

EXCISE DUTY



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**Excise Policy and Illicit Trade in
Tobacco Products:
In Search of Balanced Solutions**

ILLICIT TRADE

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The publication examines current excise policy issues in the area of tobacco products and its impact on the illicit trade in cigarettes in the EU countries. It also covers domestic trends in the development of legal and illicit tobacco markets and changes in the volume of excise revenues, analyzes the legislative initiative of the Ministry of Finance of Ukraine on reforming the excise tax to increase state treasury revenues and fulfill European integration tasks, and substantiates proposals to more effectively combating the illegal trade in cigarettes in Ukraine.

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FOREWORD

In this world, nothing can be said to be certain, except death and taxes
Benjamin Franklin

Amidst the full-scale invasion, financing defense and security measures the priority in the use of taxpayer funds. The 2024 State Budget of Ukraine allocates 95.6% of all budget revenues for these needs. When addressing the Ukrainian society last year, Thomas Sargent, Nobel laureate in Economic Sciences, emphasized *that it is taxes that are the tendon of the war*. The Memorandum with the IMF¹ includes a provision about the requirement to identify all possible measures aimed at increasing the fiscal significance of taxes. The effectiveness of the tax policy will determine the timely and complete supply of the indispensable tools, equipment and weapons for our defenders.

According to the approved National Revenue Strategy, the priority is to increase budget revenues on a sustainable basis, *to close existing opportunities for tax evasion, to increase compliance with the law and to fight the shadow economy*². Today, fighting the shadow economy is an important area of the national economic policy. The President of Ukraine has repeatedly emphasized that tax evasion in a full-scale war is unacceptable.

Despite the government's efforts to deshadow the economy, the situation in some sectors does not show signs of improvement. This particularly concerns the tobacco market where, as in all other markets, a fundamental economic law rules, i.e. *demand creates supply*. The steady rise in cigarette prices increases incentives for shadowy players to flood the market with counterfeit and smuggled products. Accordingly, it is necessary to focus on the justification of measures to combat the illicit trade in cigarettes, relying, among other things, on the experience of EU countries.

It is also important to gradually incorporate the EU excise legislation into domestic practice with due regard to the today's socio-economic conditions. Another important issue is to implement Ukraine the successful European practices in Ukraine that ensure a proper fiscal result for budgets. In view of the above, there is a growing need to systematize and summarize the experience of EU countries in taxing various types of tobacco products, including new products, which include heated tobacco products ("HTP").

¹ IMF: Ukraine: 2023 Article IV Consultation, Second Review Under the Extended Arrangement URL: <https://www.imf.org/en/Publications/CR/Issues/2023/12/11/Ukraine-2023-Article-IV-Consultation-Second-Review-Under-the-Extended-Arrangement-Under-the-542297>

² The National Revenue Strategy until 2030. URL: https://mof.gov.ua/storage/files/National%20Revenue%20Strategy_2030_.pdf

1. Excise Tax and the Illicit Tobacco Market in the EU: Guidelines and Lessons for Ukraine

On its way to joining the EU, it is important for Ukraine to follow the current European practice of developing excise taxation in the field of tobacco products and take into account its defining factors. On the one hand, the need to comply with the relevant requirements of EU legislation is becoming increasingly important, while on the other hand, it is important to take into account the experience of EU countries, which can both point to ways to resolve domestic issues and preclude dangerous mistakes. Below is an overview of a number of aspects that affects the reform of the excise tax on tobacco products.

1.1. European trends in the illicit trade in cigarettes and their connection with the excise policy

The problem of an illicit tobacco market is widespread in both developed and emerging economies. The main reasons for its existence are common to all countries: *a) rising prices of tobacco products due to increased excise taxes; b) systemic problems in of governmental control over the production and circulation of tobacco products.* James Prieger and Jonathan Kulick studied the EU cigarette market and found that the price gap between legal and counterfeit products was growing due to the increased tax burden on legal products. This is what makes consumers choose counterfeit and smuggled cigarettes. Depending on the EU country, an increase in the price of a pack of cigarettes by one euro increases the share of their illegal circulation by five to 12 percent. According to researchers, the rise in cigarette prices is the primary reason for the growth of the shadow market³.

The conclusions about the link between the excise policy and the consumption of illicit tobacco products in the EU are also supported by an analysis of the latest available data, which is presented below.

In the summer of 2023, KPMG published a report estimating the illegal cigarette trade level in Europe in 2022. This study is conducted on a regular basis, but last year it was first released with the “reassuring” title: *“Illicit cigarette consumption in the EU, UK, Norway, Switzerland, Moldova and Ukraine”*⁴. The inclusion of our country in the EU coordination system with the start of realistic European integrational processes cannot but be promising. However, it is disappointing that Ukraine is among the “five” biggest outsiders in Europe that are failing to cope with

³ Prieger J. E., Kulick J. Cigarette taxes and illicit trade in Europe. *Economic Inquiry*. 2018. Vol. 56. Issue. 3. P. 1706-1723.

⁴ KPMG LLP. *Illicit cigarette consumption in the EU, UK, Norway, Switzerland, Moldova and Ukraine*. 2023. URL: www.pmi.com/resources/docs/default-source/itp/kpmg-report---illicit-cigarette-consumption-in-the-eu-uk-norway-switzerland-moldova-and-ukraine---2022-results.pdf

the dominance of illegal cigarettes. But first, let's have a look at the situation in Europe. After all, awareness comes through comparison.

According to the KPMG's study of the illicit cigarette market, the EU showed the following trends in 2019-2022:

1. The total consumption of these products (both legal and illegal) decreased from 460.5 to 434.9 billion cigarettes, or by 5.6%.

2. The market of illicit cigarettes increased from 33.4 to 35.8 billion units, resulting in their share in total consumption increasing from 7.3% in 2019 to 8.1% in 2021 and 8.2% in 2022.

3. The share of counterfeit cigarettes within the illicit tobacco market more doubled, reaching 36.5% in 2022.

Surprisingly, in 2022, the highest share of counterfeit cigarettes in total cigarette consumption was recorded in such Western European countries as France (15.4%), the United Kingdom (13%), Greece (12.3%), Ireland (4.2%) and Belgium (3.1%). Latvia was not far behind with 3.1%, and Ukraine, unfortunately, where 7% of all consumed cigarettes were counterfeit.

However, despite the overall upward trend, the situation with the illicit cigarette trade developed differently depending on the particular EU country. The highest levels of illicit trade were recorded in France (32%), Ireland (24%), Greece (21%), Lithuania (19%), Latvia and Finland (15%). A noticeable increase in this indicator was also observed in Belgium (from 5 to 10%) and Estonia (from 10 to 14%). For comparison, in Ukraine, the illicit cigarette market share in Ukraine grew by almost 3% in 2022, reaching 20%. Something similar happened in the UK, where the respective percentages were 3% and 21%.

In contrast, in such EU countries as Bulgaria, Italy, Luxembourg, Germany, and Portugal, the level of illicit cigarette trade in 2022 did not exceed 2%, while in Denmark, Spain, Poland, Slovakia, Slovenia, Croatia and Czechia, it was up to 5%. The Netherlands (after a sharp deterioration in 2021 p.) and Slovenia showed the greatest success in the EU in reducing this indicator (by seven and four percent, respectively).

Obviously, Ukraine's accelerated accession to the EU is better served by its belonging to the second group of countries rather than to the outsiders. The EU's official slogan of "unity in diversity" is not a factor when it comes to significant risks to the single market. In this context, Moldova, which is following a parallel course with our country to join the European community, with its 6% share of the illicit cigarette market, looks more attractive.

It should be emphasized that in 2022, the consumption of the Ukrainian illegal brand *Compliment* in the EU increased from 0.6 to 0.8 billion units, and the destination countries for smuggling cigarettes from Ukraine were primarily Estonia and

Poland. Such circumstances also do not add to the optimism of our European partners.

The largest shares of illegal cigarettes in the EU in terms of their total consumption or the growth of these shares are observed in countries with the highest excise taxes on (and, accordingly, prices for) such products. In particular, in Ireland, the average price of a pack of cigarettes in 2022 was EUR 13.43 ; in France, EUR 10.19 , and in Finland, EUR 8.90 . For comparison, Germany also ranks among the top ten EU countries with the most expensive cigarettes, but the average price of a German pack was EUR 6.33. On the contrary, if we look at non-EU countries, the price of a pack of cigarettes in the UK, which we have already mentioned twice among the anti-record holders, is almost the same as in Ireland, EUR 13.42. Cigarettes are even more expensive today in Norway, one of the most developed countries in Europe and the world (EUR 14.51). But even there, despite the high standard of living, 12.4% of all consumed cigarettes are illegal.

