPs is set per unit weight of tobacco, but is somewhat higher than the excise tax on other smoking tobacco. Only in Italy, Lithuania, and Hungary, the basis for calculating excise tax on HTPs is units of production. At the same time, *in all EU countries, the excise tax burden on HTPs is lower than on cigarettes.*

Given that mixed excise tax rates are applied to cigarettes (specific per thousand units of production and ad valorem as a percentage of the maximum retail selling price), while for HTPs the EU countries have established either a specific tax rate per unit of tobacco weight in kilograms, or a rate for a thousand units of production (Italy, Lithuania, and Hungary) or mixed rates (Belgium, Germany, Poland, Portugal and France), or only an ad valorem rate (Spain), the calculations for determining the level of differentiation of the excise burden on these two types of products are complicated. The latter have never been officially published by the European Commission.

Our calculations of this level of differentiation are based on a comparison of the excise tax rate for HTPs converted from the unit of measurement in kilograms to thousand pcs. of production and the METL value for cigarettes published by the European Commission. Moreover, since the determination of the excise burden on HTPs, which are taxed at mixed excise rates (but without establishing a sufficiently high minimum excise tax) or only by ad valorem excise tax, must take into account their retail selling price, corresponding comparisons for Belgium, Spain and Portugal were not carried out²⁰.

Calculations for Germany were also not made due to the complicated methodology for calculating the excise tax for HTPs. The taxation scheme for HTPs, which the country has been using since 2022, provides for the following: a special coefficient is added to the excise rate for other smoking tobacco, equal to the share of the excise tax on cigarettes minus the excise tax on other smoking tobacco. In

²⁰ It is not correct to use the minimum excise tax for these calculations, as HTPs are quite expensive and therefore unlikely to be taxed without the ad valorem component, if such a minimum is set at a relatively low level.

addition, this coefficient is growing (in 2023 it was EUR 2.01 per pack of HTPs, in 2024 it increased to EUR 2.15)²¹.

In Italy, the excise tax rate on HTPs is 32% of the METL for cigarettes.

The results of the calculations for other EU countries where HTPs are currently on the market are presented in Table 1.

Table 1

The level of differentiation of the excise tax burden on HTPs and cigarettes in the EU* in 2024.

Countries	METL per thousand cigarettes, euros	Excise tax for HTPs per thousand pcs.**, euros	Difference in the level of rates, %
Austria	163	47.7	70.7
Bulgaria	98.9	44.7	65.1
Greece	117.5	41.5	64.7
Denmark	260.3	53.5	79.4
Estonia	169.1	29.8	82.3
Italy	204.23	77.61	62.0
Cyprus	121.5	39.8	67.3
Latvia	156.3	66.5	57.5
Lithuania	138.0	79.5	42.3
The Netherlands	293.6	57.4	80.4
Poland	129.8	34.4	74.0
Romania	134.52	58.0	64.7
Slovakia	148.0	56.0	63.0
Slovenia	141	35	75.2
Hungary	104.5	87.5	16.3
Finland	353.6	79.5	77.5
France	371.4	268	27.8
Croatia	117.9	49.2	58.3
Czech Republic	173	37.5	78.3
Sweden	161.9	52.3	67.7
On average in the EU	-	-	63.7

* By countries where HTPs are present on the national market and are taxed only at a specific excise tax rate, as well as Poland and France, where a rather high minimum excise tax is set for such products under the mixed excise tax system.

** The calculations were carried out on the basis of *Heets* HTPs (the weight of tobacco in 20 sticks of a pack is 5.3 g).

Source: European Commission. Taxes in Europe Database. URL: https://trade.ec.europa.eu/access-to-markets/en/content/excise-duties#toc_3

Thus, among the 20 countries analyzed, the ratio of excise taxes on HTPs and cigarettes ranges from 82.3% in Estonia to 16.3% in Hungary, while the EU average is 63.7%.

It should be noted that Council Directive 2011/64/EU is expected to be updated. But the process of revising European legislation is not an easy task. Back in

²¹ Germany has second thoughts, lowering the tax pressure on heated tobacco. URL: <https://tobaccointelligence.com/germany-has-second-thoughts-lowering-the-tax-pressure-on-heated-tobacco/>

early 2020. The European Commission published a report assessing the application of the provisions of Council Directive 2011/64/EU, which, in particular, justifies the need to increase the minimum excise tax on cigarettes and establish rules for taxation of HTPs. Subsequently, the areas of relevant changes were discussed with all stakeholders, but no official legislative initiative has yet been put forward.

The discussion on the revision of Council Directive 2011/64/EU continues in the non-public sphere. In particular, unofficial information was circulated that amendments to the legislation proposed to increase the minimum excise tax on cigarettes in the EU from 1.80 to 3.60 euros per pack of 20 cigarettes (EUR 180 per thousand pcs.). The media also reported, citing informed sources, that the European Commission proposed to set the minimum excise tax on HTPs at half the level of cigarettes²².