Please note that ***the United Kingdom, Ireland, Norway and Finland*** are countries with a large part of their territories next to the sea or they border each other or other countries with traditionally expensive tobacco products, which creates a barrier to cigarette smuggling. However, high excise taxes (the price of legal cigarettes) in these countries continue to attract (or have increased) the attention of tobacco criminals. In particular, in Ireland, the level of illicit trade in cigarettes in 2022 grew by more than seven percent, inter alia, due to a new phase in its historical national counterfeiting development. Domestic production of illicit products has also become widespread in the United Kingdom.

France, however, is a country located in continental Europe and has a long land border. While in 2022 the average price of a pack of cigarettes in France was EUR 10.19, in the neighboring Netherlands it was EUR 7.56; in Belgium - EUR 6.93; in Luxembourg - EUR 4.78; and EUR 4.55 in Spain. Such differences attracted smugglers, but it was not them who created the biggest problems on the French tobacco market.

It started with France raising the excise tax on cigarettes by 12.5% in 2020, and then by another 7% in 2021. This placed France in second place in the EU in terms of its excise tax rate. However, instead of reducing widespread smoking, such increases were accompanied by a sharp rise in the level of illicit trade in those products: by nine percent in 2020, and by 6 percent in 2021 . Consequently, in 2020, France topped the list of EU countries with the highest share of illicit cigarettes in relation to the total volume of their consumption, and in 2021, strengthened its "leadership" with a 29% share. In 2022, the excise tax on cigarettes did not increase, but the negative trend continued by inertia, with the illegal trade level reaching an unprecedented 34%. More than a third of French smokers have switched to illegal cigarettes.

The main factor behind those dangerous changes in France was the surge in the consumption of counterfeit cigarettes. The high excise tax has increased the counterfeiting business profitability to such an extent that it has become possible to find "weak links" in the country's law enforcement system, resulting in a serious failure in the system. And this is not the law enforcement system of Ukraine, whose institutional capacity still needs to be improved. In 2022, more than 8 billion counterfeit cigarettes were consumed in France, accounting for 61.5% of the total counterfeit market in the EU and defined the above-mentioned negative European-wide trend.

The top three EU countries in terms of the share of the total consumption of illicit cigarettes also include **Greece**, which has failed to curb its illicit tobacco market even with a relatively low excise tax and no increase in it for eight years. The spikes in Greek illicit trade were observed about 10 years ago when the excise tax rates were increased and the price of cigarettes grew. The shadow market was expanding primarily due to *illicit whites*, because the profits from their sale were increasing. Between 2008 and 2014, the retail price of a pack of cigarettes increased by 86%, which led to an increase in the share of their illegal circulation by 16% to 19.5%⁵. The counterfeit component of the country's illicit market continued to grow. Greek smokers already consume 13.2% of all counterfeit cigarettes in the EU.

In 2022, **Estonia** ranked tenth among the EU countries in terms of the excise duty levied on the price of a pack of cigarettes, while **Latvia** and **Lithuania** ranked 19th and 22nd, respectively. However, these countries suffer from the illicit market because they have relatively high cigarette prices for post-socialist EU countries, which prioritizes the smuggling flows.

The positive example of **Poland** stands out in light of failed attempts by the *Baltic countries to control their illicit cigarette markets*. In 2020, the excise tax on cigarettes in the country increased by 4.5%, and remained unchanged in 2021. In 2022, the tax included in the price of a pack of cigarettes was EUR 2.06, and the average price of such a pack was EUR 3.14. In terms of the latter indicator, Poland is ahead of only Bulgaria (2.77euros) in the EU. This excise policy was implemented despite the fact that the Polish budget needed additional resources to fight the pandemic. And they received that money. However, not by raising the excise tax, but by reducing the illicit cigarette market from 9 to 5% in 2021. At that time, it was the best indicator of in the reduction of illicit trade in the EU.

In 2022, the share of illicit cigarettes as a share of their total consumption in Poland fell to 4%, which heightens interest in the cause of this phenomenon. How did a country with a long border with Ukraine manage to build an "impenetrable wall" to prevent the flow of illicit tobacco products? The secret of success is as

⁵ Chionis D., Chalkia A. Illicit tobacco trade in Greece: the rising share of illicit consumption during crisis. Trends in Organized Crime. 2016. Vol. 19. Issue. 3. P. 236-253.

follows: 1) a good choice of the country's place in the "international excise competition"; 2) effective measures were implemented to combat the illegal trade in cigarettes.

Another positive example is *Bulgaria*. The maximum volumes of the illicit tobacco market in the country (over 30%) were recorded during the tax shock of 2010 (when the tax burden increased sharply). Taking into account the miscalculations in the 2011-2015 excise policy, the country initially did not change the excise rate; as a result of deshadowing the cigarette market, tax revenues increased by 35%. Subsequently, a balanced excise tax increase and systematic actions to strengthen the effectiveness of tax control were implemented, which allowed Bulgaria to become one of the EU leaders with the lowest illicit cigarette consumption.

Thus, we can draw the following conclusions: *1) a sharp increase in excise tax rates on tobacco products, which took place, in particular, in Bulgaria, poses a high risk of an increase in the illicit trade in tobacco products; when establishing the excise policy, the relevant rates in the region must be taken into account; 2) the counterfeit component of the cigarette market is particularly difficult to combat even for developed EU countries with an effective law enforcement system; 3) to achieve a sustainable result in reducing the illicit trade in tobacco products, it is important to combine a balanced excise policy with effective measures to combat such criminal activity.*

1.2. Approaches to HTPs excise taxation in EU countries

Another important aspect of the current reform of the excise tax on tobacco products in the EU is the definition of principles regarding the taxation of new products, which include HTPs. Given that these products, unlike traditional cigarettes, do not burn when consumed, but are only heated to a certain temperature, fewer carcinogenic substances enter the human body. There are studies that confirm this fact⁶. However, there are currently no (and cannot be, since HTPs have appeared on the market rather recently) medical conclusions on the consequences of their use over a long period of time. That is why HTPs are considered to be products with a potentially reduced risk for health, which affects their taxation.

The excise policy in the field of tobacco products in the EU is governed by Council Directive 2011/64/EU of June 21, 2011 on the structure and rates of excise duties applied to manufactured tobacco (codification)⁷. It is targeted at achieving a threefold goal: ensuring a high level of public health protection; proper functioning

⁶ FDA permits of IQOS Tobacco Heating System through premarket tobacco product application pathway. April 30, 2019 URL: <https://www.fda.gov/news-events/press-announcements/fda-permits-sale-iqos-tobacco-heating-system-through-premarket-tobacco-product-application-pathway>

⁷ On the structure and rates of excise duty applied to manufactured tobacco (codification). EU Council Directive of June 21, 2011 2011/64/EU. URL: <http://www.minjust.gov.ua/45885>.

of the domestic market of excisable goods; providing national budgets with tax revenues.

The principles of the excise policy are consistent with the strategic development goals of the EU and the fundamental principles of the European Economic Community, but take into account the economic nature of the tax and the objectives set out in Council Directive 2011/64/EU. The effectiveness of the practical implementation of this policy includes the need to reach a compromise between consumer needs, state budget revenues and the position of tobacco manufacturers⁸.

Council Directive 2011/64/EU sets out the principles of harmonization of the structure and rates of excise tax on tobacco products (processed tobacco), i.e. cigarettes, cigars and cigarillos and smoking tobacco, but does not regulate the taxation of HTPs. The reason for this is obvious: such products appeared in the market after the directive was adopted.

This means that EU countries can determine the taxation of HTPs at their own discretion, taking into account, among other things, the potentially reduced health risks of their consumption. At the same time, the European Commission, fearing that countries will introduce HTP excise taxation systems that are too different from each other, recommended that such products be taxed at the rates applied to the excisable category of "other smoking tobacco" which is the lowest among all tobacco products⁹. In most EU countries, such rates are set per unit weight in kilograms. All of this had a decisive impact on the development of the European practice of HTP taxation.

As of April 1, 2023, nine EU countries (Greece, Denmark, Estonia, Spain, Cyprus, the Netherlands, France, Czechia and Sweden) have set the same excise rates for HTPs and other smoking tobacco. In Bulgaria, Latvia, Romania, Slovakia, Slovenia, Finland and Croatia, 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, HTP excise tax is assessed based on a unit of product. At the same time, *the excise tax on HTPs is lower than on cigarettes in all EU countries*.

Given that cigarettes are subject to mixed excise rates (specific rate per thousand units of product and ad valorem rate as a percentage of the maximum retail selling price), while HTPs are subject to either a specific tax rate per unit weight of tobacco in kilograms (Italy, Lithuania, Hungary) or a mixed rate (Germany, Poland, Portugal, France) or only an ad valorem rate (Spain), the calculations to determine

⁸ The excise policy in the field of tobacco products and combating their illicit trade in the face of new challenges and threats. T. Koshchuk, N. Novytska, M. Pasichnyi, K. Shvabii / Under the general editorship of T. Koshchuk, Growford Institute. K: 2023. URL: <https://www.growford.org.ua/research/aktsyzna-polityka-u-sferi-tyutyunovyh-vyrobiv-i-protydiya-nelegalnij-torgivli-nymy-v-umovah-novyh-vyklykiv-i-zagroz/>

⁹ Report from the Commission to the Council on Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco. January 12, 2018. URL: https://ec.europa.eu/taxation_customs/sites/taxation/files/report_excise_duty_manufactured_tobacco_12012018_en.pdf

the differentiation level of the excise tax burden on these two product types are complicated. The latter have never been officially published by the European Commission yet.

Our calculations of the noted differentiation level are based on a comparison of the HTP excise tax rate converted from the unit of measure in kilograms per thousand units of product and the minimum excise tax liability for cigarettes (MET) published by the European Commission. Moreover, since the retail sales price of HTPs should be taken into account to determine the excise burden on HTPs taxed at mixed excise rates (without establishing a rather high minimum excise rate) or only at ad valorem excise rates, no relevant comparisons were made for Spain, Poland and France¹⁰.

Calculations for Italy and Germany were also not made due to the complex methodology used to assess the excise tax for HTPs. In Italy, the latter is based on a comparison of the consumption time of heating sticks and cigarettes under the same inhaling conditions with a reduction factor applied. The excise tax assessment pattern for HTPs applied in Germany since 2022, is even more complicated: a special coefficient is added to the rate for other smoking tobacco, which is equal to the share of the excise tax on cigarettes less the excise tax on other smoking tobacco. Moreover, this coefficient is increasing (in 2023, it was EUR 2.01 per pack of HTP, in 2024, it increased to EUR 2.15)¹¹.

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

Thus, *among the 18 EU countries analyzed, the ratio of the excise burden on HTPs and cigarettes in 2023 ranged from 82.5% in the Netherlands to 14.9% in Hungary, with an average of 66.3%*. In seven member states, the excise tax on HTPs was at least four times lower than the MET for cigarettes and in only one country was the ratio less than two times.

¹⁰ It is not correct to use the minimum excise tax liability 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.

¹¹ 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/>

Table 1

Differentiation level of the excise burden on HTPs and cigarettes in EU countries* in 2023

Countries	MET per 1,000 cigarettes, EUR	HTP excise tax per 1,000 units of product**, EUR	Differentiation of the excise tax level on HTPs and cigarettes	
			difference, %	ratio, times
Estonia	160.5	28.4	82.3	5.7
Slovenia	131	29.2	77.7	4.5
Bulgaria	90.5	31.6	65.1	2.9
Czechia	143.5	32.4	77.4	4.4
Austria	157.9	39.5	75.0	4.0
Cyprus	121.5	39.8	67.3	3.1
Greece	136.9	41.5	69.7	3.3
The Netherlands	243.3	42.6	82.5	5.7
Romania	125.5	44.2	64.7	2.8
Croatia	117.9	49.2	58.3	2.4
Slovakia	132.1	49.7	62.4	2.7
Portugal	143.0	51.2	64.2	2.8
Sweden	166.5	52.8	68.3	3.2
Denmark	260.3	53.5	74.9	4.9
Latvia	135.9	57.8	57.5	2.4
Lithuania	130.0	60.2	53.7	2.2
Finland	343.2	79.5	76.8	4.4
Hungary	106.9	91.0	14.9	1.2
Mean value	-	-	66.3	3.5

* Broken down by countries where HTPs are present in the national market and are taxed only at a specific excise tax rate, as well as Portugal, where a high minimum excise tax liability is set for such products under a mixed excise tax system.

** Calculations made on the basis of *Heets* HTPs (5.3 g of tobacco in a pack of 20 sticks).

Source: compiled on the basis of data provided by financial and tax authorities of the EU countries, European Commission. Taxes in Europe Database. URL: https://ec.europa.eu/taxation_customs/tedb/advSearchForm.html?taxType=EDU_TOBACCO

Let's also analyze the current changes in the EU's HTP taxation rates. Interestingly, *Italy* has already initiated a reconsideration of the planned schedule of an increase in the excise tax on these products in order to slow its growth because of the risk of increased smuggling of HTPs into the country¹². As we can see in Section 1.1, the illicit cigarette trade is such a sensitive issue for the EU that it is important to avert the creation of preconditions for its spread to the new products market.

So far, no information on the illicit HTP market in the EU has been published. It should be noted that its formation is hampered by *the complex technological process of producing heating sticks and limited access to expensive equipment. This makes it virtually impossible to produce counterfeit HTPs in the EU. However, there is a real threat of their smuggling under the favorable conditions.* The latter is most

¹² Italy's new government scraps planned increases in e-liquid excise duties. URL: <https://ecigintelligence.com/italys-new-government-scraps-planned-increases-in-e-liquid-excise-duties/>

relevant for **Hungary**, which has set the highest excise tax on HTPs not only among Central and Eastern European countries, but also in the EU (Table 1).

Other EU countries which raised the excise tax on HTPs did that gradually. For example, **Latvia** has implemented a reform that provided for an increase in the excise tax rate on HTPs in 2022 from EUR 160 to EUR 207 per kilogram, and in 2023 by another 5% to EUR 208¹³. In 2003 in **Czechia**, the excise tax for other smoking tobacco and HTPs increased from CZK 2860 to 3000¹⁴. In **Estonia**, the excise tax on HTPs has been growing at a rate of about 5% per year in recent years, increasing from EUR 97 per kilogram in 2021 to EUR 112.4 in 2024.¹⁵

In **Romania** the excise rate for this new product was RON 594.97 per kilogram in 2022, RON 834.63 per kilogram in 2023, and then increased to RON 1,094.93 in 2024¹⁶. In 2022 **Lithuania** changed the tax base for HTPs from a kilogram of tobacco per thousand units of product by increasing the excise tax burden by 52%, in 2023 by raising the corresponding rate from EUR 45.6 to EUR 60.2 per thousand units, and in 2024 - up to EUR 79.5¹⁷.

In **Austria, Denmark, Greece, Spain, Cyprus, the Netherlands, Slovenia and Finland**, the excise tax on HTPs in 2022-2023 remained unchanged. In **Sweden**, it increased in 2023 from only EUR 196.68 to EUR 199.19 per kilogram, and in **Slovakia** – from EUR 160 to EUR 187.7 per kilogram¹⁸.

The policy of differentiating the level of the excise tax burden on HTPs and cigarettes is also being implemented by European non-EU countries. On April 15, 2023, **Great Britain** increased their excise rates on tobacco products, but the ratio between the minimum excise tax liability on cigarettes and the excise tax on HTPs

¹³ Ministry of Finance Republic of Latvia. Excise duty rates for tobacco products. URL: https://www.fm.gov.lv/en/s/taxes/excise_duty/

¹⁴ Indirect tax changes from 2021 – excise and customs duties. URL: https://assets.ey.com/content/dam/ey-sites/ey-com/cs_cz/topics/tax/alerts/06/ey-38-indirect-tax-changes-from-2021-excise-and-customs-duties.pdf

¹⁵ Ministry of Finance Republic of Estonia. Excise duties. Tobacco products. URL: <https://www.emta.ee/en/business-client/taxes-and-payment/excise-duties/tobacco-products>

¹⁶ Ministry of Finance Republic of Romania. Excise duty. URL: <https://mfinante.gov.ro/ro/domenii/fiscalitate/impozite-si-taxe/regim-accize>

¹⁷ Ministry of Finance Republic of Lithuania. Excise duty. URL: <https://finmin.lrv.lt/en/competence-areas/taxation/main-taxes/excise-duties/>; Dėl Lietuvos Respublikos akcizų įstatymo pakeitimo nuo 2022 m. sausio 1 d. URL: https://www.vmi.lt/evmi/en/-/d-c4-971-lietuvos-respublikos-akciz-c5-b3-c4-afstatymo-pakeitimo?redirect=%2Fevmi%2Fmokesciu-naujienos#_ftn1