Subsequently, Angel Lopez-Nicolas²³ study stated that the updated directive would set a *time horizon for countries to raise their excise taxes on tobacco products to the new minimum levels in the EU: 2027-2030*. At the same time, *these minimum standards will not be the same for everyone* (since the indicators that will be achievable for the least developed countries are already too low for most other member states), but will *take into account the country's purchasing power parity and be adjusted for inflation*. This means that while Germany will be required to apply the Minimum Excise Tax Liability (METL) on cigarettes at least EUR 180 per thousand pcs. and the excise tax on HTP at EUR 91 per thousand pcs. no later than 2030, we estimate that for Ukraine the corresponding rates will be about EUR 140 and 70, respectively.

Earlier, the European Commission emphasized that differences in approaches to excise taxation of HTPs in the EU countries create obstacles to the functioning of the single market. This can distort competition and cause disputes over enforcement. In addition, there are administrative barriers to the cross-border movement of these products between countries that have chosen different approaches in this area²⁴.

²² Brussels to propose rise in cigarette taxes and first EU-wide vaping levy. Financial Times. URL: <https://www.ft.com/content/6f1c4211-5e54-4aa8-a391-0ec9bc5244de>; Commission to Propose EU-Wide Vaping Levy. Tobaccoreporter. 28.11.2022. URL: <https://tobaccoreporter.com/2022/11/28/commission-to-propose-eu-wide-vaping-levy/>; EU tobacco taxation: The fine line between killing smoking and illicit trade. EURACTIV. 29.11.2022. URL: <https://www.euractiv.com/section/health-consumers/news/eu-tobacco-taxation-the-fine-line-between-killing-smoking-and-illicit-trade/>

²³ López-Nicolás, A. (2024). Tobacco taxes in the European Union An evaluation of the European Commission's Tobacco Tax Directive proposals for cigarettes, cigarillos, pipe tobacco, electronic cigarettes, heated tobacco products, and nicotine pouches. URL: <https://tobaccconomics.org/files/research/902/working-paper-tobacco-taxes-eu-other-products-final-md.pdf>

²⁴ Study on Council Directive 2011/64/EU on the Structure and Excise Tax Rates Applied to Manufactured Tobacco. Final report. Volume 1 – Study. Luxembourg: Publications Office of the European Union, 2020. URL: <https://op.europa.eu/en/publication-detail/-/publication/8c9dd329-4d4f-11ea-aece-01aa75ed71a1/language-en>

To unify the approaches to excise taxation of HTPs, the European Commission proposed to move to determining their tax base on the basis of thousands of units of production.

The respective position of the EU countries and the European Commission on the taxation of HTPs is not a "matter of taste". And can the EU, whose institutional environment and corruption "safeguards" we look up to, be more guilty of lobbying than Ukraine? Apparently not. The logic of the rationale used to set past, present and future excise rates in the EU is described above. We see an example of a balanced excise policy.

This example was used by the Ministry of Finance of Ukraine as a basis for developing a plan to increase the excise tax. The latter takes into account the need to increase the excise tax on cigarettes to the minimum rates in the EU; It also takes into account the taxation practices of the EU countries on HTPs, which is a progressive step towards harmonizing national tax legislation with the European one.

Plan to increase the excise tax on tobacco products in Ukraine by 2028

When forming the draft State Budget of Ukraine for 2025²⁵, the provisions of the Draft Law of Ukraine "On Amendments to the Tax Code of Ukraine on Revision of Excise Tax Rates on Tobacco Products" (the "Draft Law")²⁶ adopted in the first reading, were taken into account. Its main innovations are as follows:

First, setting excise tax rates on tobacco products in euros. This is in line with the provisions of the National Revenue Strategy until 2030²⁷ approved by the Cabinet of Ministers of Ukraine and agreed with representatives of international financial organizations that act as financial donors during a full-scale invasion. Initially, the Draft Law envisaged that the excise tax would be introduced in euros on July 1, 2024. This has not been done, and the most realistic scenario for the change is now 2025;

Second, taking into account the approaches of EU countries to taxation of new nicotine products, differentiated excise tax rates for HTPs and cigarettes are envisaged. Effective January 1, 2025 The METL on cigarettes will increase to EUR 78 per thousand pcs., while the excise rate on HTPs is to increase to EUR 70.4. Taking into account the official exchange rate of hryvnia to euro set by the NBU as of 25.09.2024 (46.04 UAH/EUR), the current METL for cigarettes and the excise rate for HTPs are EUR 54.66 (UAH 2,516.54 per thousand pcs.). Thus, starting from

²⁵ Draft Law on the State Budget of Ukraine for 2025. URL: <https://itd.rada.gov.ua/billInfo/Bills/Card/44888>

²⁶ Draft Law on Amendments to the Tax Code of Ukraine on Revision of Excise Tax Rates on Tobacco Products URL: <https://itd.rada.gov.ua/billInfo/Bills/Card/43855>

²⁷ National Revenue Strategy until 2030. 2023. URL: https://mof.gov.ua/storage/files/National%20Revenue%20Strategy_2030_.pdf

2025, the excise tax on cigarettes will increase by 42.77%, and the excise tax on HTPs will increase by 28.8%, assuming the euro remains unchanged.