¹⁸ European Commission. Taxes in Europe Database. URL: https://ec.europa.eu/taxation_customs/tedb/advSearchForm.html?taxType=EDU_TOBACCO; Austria. Tobacco Tax. URL: https://www.usp.gov.at/en/steuern-finanzen/verbrauchsteuern_und_energieabgaben/tabaksteuer.html; Ministry of Finance Republic of Greece. Excise duties. Tobacco products. URL: <https://www.gov.gr/en/sdg/taxes/excise-duties/national-excise-duties/information-for-excise-products>; Republic of Cyprus. Excise duties. URL: <https://www.mof.gov.cy/mof/customs/customs.nsf/All/A2C3593B5465A799422577D6002FEAC4?OpenDocument>; Finland. Excise duty table on tobacco. URL: <https://www.vero.fi/en/businesses-and-corporations/taxes-and-charges/excise-taxation/excise-duty-on-tobacco/excise-duty-table-for-tobacco/>; Sweden. Excise duty table. URL: <https://www.skatteverket.se/serVICelankar/otherlanguages/inenglishengelska/businessesandemployers/startingandrunningaswedishbusiness/payingtaxesbusinesses/tobaccotax/excisedutyrateontobacco.4.676f4884175c97df419171b.html>; Slov-Lex – Legislative and Information Portal of the Ministry of Justice of the Slovak Republic. URL: <https://www.slov-lex.sk/pravne-predpisy/SK/ZZ/2004/106/#paragraf-19aa>

is 4.9 times¹⁹. In **Norway**, the MET on cigarettes is 3.8 times higher than the excise tax on HTPs²⁰. **Switzerland** applies only ad valorem excise taxes to tobacco products: 51% for cigarettes and 12% for HTPs²¹.

Hence, the distribution of new products on the EU market modifies the vision of the excise policy in the field of tobacco products and the ways to achieve its goals. *The potentially reduced risk of HTP consumption may change approaches to ensure a high level of public health protection.* If the reduced risk is also confirmed by the findings of further medical studies, this will be reflected in legislation at the European-wide level. At the same time, this possibility itself warns EU countries against making any sudden moves in the direction of increasing the excise tax on HTPs at the present time.

The ensuring of the proper functioning of the internal market for excisable goods in the EU requires a coordination of excise policies of the countries, which has become the focus of the European Commission's efforts. The latter recommended that HTPs be taxed in accordance with the approaches used for the harmonized excisable category of "other smoking tobacco", which implies setting relatively low excise rates.

The absence of an illicit HTP market in the EU contributes to the inflow of tax revenues to the budgets. The fiscal effect of increasing (applying high) excise tax rates on cigarettes in a number of countries is offset by significant tax losses due to the existence of their illicit market.

It is important for Ukraine to take into account the above-mentioned EU practices regarding the excise taxation of HTPs and to monitor future changes in EU legislation under discussion.

1.3. Discussion on the revision of Council Directive 2011/64/EU

As noted in Subsection 1.2, EU countries implement their excise policies in the field of tobacco products with due regard to the benchmarks and restrictions set by EU legislation. Today, this is principally Council Directive 2011/64/EU, which, however, is expected to be updated shortly.

The process of revising European legislation is not an easy task. Back in early 2020, the European Commission published a report assessing the application of the provisions of Council Directive 2011/64/EU, which, in particular, justified the need to increase the minimum excise tax liability on cigarettes and establish taxation rules

¹⁹ HM Revenue & Customs. Tobacco Products Duty rates. URL: <https://www.gov.uk/government/publications/rates-and-allowances-excise-duty-tobacco-duty/excise-duty-tobacco-duty-rates>

²⁰ Norway. Tobacco Products Tax. URL: <https://www.skatteetaten.no/en/business-and-organisation/vat-and-duties/excise-duties/about-the-excise-duties/tobacco/>

²¹ Switzerland. Tobacco Products Tax. URL: <https://www.admin.ch/opc/de/classified-compilation/19690056/index.html>

for new nicotine products, which include HTPs²². Further, the areas of relevant changes were discussed with all stakeholders, and the European Commission was expected to present final proposals in this regard at the end of 2022. However, this never happened. Moreover, there is no official word on a new date for the introduction of this legislative initiative.

The discussion on the revision of Council Directive 2011/64/EU continues in the non-public sphere, while its urgency has become clear based on the leaks in the media about certain innovative aspects. In particular, unofficial information was leaked that amendments to the legislation proposed to increase the minimum excise tax liability on cigarettes in the EU from EUR 1.80 to EUR 3.60 per pack of 20 cigarettes²³. Apparently, such a decision cannot be easily made without objections from Bulgaria, where the minimum excise tax liability on cigarettes is set at about EUR 90 per thousand units, and requires at least a long enough time for implementation. The European Commission should take into account the risks in the expansion of illicit cigarette trade in Central and Eastern European countries, where these changes will be most difficult to implement.

As we know, changing consumer priorities, which is one of the goals of the excise policy, does not always lead to a reduction and/or cessation of cigarette consumption. In the case of unaffordability or limited availability of products, the demand may be replaced by other products, which are often of lower quality and thus more harmful to the user's health. Finally, it also leads to significant tax losses that may arise from the insufficient institutional capabilities of regulatory authorities and the improper functioning of the tobacco market.

The media, based on informed sources, also reported that the European Commission proposed to set a minimum excise tax liability on HTPs of half of that assessed on cigarettes²⁴. This seems realistic, as the likelihood of EU legislation to set equal excise rates for HTPs and cigarettes in the near future is negligible. It is unlikely that member states will agree to increase their excise taxes on HTPs by 2-3 times (when the reduced health risks of their consumption have not been officially rebutted), as is the possibility of a respective unanimous decision by all EU countries.

²²Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the Structure and Excise Tax Rates Applied to Manufactured Tobacco: Commission Staff Working Document. URL: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1570-Evaluation-of-the-excise-duties-applied-on-manufactured-tobacco_en

²³ Commission to Propose EU-Wide Vaping Levy. *Tobaccoreporter*. November 28, 2022. URL: <https://tobaccoreporter.com/2022/11/28/commission-to-propose-eu-wide-vaping-levy/>

²⁴ 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*. November 28, 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*. November 29, 2022. URL: <https://www.euractiv.com/section/health-consumers/news/eu-tobacco-taxation-the-fine-line-between-killing-smoking-and-illicit-trade/>

Earlier, the European Commission emphasized that differences in approaches to the excise taxation of HTPs in the EU hindered the functioning of a single market. This can alter the competition and create disputes regarding enforcement. In addition, there are administrative barriers to the cross-border movement of these products between those countries that have chosen different approaches in this area²⁵.

In general, with the increased use of HTPs, *the discussion about raising the excise tax on tobacco products without violating the "fine line between achieving public health goals and preventing the illicit market growth" is gaining a new focus. With regard to HTPs, this question can no longer be posed unequivocally in an "either/or" format. On the one hand, research continues to prove the reduced health risks of their consumption. On the other hand, today there are no prerequisites for the active development of the illegal HTP market and this will remain unchanged as long as the EU countries choose a coordinated and balanced approach to raising excise rates on them.*

²⁵ 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>.

2. Analysis of the Tobacco Market and Excise Tax Revenues from these Products in Ukraine during 2021-2023

For Ukraine, it is particularly important to now analyze tobacco market trends, changes in its structure (including legal and illegal components) and how budget revenues depend on these factors.

2.1. Transformation of the legal tobacco market and impact on excise tax revenues

With the outbreak of a full-scale war against Ukraine, the economy and the tobacco industry faced many challenges.

First of all, some production facilities were or continue to be located in areas in which active hostilities are continuing or in the adjacent territories, which made (and continues to make) production impossible for many reasons, primarily due to security and logistics. This concerns the facilities located on the outskirts of Kharkiv; the region has been constantly bombarded from the very beginning of the invasion on February 24, 2022; production at facilities in Kyiv were suspended until April 2022; the production facilities located in Pryluky, Chernihiv Oblast, also faced a significant onslaught from the aggressor; accordingly tobacco product production had to stop until the region was fully freed from the invaders. Due to the difficult security situation, one of the tobacco manufacturers plans to launch a new factory in the Lviv Oblast in the spring of 2024 by attracting foreign investment for this project.

Secondly, the war has caused significant migration flows within the country and abroad. According to the UN²⁶, as of January 27, 2024, 5.93 million Ukrainian refugees registered in the EU, and another 403.6 thousand refugees registered in other countries. According to the Ministry of Social Policy and Iryna Vereshchuk, Deputy Prime Minister and Minister for the Reintegration of Temporarily Occupied Territories of Ukraine, as of the end of 2023, approx. 4.9 million Ukrainian citizens were internally displaced persons, and at its peak in 2022, this figure exceeded 6.5 million citizens. According to the International Organization for Migration, the number of internally displaced persons as of September 25, 2023 was less – 3.7 million people²⁷.

Thirdly, at the moment, a significant portion of the territory of Ukraine with its population remains temporarily occupied, and the occupiers are forcibly deporting Ukrainians to Russia. A sharp decline in population leads to a decrease in demand for all types of goods, including tobacco products.