At the same time, the Draft Law "On the State Budget for 2025" sets the average annual euro exchange rate for calculating tax revenues at UAH 48.60, which is 5.5% higher than the current rate.

The Draft Law also provides for a further increase in excise tax rates on tobacco products for 2026-2028. Thus, the minimum excise tax on cigarettes will increase by 5% annually, reaching EUR 90, and the excise tax rate on HTPs is to rise to EUR 72 in 3 years. This is roughly the level of the rate for HTPs that is expected to be provided for Ukraine in the successor to Council Directive 2011/64/EU. Instead, a new excise tax increase plan will have to be implemented for cigarettes after 2028.

Third, it is established that for the period of martial law, for three consecutive reporting months preceding the month in which the excise rates are increased, the average monthly sales volume of excise tax stamps to a tobacco producer and/or importer may not exceed 120% (*previously 115%*) of the average monthly sales volume of tobacco products by such producer and/or importer for the previous nine calendar months.

If the Draft Law is adopted, the Government expects the state budget to receive additional revenues from the excise tax on tobacco products at the level of **UAH 28.84 billion**, including UAH 0.61 billion in 2025, UAH 5.0 billion in 2026, UAH 9.38 billion in 2027, and UAH 13.85 billion in 2028.

We will conduct our own calculations of the fiscal effect of the above plan to increase the excise tax on tobacco products in Ukraine.

Estimation of the fiscal impact of the Draft Law implementation

It is important to assess the impact of the proposed innovations on the dynamics of tobacco excise tax revenues to the state budget, taking into account the influence of both internal and external factors. To forecast potential budget revenues, we need to justify a set of parameters.

Primarily, it is necessary to have reliable information on the volume of tobacco consumption. One approach to calculating consumption is to multiply the number of smokers by the volume of products consumed:

$$n_{tp} = n_s * dc_{tp} * 365 \quad (1),$$

Where n_{tp} is the volume of tobacco products;

n_s is the number of tobacco consumers

dc_{tp} is average daily consumption of tobacco products;

According to a sociological survey conducted by the *Kyiv International Institute of Sociology* (KIIS)²⁸, as of April 2023, 27.4% of Ukrainians (aged 18 and older) were consumers of tobacco and nicotine-containing products. Moreover, 22.2% were cigarette users, 3.3% were e-cigarette users, and 3% were HTP users. Instead, in December 2023, according to the mentioned agency, already about 30% of our compatriots (over the age of 18) smoked, 24.5% of whom smoked on a regular basis. 75% of smokers preferred cigarettes, 18% preferred HTPs, and 16% preferred vapes²⁹.

However, Ella Libanova, an Academician of the National Academy of Sciences and Director of the Institute of Demography, notes that since the full-scale invasion, there is no information on the gender and age structure of the population in Ukraine (the State Statistics Service of Ukraine does not know it), so the representativeness of any opinion polls should be treated with caution³⁰.

According to the State Statistics Service, as of January 1, 2022, 41.17 million people lived in Ukraine³¹. Since the full-scale invasion, several million people have been forced to stay in the territories occupied by the aggressor, and 6.725 million Ukrainians have fled abroad as refugees (according to the UN)³². It is not known for certain how many of them returned. According to the UNFPA (*United Nations Populations Fund*) dashboard, there were 37.9 million people in Ukraine on January 1, 2024, and 36.74 million on January 1, 2023³³. That is, in 2023, more than 1.1 million compatriots returned to Ukraine.

Given that the population aged 18 and over accounts for 80% of the total population, the number of adults is 30.3 million. Based on the latest KIIS data on tobacco consumption³⁴, it turns out that there are 9.1 million smokers/nicotine users in Ukraine (7.4 million are regular users), of whom 6.8 million consume cigarettes, 1.637 million use HTPs, and 1.46 million use e-cigarettes. This seems to be a significantly overestimated figure. According to another study, the prevalence of smoking

²⁸ World No Tobacco Day in Ukraine: progress in Ukraine and survey results. Kyiv International Institute of Sociology. URL: <https://www.kiis.com.ua/?lang=ukr&cat=reports&id=1240&page=1>

²⁹ Use of tobacco and nicotine products and attitudes towards anti-tobacco measures: December 2023. Analytical report. KIIS. URL: <https://center-life.org/wp-content/uploads/2024/03/Vzhyvannia-tiutiunovykh-ta-nikotynovykh-vyrobiv-ta-stavlennia-do-antytiutiunovykh-zakhodiv-hruden-2023.pdf>

³⁰ Libanova: The results of polls in Ukraine should be treated with caution. Glavkom. 29.01.2024. URL: <https://glavcom.ua/country/society/do-rezultativ-opituvan-v-ukrajini-potribno-stavitis-oberezhno-libanova-983123.html>

³¹ The number of the current population of Ukraine as of January 1, 2022. Statistical digest. State Statistics Service of Ukraine. URL: https://ukrstat.gov.ua/druk/publicat/kat_u/2022/zb/05/zb_Nas.pdf

³² [Ukraine Refugee Situation](https://data.unhcr.org/en/situations/ukraine) URL: <https://data.unhcr.org/en/situations/ukraine> (date of access: 26.09.2024).

³³ [United Nations Population Fund World Population Dashboard Ukraine](https://www.unfpa.org/data/world-population/UA) URL: <https://www.unfpa.org/data/world-population/UA> (date of access: 25.09.2024)

³⁴ Use of tobacco and nicotine products and attitudes towards anti-tobacco measures: December 2023. Analytical report. KIIS. URL: <https://center-life.org/wp-content/uploads/2024/03/Vzhyvannia-tiutiunovykh-ta-nikotynovykh-vyrobiv-ta-stavlennia-do-antytiutiunovykh-zakhodiv-hruden-2023.pdf>

in Ukraine in 2024 is 22.8%³⁵. Instead, according to the State Statistics Service's 2021 data, there were only 5.054 million smokers in Ukraine (8.5% less than in 2020), which is 16.5% of the population sample mentioned in the report³⁶.

Summarizing the above, we state that in the current environment, the *calculation of consumption of cigarettes or other types of tobacco products*, given the lack of reliable information on the prevalence of smoking and the lack of data on the population, ***will be very approximate and inaccurate***. In addition, it is necessary to distinguish between legal and illegal consumption, since the peculiarity of the illegal tobacco market is that no taxes are paid on them at all.

Another approach to forecasting the volume of tobacco consumption is to take into account the actual figures for legal consumption and illegal trafficking.

The largest component of this market is the market for conventional cigarettes. According to the State Tax Service of Ukraine, in 2023, 31.62 billion cigarettes were produced, 4.39 billion cigarettes were imported, and 4.04 billion cigarettes were exported to other countries. Thus, the volume of taxable cigarette sales amounted to 31.62 billion pcs. Consumption should still be adjusted for changes in inventory balances, but in our study we assume that this will be insignificant in the medium term, as evidenced by the data provided by the Ministry of Finance of Ukraine for 2012-2022³⁷. For comparison, in 2021, the volume of taxable cigarette sales amounted to 34.4 billion units and decreased by 8% over the 2 years of the full-scale invasion. According to *Kantar*, in 2023, the share of the illegal cigarette market amounted to 21.8%³⁸.

Actual cigarette consumption can be estimated using the formula:

$$n_{cig} = \frac{cons_l}{(1 - cons_{il})} \quad (2),$$

where n_{cig} is the volume of cigarette consumption;

$cons_l$ is the legal consumption of cigarettes on which taxes are paid;

$cons_{il}$ is the coefficient of illegal cigarette consumption.

Thus, we estimate total cigarette sales in Ukraine in 2023 at 40.43 billion pcs. Given that, according to KIIS surveys, the average smoker consumes 17.7 cigarettes

³⁵ Analysis of the fiscal and health impact of increasing excise taxes on tobacco products in Ukraine. URL: <https://wiw.ac.at/analysis-of-the-fiscal-and-health-impact-of-increasing-tobacco-excise-taxes-in-ukraine-ukrainian-version-analiz-fiskal-nogo-ta-medichnogo-vplivu-pidvischennja-akciziv-na-tjutjunovi-virobi-v-ukraini-dlp-6996.pdf>

³⁶ Self-assessment of health status and access to certain types of medical care in 2021. Statistical digest. State Statistics Service of Ukraine. URL: https://ukrstat.gov.ua/druk/publicat/kat_u/2022/zb/03/zb_snsz_21.pdf

³⁷ Consolidated budget revenues for 2022 URL: https://mof.gov.ua/storage/files/Zvit_2022_%D1%81%D0%B0%D0%B9%D1%82.pdf

³⁸ Kantar. Monitoring of illicit trade in tobacco products in Ukraine, 2023. Wave 3. URL: https://www.kantar.com/ua/inspiration/ait/monitoring-nelehalnoi-torgivli-tutunovyh-vy-robiv_zhovten-2023

per day, we can assume that in 2023 there were 6.26 million cigarette smokers in Ukraine.

Cigarette consumption for 2024 is calculated based on the consumption in 2023, taking into account the price elasticity of demand for tobacco products. The volume of legal consumption is adjusted for the average annual level of illicit cigarette trade (according to *Kantar*, as of September 2024, 17.2%)³⁹. We estimate it at 38.2 billion pcs. (including sales of illegal products). According to *Kantar*, in 2024, the volume of the illegal cigarette market in Ukraine will reach 6.65 billion pcs.; The total market size will be 38.66 billion pcs., which is in line with our expectations for the year.

The elasticity index was calculated on the basis of data from the State Tax Service of Ukraine from 3-PC reports on cigarettes sold by domestic tobacco producers to the domestic market for the reporting month and imports of products under the UKTZED (Ukrainian Customs Commodity Classification Codes for Foreign Trade) code 2402 20 0000. *The elasticity coefficient is 0.3*, which suggests that a 1% increase in the price of cigarettes leads to a 0.3% decrease in demand for them.