²⁶ UN official data. URL: <https://data.unhcr.org/en/situations/ukraine>. Request date: January 25, 2024.

²⁷ Ukraine - Internal Displacement Report. The International Organization for Migration. 2023. URL: https://dtm.iom.int/sites/g/files/tmzbd1461/files/reports/IOM_Gen%20Pop%20Report_R14_Displacement_ENG-UKR.pdf

Fourthly, the war has caused a decrease in the purchasing power of most of the population, which has led to a change in smoker preferences and the growth of illicit trade in tobacco products. According to Danylo Hetmantsev, Chairman of the Parliamentary Committee on Finance, Tax and Customs Policy, losses in labor income since the beginning of the full-scale war remain significant, with real wages down 9.3% in the first nine months of 2023 compared to the same period of 2021²⁸.

As a result of the invasion, there has been a sharp decline in the domestic production of the main categories of tobacco products in Ukraine. In 2023, only 57.55% of excise stamps for *cigarettes* produced in Ukraine were purchased, compared to 2021. This affected the overall purchase of excise stamps for cigarettes, which decreased by 36.50% in 2023 (Table 2).

A steady downward trend was recorded for domestically produced cigarettes, with a 38.9% (year-on-year) decline in the volume of purchased stamps in 2022, and 5.7% in 2023. The forced downtime of domestic cigarette production was offset by an increase in their imports resulting in timely amendments to the tax legislation. The difficulty in printing and delivering excise stamps to foreign producers resulted in the need to introduce changes to the labeling of excisable goods. The Verkhovna Rada of Ukraine adopted the Law of Ukraine No. 2120-IX dated March 15, 2022 "On Amending the Tax Code of Ukraine and Other Legislative Acts of Ukraine Regarding the Effect of the Norms for the Period of Martial Law".

This Law allows the importation into the customs territory of Ukraine of tobacco products marked with excise stamps printed abroad during the period of martial law and the state of emergency. However, the legal requirements for the size, color scheme and elements of excise stamps must be met; this is only possible if there is information on the official web portal of the State Tax Service of Ukraine on the impossibility in ensuring the sale of excise stamps to importers of tobacco products. At the same time, the Ministry of Health of Ukraine granted permission to import and sell tobacco products labeled by their manufacturer in accordance with the requirements of an EU member state.

The inability of domestic producers to ensure the uninterrupted production of cigarettes during the first months of the full-scale invasion due to the risks and logistical obstacles led to a significant increase in imported cigarettes in the country. In Q2 2022, the volume of cigarettes imported from abroad exceeded the volume of products manufactured in Ukraine for the first time, as evidenced by the data on the purchase of excise stamps for tobacco products.

²⁸ Danylo Hetmantsev's official Telegram channel. URL: <https://t.me/getmantsevdanil/5985> (Request date: January 27, 2024)

Table 2

Volumes of excise stamps purchased for tobacco products and liquids used in electronic cigarettes in 2021-2023, million units

Tobacco products	2021					2022					2023					Relative deviation 2023/2021, %
	Q1	Q2	Q3	Q4	Total	Q1	Q2	Q3	Q4	Total	Q1	Q2	Q3	Q4	Total	
Cigarettes, including:	289.12	726.99	497.26	710.75	2,224.12	404.49	386.42	574.72	288.41	1,654.04	287.21	406.05	401.88	317.08	1,412.22	63.50
<i>produced in Ukraine</i>	274.56	722.47	486.03	708.93	2,191.99	393.92	167.61	488.51	288.24	1,338.28	276.00	386.68	338.99	259.83	1,261.50	57.55
<i>imported</i>	14.56	4.52	11.23	1.82	32.13	10.57	218.81	86.21	0.17	315.76	11.21	19.37	62.89	57.25	150.72	469.09
Cigarillos	0.68	2.77	3.83	3.38	10.66	1.61	11.45	28.50	4.50	46.06	8.02	20.61	46.00	1.80	76.43	716.98
HTPs, including:	91.60	105.52	147.34	35.92	380.38	100.38	79.20	50.16	45.12	274.86	36.96	188.16	96.18	42.72	364.02	95.70
<i>produced in Ukraine</i>	0.00	0.00	0.28	0.00	0.28	10.08	0.00	0.00	5.04	15.12	15.12	8.16	13.20	9.12	45.60	16,285.71
<i>imported</i>	91.60	105.52	147.06	35.92	380.10	90.30	79.20	50.16	40.08	259.74	21.84	180.00	82.98	33.60	318.42	83.77
E-liquids	0.99	2.09	12.57	20.28	35.93	55.60	7.97	8.43	5.76	77.76	3.41	2.78	1.07	0.37	7.63	21.24
<i>produced in Ukraine</i>	0.00	0.03	0.05	0.14	0.22	0.27	0.04	0.04	0.05	0.40	0.51	0.18	0.16	0.00	0.85	386.36
<i>imported</i>	0.99	2.06	12.52	20.13	35.70	55.33	7.93	8.39	5.71	77.36	2.90	2.60	0.91	0.37	6.78	20.92
Other tobacco products, including:	0.56	0.24	0.75	0.70	2.25	0.38	40.19	0.27	0.34	41.18	0.88	0.44	0.40	0.43	2.15	95.56
<i>produced in Ukraine</i>	0.03	0.02	0.03	0.03	0.11	0.05	0.01	0.24	0.00	0.30	0.00	0.02	0.07	0.07	0.16	145.45
<i>imported</i>	0.53	0.22	0.72	0.67	2.14	0.33	40.18	0.03	0.34	40.88	0.88	0.42	0.33	0.36	1.99	92.99

Source: compiled by the authors based on data from the State Tax Service of Ukraine

The overall volume of excise stamps purchased for imported cigarettes in 2023 was 4.7 times higher compared to 2021. Moreover, in 2022, there was a staggering increase in the number of excise tax stamps purchased of 9.8 times (year-on-year), but in 2023, the number of those stamps decreased by 2.1 times compared to the previous year. The main reasons for the gradual decline in cigarette imports are a decrease in the number of smokers and the smoking prevalence index, replacement of these products with those produced in Ukraine and a shift to other types of tobacco products.

As we can see from Table 1, there has been a decline in the purchase of excise stamps for *HTPs*. In 2023, the number of excise stamps purchased was 4.3% less than in 2021. Moreover, while the volume of stamps for imported HTPs decreased by 16.23%, the volume of stamps for HTPs produced in Ukraine increased by 162.8 times. This trend has been steady over the past two years: in 2022, domestic production of HTPs increased by 18 times compared to the previous year, and in 2023, by another 9 times. It should be noted that in 2021, there was almost no production of HTPs in Ukraine and imported products covered all consumer needs. Despite the increase in domestic production of HTPs in 2022-2023, its share in total consumption remains low at only 12.5%.

In 2022, the decline in the purchase of excise stamps for HTPs was 27.74%. This was the result of the urgently adopted excise policy and the full-scale military aggression. In 2021, the excise tax rate on HTPs increased by 4.2 times. Currently, in Ukraine, unlike all EU member states, Switzerland and the UK, the excise tax on HTPs is set at the same level as on cigarettes. In European countries, the excise tax rate on HTPs is lower than on cigarettes (see Subsection 1.2). This approach is based, among other things, by taking into account the risks of consuming various tobacco products.

The biggest decline is shown by *liquids used in e-cigarettes*. According to the analysis of the number of purchased excise stamps, in 2023 their volume decreased by 79.81% compared to 2021. At the same time, it should be noted that in 2022 there was a 2.16-fold increase in the number of purchased stamps for these products compared to 2021. **But in 2023, there was a significant decrease of 9.8 times in the volume of purchased stamps!** Thus, the following can be assumed: a certain number of consumers have quit smoking; some consumers of these products have moved abroad, while some smokers have switched to consuming other types of tobacco products. Given that the volume of excise stamps for e-liquids decreased by 70.13 million units in 2023 compared to 2022, one of our assumptions is that the shadow segment of the e-cigarette market will grow, which we will explore in our next publications.

We believe that the decrease in consumption of legal e-liquids was influenced by the Law of Ukraine No. 1978-IX dated December 16, 2021 "On Amending

Certain Laws of Ukraine on Public Health Protection against the Harmful Effect of Tobacco" that entered into force on July 11, 2023 in accordance with Directive 2014/40/EU of the European Parliament and of the Council of April 3, 2014 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products and repealing Directive 2001/37/EC.