When forecasting cigarette consumption for 2025-2028, we also took this indicator into account. The forecasted figure for the illicit cigarette market was calculated taking into account its potential increase in 2025 compared to 2024 due to a significant increase in excise tax (based on the experience of EU countries), and further decline in 2026-2028.

The market for HTPs and e-liquids is almost the same in terms of consumption. At the same time, as noted, the markets for these types of products have diametrically opposite development trends. *The market for HTPs is only legal, while the market for vapes is almost entirely illegal*. They can even be called "white and black without shades of gray," a very apt metaphor.

When forecasting the legal consumption of HTPs, from which taxes are fully paid to the budget, we believe that in the next three years their market *will be exclusively legal*. However, while in previous years there was a gradual growth of this market due to the replacement of other types of tobacco products with HTPs, it has probably reached a plateau. The fact is that in Ukraine, there are HTPs of the premium segment, which are used by relatively wealthy citizens, the stratum of which is decreasing (although in the EU countries, you can find corresponding products of the medium segment, which may be supplied to domestic consumers later).

The plateau in HTP consumption is also evidenced by the calculations of the Ministry of Finance of Ukraine. According to the State Tax Service of Ukraine, in 2023, 0.91 billion HTP sticks were produced, 5.95 billion sticks were imported, and

³⁹ Monitoring of illicit trade in tobacco products in Ukraine. Wave 3 URL: <https://www.kantar.com/ua/inspiration/ait/ait-wave-3>

this type of product was not exported. Thus, the total tax base was UAH 6.86 billion, and the draft State Budget for 2025 includes a projected tax base of UAH 6.695 billion.

In the long run, an increase in excise tax rates may also lead to a decrease in heat-not-burn products consumption, although previously the elasticity of demand for HTPs was much higher than for cigarettes. This was achieved through the transition of cigarette smokers to the use of tobacco and nicotine-containing products, which are a smokeless alternative.

Given the introduction of lower excise rates on HTPs compared to cigarettes by 9.74% in 2025, we expect a certain part of consumers to switch from cigarettes to HTPs, which will reduce the risks of expanding the illegal tobacco segment and have positive effects on tax revenues (excise, VAT, retail excise).

In contrast, if the excise tax is identical for cigarettes and HTPs, a partial **transition of smokers to illegal consumption of cigarettes, vaping products, hand-rolled cigarettes**, etc. is expected. This will lead to an increase in the level of illegal tobacco trafficking and loss of budget revenues. It has been established that higher prices for tobacco products cause consumers to switch to cheaper alternatives to tobacco products, including illegal ones. Moreover, vapes are one of the options for switching to cheaper (illegal) products⁴⁰. Another study also found that increasing cigarette taxes has a significant impact on the market for illicit white cigarettes (*illicit whites*). The survey found that the illicit market is supported by a certain category of consumers who seek to buy tobacco products at lower prices⁴¹.

Under the implementation of the scenario of structural substitution of consumption, the main objectives of the regulatory mechanisms of excise taxation to reduce the prevalence of smoking and improve public health are not being met.

We would like to emphasize once again that after the ban on the production, wholesale and retail trade, as well as imports for sale in Ukraine of e-liquids with flavoring additives, the illegal market for these products has reached a catastrophic scale: 99% of its total volume. This once again warns us that overestimated expectations of budget revenues may result in additional expansion of illegal markets for excisable goods. Arthur Laffer notes that the policy of taxation of tobacco products should contribute to limiting the prevalence of smoking, **and not to the transition of consumers to the illegal market**⁴².

⁴⁰ Prieger, J. E. (2022). Tax evasion and illicit cigarettes in California: prevalence and demand-side correlates. *Crime, Law and Social Change*, 78(4), 427-451.

⁴¹ Bate, R., Kallen, C., & Mathur, A. (2019). The perverse effect of sin taxes: the rise of illicit white cigarettes. *Applied Economics*, 52(8), 789-805.

⁴² Handbook of Tobacco Taxation: Theory and Practice, by Arthur B. Laffer. Pacific Research Institute for Public Policy, 2014. 392 p.

Consumption of cigarillos, cigars, and other tobacco products is significantly lower than the above tobacco and nicotine-containing products and is assumed to be almost unchanged in the forecast.

When forecasting the hryvnia exchange rate against the euro in 2025-2028, we were guided by the forecast data of the hryvnia exchange rate against the dollar presented in the IMF *World Economic Outlook*⁴³ report, the consensus forecast of the Ministry of Economy of Ukraine⁴⁴, exchange rate expectations of financial analysts (as of September 13, 2024), and forecasts of the euro/dollar pair⁴⁵. The average annual euro exchange rate for 2025 is set at UAH 48, which is 1.2% lower than the exchange rate used in the forecasting of tax revenues in the draft State Budget of Ukraine for 2025. The dynamics of actual excise tax revenues from tobacco products and e-liquids in 2018-2023, expected revenues for 2024, and projected revenues for 2025-2028 are shown in Fig. 1.