This law, in particular, prohibits the commercialization of e-cigarettes, refill containers and liquids that have a typical odor/taste resulting from the introduction of an additive or a combination of additives, including fruits, spices, herbs, alcohol, candy, menthol or vanilla. It is also forbidden to add vitamins, caffeine, taurine and a number of other additives to liquids that may create the impression that the product has health benefits, etc. In addition, the production (except for production for export), wholesale and retail trade, import for sale in Ukraine of cigarettes, as well as tobacco for roll-your-own tobacco with flavoring additives is prohibited.

*At the same time, the law does not prohibit the production of **cigarillos** with flavor additives, which is why the market is replacing e-cigarettes and cigarettes containing these additives with cigarillos. The volume of excise stamps purchased for cigarillos in 2023 showed a 7.2-fold increase compared to 2021. In particular, in 2022, compared to 2021, the number of excise stamps purchased for cigarillos increased by 4.3 times, and in 2023, compared to 2022, by 1.7 times. *Smokers' switching from one type of tobacco product to another hinders the objective of meeting the regulatory goals of excise taxation to reduce smoking.**

The analysis of the trend of excise stamp purchases for **other tobacco products (primarily roll-your-own tobacco)** shows a rapid increase in consumption of these products in 2022. Excise stamps for this category of tobacco products were purchased 18.3 times more than in 2021, with their imports increasing by 19.1 times and domestic production increasing by 2.9 times. In 2023, the volume of excise stamps for other tobacco products again decreased significantly, falling by 4.44% compared to 2021.

The excise tax accounted for 11% of state budget revenues in 2022, and 13.9% in 2023. *The share of the excise tax on tobacco products in the total structure of excise revenues amounted to 56% in 2022 and 48% in 2023²⁹. In 2023, excise tax revenues from tobacco products amounted to UAH 80.29 billion. At the same time, budget revenues could have been even higher if not for the high share of the illicit cigarette market.*

²⁹ NBU statistical data. Macroeconomic indicators. URL: <https://bank.gov.ua/ua/statistic/macro-indicators#4>. Request date: February 1, 2024

2.2. *Negative records of the illicit cigarette market: causes and effects*

As the full-scale war continues in Ukraine and international partners call for a search for domestic resources to fill the budget, solutions aimed at de-shadowing the economy are even more relevant. The discussion around the National Revenue Strategy until 2030 has shown that there are not many other options left to reduce the deficit in the state treasury.

At the same time, it is difficult to combat shadow activities, while the deteriorating socioeconomic situation creates additional preconditions for their expansion. This can be clearly seen in the illicit trade in tobacco products. Despite the increased attention to this problem by the Verkhovna Rada Committee on Finance, Taxation and Customs Policy, the Temporary Investigation Commission of the Verkhovna Rada of Ukraine on Economic Security (hereinafter - TIC), and regular measures to strengthen tax control (including legislative changes and operational actions of authorized bodies), the share of the illicit cigarette market has not decreased, but has shown a new negative record.

Let's try to figure out why this happened and what it means.

According to *Kantar*³⁰, Ukraine saw another *increase in the level of illicit trade in tobacco products* from 19.9% in 2022 to 21.8% in 2023, accompanied by *an increase in tax revenue losses* (excise tax + VAT + retail excise) from UAH 19.1 billion to UAH 23.5 billion (or by 23%). As the excise tax on tobacco products grows by 20% per year, we have an increasing shortfall in taxes that could be used to finance military needs. For comparison, in 2021, the share of the illegal cigarette market was 16.9%, and budget losses amounted to UAH 15.5 billion.

Alternative estimates of the level of illicit trade in tobacco products in Ukraine conducted by experts of the *Economic Expert Platform*³¹ show a similar trend in this indicator with a sharp deterioration in Q4 2023.

According to the results of the analysis published by Yaroslav Zhelezniak, head of the TIC³², there has been a rather significant decrease in the retail sales of legal tobacco products since August 2023. Obviously, this is not due to mass smoking cessation.

The main reason for this negative phenomenon was *an increase in sales of counterfeit products*, whose share in the total volume of all cigarettes consumed in Ukraine in 2022-2023 increased from 6.6% to 8.7%. This figure decreased in November 2022 compared to August from 8.0 to 5.2%, and in June 2023 it was at a level of 6.9%, until it reached its all-time high of 11.3% in October. What was the reason? In the second half of 2022 a large manufacturer of counterfeit cigarettes was

³⁰ Kantar. Monitoring of illicit trade in tobacco products in Ukraine, 2021. Wave 3. URL: https://www.kantar.com/ua/inspiration/ait/monitoring-nelehalnoi-torgivli-tutunovyh-vyrobiv_zhovten-2023

³¹ Dashboard. The Economic Expert Platform. URL: <https://economics.org.ua/index.php/nasha-robota/dashbord>

³² Yaroslav Zhelezniak's official Telegram channel. URL: <https://t.me/yzheleznyak/6708?single>

shut down, whose production resulted in budget losses of more than UAH 6.5 billion; the intervention of the President of Ukraine was required to close this factory³³. But the positive effect did not last long. There is every indication that the vacated niche has again been filled.

However, the new surge has some particular features. Today, the illicit market is filled not only with counterfeit cigarette brands familiar to Ukraine, but also with *counterfeits of well-known brands*. They are already being seized by³⁴ law enforcement agencies and are often sold in kiosks along with original products, but at half the price. This might be a kind of "disguise strategy" or "trick" to attract smokers. It is clear that new marketing measures are introduced from time to time in the illicit market as well.

Nevertheless, this phenomenon should be taken very seriously. After all, what will happen if the quality of counterfeit cigarette packs and excise stamps reaches a level where consumers can be deceived by selling illicit cigarettes at the price of legal ones? *Increased sales of illegal producer products improves their ability to use modern technologies.*

The level of illicit trade in products labeled "Duty Free" or intended for export remained high. In 2023, it averaged 11.5%, a reduction of 0.2% compared to 2022. The pertinent scheme is under the special control of the government, and on October 1, 2023, legislative changes prohibiting the sale of domestic tobacco products labeled "Duty Free" in duty-free shops during martial law came into force. This measure which adopted not without some obstruction³⁵ should be welcomed. But we will see its effectiveness from the new *Kantar* reports on the illicit trade in tobacco products.

It should be noted that *cigarette packs with the inscription "Duty Free" will be "sold from warehouse stocks" for some time to come.* The ban also makes it impossible to document sales through duty-free shops. But the production of illicit cigarettes may continue, for example, with the use of unaccounted raw materials. Some tobacco manufacturers have suspiciously high losses of tobacco raw materials³⁶.

On January 19, 2024, the Cabinet of Ministers of Ukraine decided to increase controls over compliance with the restrictions on the sale of tobacco products and alcoholic beverages produced in other countries to one person during one day by *Duty Free* stores. For this purpose, the procedure for information exchange between

³³ Law enforcers have been unable to close an illegal tobacco factory in Zhovti Vody for years, Hetmantsev says. Business. Censor. URL: https://biz.censor.net/news/3371413/pravoohorontsi_rokamy_ne_mogly_zakryty_nelegalu_tyutyunovu_fabryku_u_jovtyh_vodah_getmantsev

³⁴ A batch of counterfeit cigarettes worth UAH 12 million was seized in Kyiv - Bureau of Economic Security. Mirror of the Week. Telegram channel. URL: https://t.me/znua_live/129516

³⁵ The ban on cigarette sales for Duty Free did not come into force due to delays in publishing the law - Zhelezniak. Forbes. URL: <https://forbes.ua/news/zaborona-prodazhu-tsigarok-dlya-duty-free-ne-nabrала-chinnosti-zheleznyak-nazvav-prichinu-zvolikannya-z-publikatsieyu-zakonu-04092023-15799>

³⁶ Yaroslav Zhelezniak's official Telegram channel. URL: <https://t.me/yzheleznyak/3950>

competent bodies for the identification of buyers of excisable goods has been introduced³⁷. This will help to decrease abuse using this scheme.

There is another dangerous trend. In 2023, *69% of illicit cigarettes were sold in kiosks and stores*, where they were placed next to legal products. A year earlier, this figure was 63%. This indicates that the illicit tobacco market is "much more ingrained" and the fight against it is becoming more complex.

In the regional context, the "leaders" in terms of illicit product sales in 2023 were the Dnipropetrovsk Oblast (17% of all-Ukrainian sales), Odesa Oblast (12%), Lviv and Kharkiv Oblasts (9% each). One can analyze for a long time why these particular regions have become the leaders of this negative trend. But for now, let's pay attention to the fact that *the proximity of the region to the front line increases the risks of illicit trade in tobacco products*.

It is also important to add that, according to a report by the International Organization for Migration, 52% of all internally displaced persons in Ukraine are concentrated in just five oblasts of Ukraine. Moreover, the largest number of such persons is registered in Dnipropetrovsk and Kharkiv Oblasts (about 498 and 494 thousand people, respectively)³⁸. The forced migration of the population has a significant impact on the regional breakdown of illicit cigarette consumption.

At the same time, in December 2023 (not included in the period analyzed in the current *Kantar* report), there was a noticeable decrease in the retail sales of legal tobacco products in Dnipropetrovsk, Odesa and Cherkasy Oblasts and in Western Ukraine (Volyn, Zakarpattia, Ivano-Frankivsk, Lviv, Rivne, Ternopil, Khmelnytskyi and Chernivtsi Oblasts)³⁹. This is indicative of the systemic nature of the problem.

In general, in light of the increasing illicit cigarette trade in Ukraine, the negative effects of the spread of such criminal activity are even more tangible: increased tax revenue losses; increased corruption in government agencies and an overall increase in crime; increased proceeds from the illicit trade in tobacco products that which are then "money laundered"; loss of market share and loss of profits by legal cigarette manufacturers and other tobacco market operators; deterioration of the healthcare situation and a decrease in the government's impact on the reduction of smoking prevalence.

What are the lessons based on foreign experience?

³⁷ Ministry of Finance: The Government has adopted a decision to dismantle the scheme of tax evasion on the sale of cigarettes and alcohol in Duty Free. URL: https://www.mof.gov.ua/uk/news/minfin_uriad_priiniav_rishennia_dlia_ruinuvannia_skhemi_ukhilennia_vid_splati_podatkiv_z_prodazhu_tsigarok_ta_alkogoliu_v_duty_free-4396

³⁸ IOM Ukraine Internal Displacement Report: General Population Survey. The International Organization for Migration. 2023. URL: https://dtm.iom.int/sites/g/files/tmzbdl1461/files/reports/IOM_Gen%20Pop%20Report_R14_Displacement_ENG-UKR.pdf.

³⁹ Yaroslav Zhelezniak's official Telegram channel. URL: <https://t.me/yzheleznyak/6708?single>

As described in Subsection 1.1, *the counterfeit tobacco market is extremely difficult to combat*. While fighting against smuggled products primarily requires the strengthening of customs control and the establishment of effective international co-operation in this area, the entrenchment of large counterfeit tobacco businesses is becoming a systemic problem. Within this context, the French example is illustrative. In 2019-2022, as a result of a poorly considered excise policy, the level of illicit trade in tobacco products increased from 14 to 32%, while about half of illicit cigarettes sold today are counterfeit. And that is despite the fact that France, unlike Ukraine, is a country with a generally effective law enforcement system.

It should also be noted that *countries with a relatively low incomes and traditionally high smoking prevalence have high risks of illicit trade in tobacco products*. In particular, the top three EU "leaders" in terms of the illicit cigarettes share in total consumption (21% in 2022) include **Greece**. The country cannot significantly reduce its own illicit market even in the face of many years of refusal to raise the excise tax on cigarettes.

Another example is **Bulgaria**, which is one of the least developed countries in the EU. The country has experienced several outbreaks of illicit trade in tobacco products, which have been successfully combated. In 2020-2022, the share of the illicit cigarette market in Bulgaria was stable at 2%, which is the lowest indicator in the EU. However, the country also refused to raise the excise tax on cigarettes after it had reached the minimum European standard of EUR 90 per thousand units.

Finally, let's remember that *the exacerbation of social problems encourages the consumption of more tobacco products*. According to a study⁴⁰ conducted in **Australia**, smoking intensity is not uniform throughout the country. People living in the country's most disadvantaged regions have the highest daily smoking rates (16%) compared to those living in the most developed regions (5.3%).

With respect to Ukraine, it was also noted that the war with its stresses and social problems has led to an increase in tobacco product consumption. And as real incomes continue to decline and the price of legal cigarettes increases along with the excise tax, more and more smokers are choosing illicit products. Supply is trying to respond to this demand, which strengthens the illicit cigarette market in Ukraine.

It is important to realize that the same tax control measures have different effectiveness depending on socio-economic circumstances. If last year's steps taken to combat the illicit trade in tobacco products had been implemented in peacetime, we might have seen better trends. However, the increased demand for illicit cigarettes, the adaptability of tobacco criminals fueled by their desire to seize the moment to make high profits, along with corruption often allow them to circumvent the

⁴⁰ Australia's tobacco tax is among the highest in the world – and it's about to get higher. The Guardian. URL: <https://www.theguardian.com/news/datablog/2023/may/04/australia-tobacco-tax-is-among-the-highest-in-the-world-and-is-about-to-get-higher>

obstacles created by the state. At the same time, *the fact that Ukraine has managed to avoid an even greater surge in the illicit trade in tobacco products is already a positive result of the considerable efforts made by many.*

We should be prepared for the fact that some criminals may be replaced by others, and that more sophisticated methods of manipulation may replace the impossible ones. But Ukraine has no option to stop its efforts to combat illegal trade and not to respond to new challenges. It is necessary to establish and adjust systemic counteraction to the causes of the illicit market. And, of course, in order to achieve a sustainable result, it is important to further strengthen the institutional capacity of the supervisory bodies. More attention is paid to this issue in Subsection 3.4.

Ukraine is forced to raise the excise tax on cigarettes as it seeks to join the EU. However, the rate of its growth should not lead to the exacerbation of the problem of illicit cigarette trade. We will definitely not have an easy path to EUR 90, and in the longer term, Ukraine is unlikely to be guided by the EU average excise rates.

2.3. Absence of an illegal HTP market as a factor of tax revenue stability

Let's consider another relevant aspect of excise policy formation in Ukraine related to the development of the HTP market. Given the annual decline in cigarette consumption along with the increase in illicit cigarette trade, as well as the sharp decline in sales of legal e-liquids in 2023, the market for which had previously developed mostly in the illegal segment⁴¹, it is important to determine whether there is an illicit market for e-liquids in Ukraine. As noted in Subsection 1.2, at the present time there is no information on the development of such a market in the EU; its absence allows avoiding the corresponding loss in budget revenues.

It should be noted that estimating *the volume of HTP consumption* in Ukraine is not an easy task. Currently, it has not become part of *Kantar's* regular tobacco market research, and is significantly complicated by the lack of reliable statistical information. We can only roughly estimate the size of the HTP market (which would include the legal and hypothetical illegal components) based on data on the prevalence of its consumption among adults, the population of Ukraine and the daily rate of consumption of these products. But there are a number of caveats to using each of these indicators.

According to estimates of the *Kyiv International Institute of Sociology* ("*KIIS*")⁴², in 2023, 3% of the population in Ukraine consumed HTPs (3.4% of men

⁴¹ 80% of the market for e-liquids is in the shadows - association. Business NV. November 17, 2021. 2021. URL: <https://biz.nv.ua/ukr/markets/ukrtyutyun-rinok-ridin-dlyana-elektronnih-sigaret-v-osnovnomu-v-tini-novini-ukrajini-50196435.html>; The loss of UAH 5 billion in budget revenues - is it already an argument or not? Dengi.ua. September 28, 2023. URL: <https://dengi.ua/ua/business/7331254-poterya-5-milliardov-griven-postuplenij-v-byudzheth-uzhe-argument-ili-net>

⁴² 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>

and 2.7% of women). At the same time, the methodological notes state that the survey was conducted from April 4 to April 12, 2023, by telephone interview. They surveyed 2020 adults in Ukraine aged 18 and older. A random sample of randomly generated cell phone numbers was used (*random digit dialing*). At the data processing stage, the results were weighted with due regard to the gender and age structure of the resident population of Ukraine according to the State Statistics Service as of January 1, 2022. The survey sample is representative of the adult population of Ukraine (aged 18 and older).

However, Ella Libanova, an academic of the National Academy of Sciences, notes that *today Ukraine has no information on the gender and age structure of the population, so the representativeness of any opinion polls should be treated with caution*. "We have no idea what the gender and age structure of the population is in Ukraine today. We just don't know that. I don't know, our institute doesn't know, neither does the State Statistics Service. No one knows that. Just take our word for it. ... If we don't know the gender and age composition, it is extremely difficult, even if theoretically possible, to ensure that the sample is representative"⁴³.

There are no estimates of the daily consumption rate of HTPs in Ukraine at all. *KIIS* only claims that daily smokers smoke 17.2 cigarettes per day (men – 18.6, women – 12.5). Using these data may affect the accuracy of the estimate because, first of all, consumption rates for cigarettes and HTPs may differ. Secondly, the difficulty of determining the gender and age composition of the population makes even these survey results approximate. Finally, when estimating the volume of HTP consumption, one cannot additionally take into account the fact that other consumers consume them from time to time.