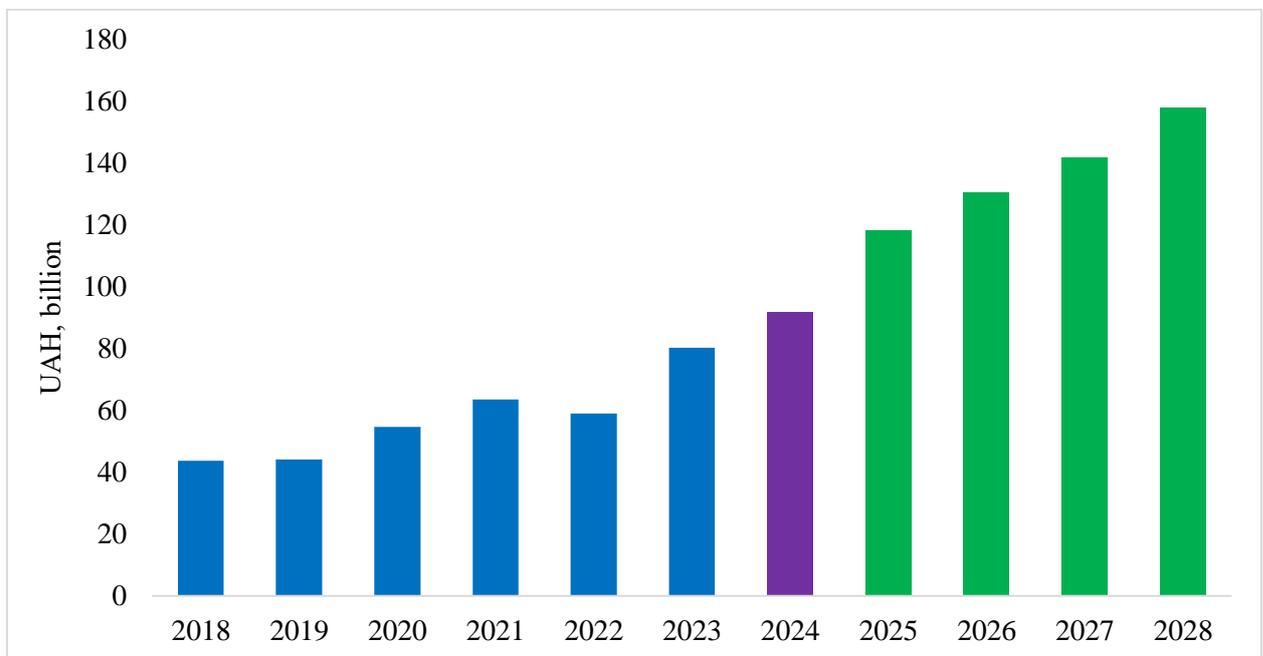


Fig. 1. Dynamics of excise tax revenues from tobacco products and e-cigarette liquids in 2018-2028*

* - data for 2024 are expected, for 2025-2028 – forecasted

Source: compiled by the authors

Thus, the implementation of the baseline scenario, which we assume to be the adoption of the Draft Law, which provides for the establishment of rates in euros

⁴³ IMF. World Economic Outlook. URL: <https://www.imf.org/en/Publications/WEO> (date of access: 27.09.2024)

⁴⁴ Ministry of Economy of Ukraine. Consensus forecast URL: <https://me.gov.ua/Documents/List?lang=uk-UA&tag=Konsensus-prognoz> (date of access: September 27, 2024)

⁴⁵ National Bank of Ukraine. Market surveys, exchange rate expectations. URL: <https://bank.gov.ua/ua/statistic/nbusurvey>

and differentiation of excise rates for cigarettes and HTPs from January 1, 2025 (subject to the simultaneous implementation of an effective policy to counteract the illicit trade in tobacco products), may bring about UAH 157.8 billion in excise revenues to the budget in 2028. This is 72.1% more than our expected revenue in 2024 and 96.5% more than in 2023.

If the Draft Law enters into force earlier than January 1, 2025 (the original version envisaged changes in taxation as early as July 1, 2024, and the media recently published October 1, 2024, as a potential date for the establishment of the excise tax on tobacco products in euros), there will be a correction in excise tax revenues in 2024-2025.

The policy of increasing tax rates will lead to a decrease in the production and import of legal tobacco products, as observed during the study period of 2018-2023. For example, in 2020, cigarette production decreased by 5.0%, or 3.4 billion pcs.⁴⁶, compared to the previous year, and in 2021 - by 9.4%, or 6.1 billion pcs⁴⁷. According to *Kantar*, the level of the illegal cigarette market in 2020 was 6.9%, and in 2021 it was 16.9%. The years 2022 and 2023 are less indicative in this regard, as 2022 was a shock year (cigarette production decreased by 53.6% and exports by 67.6%, partially offset by a 5.4-fold increase in imports⁴⁸), and in 2023 there was a correction in production and imports of such products. A reasonable and balanced excise policy should be aimed at increasing budget revenues and reducing the prevalence of smoking, not at driving consumers to illegal consumption.

At the same time, the taxation of tobacco products in 2026-2028 should be more balanced to reduce the illegal segment of this excisable goods market. The decision of the Parliament's Tax Committee of October 4, 2024, contains information about the resumption of criminal activities of domestic tobacco manufacturers, which is a risk of increasing the level of the illegal cigarette market and budget losses⁴⁹. A significant potential for growth in excise revenues lies primarily in reducing the level of shadow trade in tobacco products, especially cigarettes. Despite the decline in the share of the illegal cigarette market in 2024 compared to 2023, budget losses remain identical – about UAH 23 billion. More than UAH 3 billion of excise tax is lost due to the existence of the illegal e-cigarette market.

⁴⁶ Consolidated budget revenues for 2020 URL: https://mof.gov.ua/storage/files/zvit_2020_%D1%81%D0%B0%D0%B9%D1%82.pdf

⁴⁷ Consolidated budget revenues for 2021 URL: https://mof.gov.ua/storage/files/Zvit_2021_%D1%81%D0%B0%D0%B9%D1%82.pdf

⁴⁸ Consolidated budget revenues for 2022 URL: https://mof.gov.ua/storage/files/Zvit_2022_%D1%81%D0%B0%D0%B9%D1%82.pdf

⁴⁹ The official Telegram channel of Danylo Hetmantsev. URL: <https://t.me/getmantsevdanil/7893>

Alternative scenarios for the development of events

Raising the tax rate is not always a factor in generating more budget revenues. The experience of the EU countries described above shows that after sharp increases in cigarette excise rates, mechanisms were even launched to slow (suspend) the growth of these rates, which effectively counteracted the illicit trade in tobacco products and increased budget revenues. This experience should be taken into account by Ukraine when formulating and implementing its tobacco taxation policy in 2026-2028, after a significant increase in the excise tax in 2025.

Otherwise, we will see the growth of the illegal tobacco market, and international financial institutions, including the IMF⁵⁰, will pay attention to this problem and its consequence – the loss of tens of billions of hryvnias in budget revenues.

In particular, the following undesirable scenarios of changes in the tobacco market and their impact on tax revenues remain possible.

1. ***Relapse in the growth of the illegal cigarette market to more than 20%.*** If the average annual rate of the illegal cigarette market reaches 20% in 2025, budget losses will amount to about UAH 32 billion, given the increase in the price of these products due to the increase in the excise tax burden. At the same time, if the "cigarette shadow" returns to its historical highs of October 2023, budget losses will increase to UAH 40 billion. A similar sharp increase in excise tax rates has already led to an expansion of the illegal tobacco market in the EU.

The differentiation of excise taxes on cigarettes and HTPs from 2025 at 9.7% with a gradual increase to 20% is in line with the approaches to taxation of tobacco products in the EU and may limit the growth of the illegal cigarette market due to the insignificant price difference between legal cigarettes and HTPs. Switching cigarette smokers to HTPs, which are fully legal, is a better alternative for the state budget than potentially switching to illegal products. The increase in the volume of illicit trade in tobacco products provides benefits exclusively to participants in shadow schemes.

2. ***Rapid scaling of the illegal market for e-liquids.*** According to KIIS estimates, the level of consumption of e-cigarettes (16%) and HTPs (18%) in the structure of tobacco consumption is almost identical. However, in 2023, excise tax revenues from HTPs (according to the State Tax Service of Ukraine, UAH 12.63 billion in excise tax stamps sold) were almost 30 times higher than the excise tax paid on

⁵⁰ Ukraine: Fourth Review of the Extended Arrangement under the Extended Fund Facility, Request for Modifications of a Performance Criterion, and Financing Assurances Review-Press Release; Staff Report; and Statement by the Executive Director for Ukraine URL: <https://www.imf.org/en/Publications/CR/Issues/2024/06/28/Ukraine-Fourth-Review-of-the-Extended-Arrangement-under-the-Extended-Fund-Facility-Request-551207>

e-liquids (UAH 0.43 billion)⁵¹. In 2024, this gap in revenues increased. This is a direct indication of the consequences of the parallel functioning of only legal and almost entirely illegal markets for excisable goods.

If the illicit trade in e-cigarette liquids is not effectively countered, then as excise tax rates on cigarettes and HTPs increase, both cigarette smokers and HTP users may switch to vaping products. In Ukraine, it is important to avoid a significant price gap between HTPs and e-liquids. Illicit market players are very interested in creating a price advantage for vaping products. If the excise tax on HTPs is increased at the same level as the excise tax on cigarettes, there is a risk that consumers of conventional cigarettes and HTPs will often choose illegal vapes as an alternative, which will further reduce the volume of legal tobacco sales. The corresponding losses can be estimated at about UAH 30 billion for the period 2025-2028.

The provisions of the Draft Law are a kind of insurance mechanism against the realization of undesirable changes in the structure of the tobacco and nicotine-containing products market and the associated loss of tax revenues.

General conclusion

The analyzed Draft Law on increasing excise tax rates on tobacco products is an optimal state fiscal solution. First, it is guaranteed to provide additional tax revenues to the budget, which is extremely important for strengthening the state's defense capabilities. The direct fiscal effect is estimated at more than UAH 25 billion compared to the current schedule of annual excise tax increases on cigarettes, HTPs and other tobacco products by 20%. Second, it aims to bring the excise tax rate on cigarettes to its minimum EU level by 2028. Setting rates in euros offsets the impact of the national currency devaluation. Third, the Draft Law takes into account the established and effective EU practice of differentiating tax rates on tobacco products, which will prevent the expansion of illegal markets for tobacco and nicotine-containing products and budget losses of at least UAH 30 billion over 2025-2028.

In the coming years, when the purchasing power of the population is likely to continue to decline, a gradual increase in excise tax rates on cigarettes will serve to prevent new outbreaks of illicit trade in cigarettes and the expansion of the now almost entirely illegal market for e-liquids. The price of the latter can remain relatively stable because illegal players do not pay excise duty. At the same time, a slight differentiation in excise tax rates (prices) for cigarettes and HTPs may provide an additional "filter" effect that will limit the growth of new consumers of illegal conventional and electronic cigarettes. Since the HTP market is developing only in the

⁵¹ E-liquid illicit trade: prerequisites, trends, countermeasures. Koshchuk T., Pasichnyi M. / edited by T. Koshchuk, Growford Institute, K: 2024 URL: <https://www.growford.org.ua/research/nelegalna-torgivlya-ridynamy-dlya-el-ektronnyh-sygaret-peredumovy-tendentsiyi-zahody-protydyi/>

legal segment, an increase in their consumption will ensure higher tax payments from each pack.

After 2028. Ukraine will have to continue to raise the excise tax on cigarettes quite substantially to meet the upcoming new EU standards, but will not have such obligations with regard to heat-not-burn products. In other words, there will be no requirement to abandon the differentiation of excise taxes on cigarettes and HTPs. This, in the context of a generational shift and the associated increase in the prevalence of the use of newer nicotine products, will ensure that the legal cigarette market does not become "grayer" and, most importantly, is not largely replaced by the "black" market for e-liquids. If the "white" market for HTPs grows, the budget will be protected from significant fiscal "failures".

The fact that the Draft Law was developed by the Ministry of Finance of Ukraine, submitted to the Parliament by the Cabinet of Ministers of Ukraine and supported by many representatives of the expert community and leading business associations of Ukraine also proves the balance of its provisions. Such coherence of positions is not so common these days.



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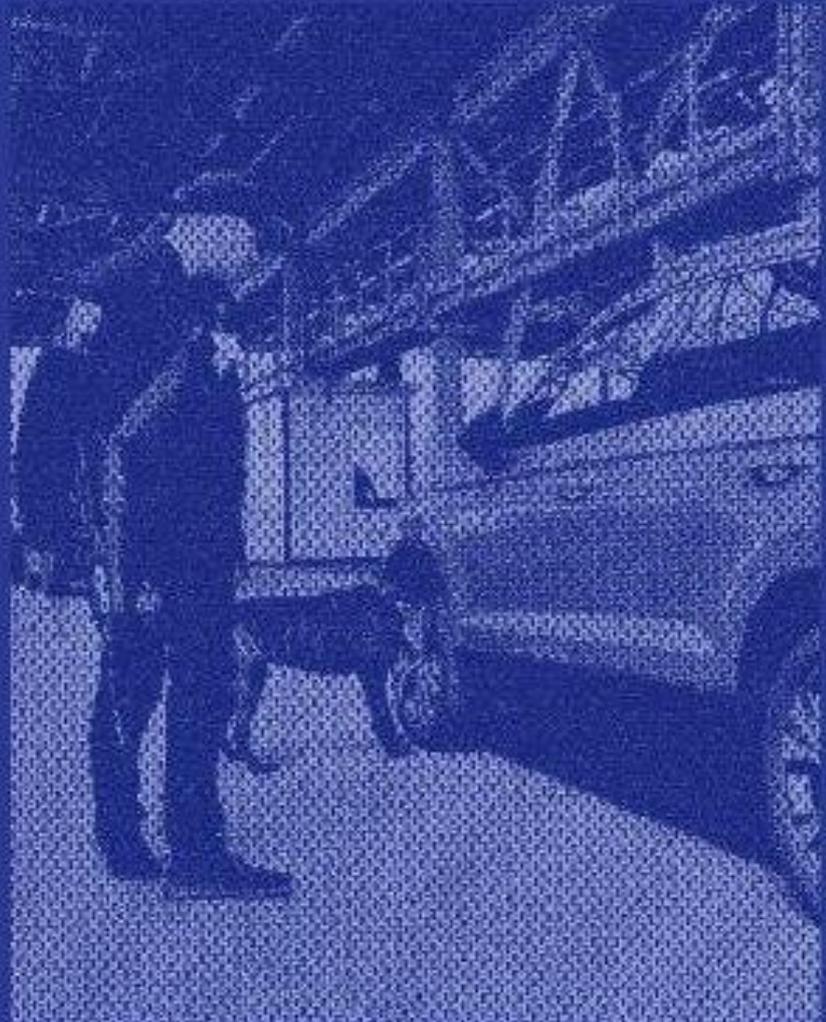


Photo: State Border Guard Service of Ukraine



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