According to *the UN Population Fund (UNFPA)*, as of January 1, 2023, the total population in Ukraine was 36.7 million people⁴⁴. At the same time, *UNFPA* provides no statistics on the adult population. It can only be estimated with certain assumptions that in 2023, the number of people aged 18 and older, some of whom are tobacco product consumers, amounted to 27 million 540 thousand people.

Of course, the accuracy of HTP consumption estimates will also be affected by the fact that with the start of the full-scale invasion, millions of people, mostly women with children, have left for other countries, and men are more inclined to use tobacco products. In addition, such a bad habit is particularly common in the military, whose members consume more tobacco products under stressful conditions. Unfortunately, these factors cannot be taken into account in the calculations.

Taking into account all the circumstances described above, *we estimate the volume of HTP consumption (legal and hypothetically illegal) in Ukraine in 2023 at*

⁴³ Libanova: The results of polls in Ukraine should be treated with caution. Glavcom. January 29, 2024. URL: <https://glavcom.ua/country/society/do-rezultativ-opituvan-v-ukrajini-potribno-stavitis-oberezhno-libanova-983123.html>

⁴⁴ Official website of the United Nations Population Fund. URL: <https://www.unfpa.org/data/world-population/UA>

the minimum level of 5.19 billion units. The calculations and their results are presented in Table 3.

Table 3

Calculations of HTP consumption in Ukraine in 2023

Indicators and/or their calculation	Value indexes
Population aged 18 and older, thousand people	27540
HTP consumption prevalence, %	3
HTP consumers, thousand people (27,540*0.03)	826.2
Cigarette/HTP daily consumption, units	17.2
Annual daily HTP consumption by one person, units (17.2*365)	6278
Total annual HTP consumption, billion units (826.2*6278)/1000000	5.19

Source: compiled by the authors based on KIIS and UNFPA data

Next, to test the hypothesis about the illicit HTP market, it is necessary to compare the total volume of their consumption with the size of the legal market for these products. There is also no data on the *HTP legal market size* in Ukraine for 2023. However, conclusions about the legal consumption of these products can be made on the basis of information from the State Tax Service of Ukraine on the volume of purchases of excise tax stamps. In 2023, 364.02 million of these stamps were purchased for HTPs (Table 2). Taking into account that each pack with an excise stamp contains 20 heating sticks, we can determine an HTP legal market size of 7.28 billion units.

However, more than two months may pass between the date of the order for excise stamps and the actual consumption of HTPs, which is used to calculate the volume of their legal market. Therefore, the period of HTP consumption corresponds more accurately to the number of stamps sold for these products, which amounted to 301.1 million units in 2023. Thus, *the HTP legal market size can be roughly estimated at 6.02 billion units.*

Based on the above, it is clear that the HTP consumption (legal and hypothetically illegal) calculated above may be underestimated, and the estimated size of the HTP legal market is not based on official reports from their manufacturers and, therefore, may be subject to some error. Nevertheless, the comparisons show that *as of today there is no illicit market for HTPs in Ukraine.*

This conclusion is confirmed by the fact that the production of heating sticks is a high-tech process that requires the installation of expensive modern equipment. It is unlikely that domestic players in the illicit tobacco market could get access to it. And it would not be as profitable as organizing the production of counterfeit

cigarettes. At the same time, HTP smuggling to Ukraine, for example, from China, is significantly complicated at the moment due to the security risks of shipping by sea.

At the same time, the state lost UAH 59 of tax revenues on every pack of cigarettes sold illegally in Ukraine in 2023.

Thus, the transition of consumers to HTPs, the market for which, unlike the markets for traditional and electronic cigarettes in Ukraine, is developing only in the legal segment, ensures the stability of tax revenues. This is important to take into account when taxing them along with a potentially reduced risk to human health resulting from their consumption and the corresponding approaches to the formation of the excise policy in the EU countries.

3. European Integration Changes and the Fiscal Potential of the Excise Tax on Tobacco Products in Ukraine

On December 14, 2023, the European Council approved the decision to start negotiations on Ukraine's accession to the European Union, which further underscored the need to harmonize domestic legislation with EU law. This primarily concerns EU directives. In this war period, another important issue is to implement successful European practices that ensure a proper fiscal budgetary results.

The biggest changes will affect indirect taxes harmonized in the EU, including the excise tax on tobacco products. Over time, it will be necessary to fully adapt the provisions of the Tax Code of Ukraine (hereinafter, "TCU") with the provisions of Council Directive 2011/64/EU of June 21, 2011 on the structure and rates of excise duty applied to manufactured tobacco (codification)⁴⁵ (and later, to its successor). As described in Section 1, this directive was approved to achieve a threefold goal: ensure a high level of public health protection; the proper functioning of the domestic market in excisable goods; provide the national budgets with tax revenues.

In addition, just like with the Association Agreement with the EU, the accession negotiations will raise the issue of Ukraine's introduction of effective measures to combat the illicit trade in tobacco products in order to minimize the threat of the smuggling of these products into the EU.

The fulfillment of European integration requirements by Ukraine was reflected in the National Revenue Strategy until 2030⁴⁶. Achieving this goal will obviously require more than one legislative change. And it is to be welcomed that relevant proposals are already emerging.

3.1. The legislative initiative of the Ministry of Finance of Ukraine: how the excise tax should be changed

On December 8, 2023, the Ministry of Finance of Ukraine published the draft Law of Ukraine "On Amending the Tax Code of Ukraine to Revise Excise Tax Rates on Tobacco Products" (hereinafter, "the Draft Law")⁴⁷, which provides for an update of the schedule of increasing the excise tax on tobacco products, conversion of their taxation rates into euros, as well as a temporary clarification of the rules of anti-forstalling regulations.

According to the Draft Law, starting on July 1, 2024, the minimum excise tax liability (hereinafter - "MET") for cigarettes will be EUR 63.45 per 1000 units. This

⁴⁵ On the structure and rates of excise duty applied to manufactured tobacco (codification). EU Council Directive of June 21, 2011 2011/64/EU. URL: <http://www.minjust.gov.ua/45885>.

⁴⁶ The National Revenue Strategy until 2030. 2023. URL: https://mof.gov.ua/storage/files/National%20Revenue%20Strategy_2030_.pdf

⁴⁷ Draft Law of Ukraine "On Amending the Tax Code of Ukraine to Revise Excise Tax Rates on Tobacco Products." URL: https://mof.gov.ua/uk/legal_acts_drafts_2023-607

will be done by simply converting the current rate from hryvnia to euros. The same provision applies for the excise tax rate on HTPs.

However, further on, the schedules of excise tax increases for these products will differ. While the MET for cigarettes is expected to increase to EUR 78 in 2025 (with a slight deviation from the current excise tax increase plan), the tax rate on HTPs is expected to increase at half the rate to EUR 70.40. The Draft Law also regulates the increase in rates for 2026-2028, which is not currently provided for by the Tax Code. In particular, the minimum excise tax liability on cigarettes will increase by 5% annually, reaching EUR 90 in 2028, and the excise tax rate on HTPs is to increase to EUR 72 within three years.

In addition, a temporary increase on the restriction on the purchase of excise stamps and the volume of sales (imports) of tobacco and related tobacco products from 115% to 120% is proposed, aimed at preventing the accumulation of stocks of these excisable goods (during martial law). We will devote more attention to this in the next subsection.

Here are two key changes:

1. In 2028, Ukraine will meet the European standard of a minimum cigarette excise tax of EUR 90 per thousand units, as defined in Council Directive 2011/64/EU. It should be emphasized that this applicable provision applies to cigarettes only. Moreover, the achievement of this target will not depend on UAH exchange rate fluctuations, as the tax rates will be set in euros. Council Directive 2011/64/EU does not set requirements for the currency rates.

We should also add that, according to the National Revenue Strategy, the priority of the government policy is to continue the schedule of approximating excise tax rates on tobacco products to the minimum rates in force in the EU to ensure full compliance by 2029.

2. The level of differentiation in the excise tax burden on cigarettes and HTPs will gradually increase to 20%. That is, in five years the excise tax on HTPs will be 20% lower than that on cigarettes. This is also in line with the current European practice, as described in Subsection 1.2.

We note, at the same time, that in EU countries, *the ratio of excise taxes on HTPs and cigarettes is even higher*. In 2023, it averaged 66.3%. In seven Member States, the excise tax on HTPs was at least four times lower than the MET on cigarettes.

Moreover, as demonstrated in Subsection 2.3, *such a novelty would not only take into account the potentially reduced risk to human health of HTP consumption, but would also contribute to better filling the state treasury*. After all, switching to these products, which are not available on the illicit market, does not lead to the loss of tax revenues (which are associated with illicit trade; they are equal to the full amount of unpaid excise tax, VAT and retail excise). There is no illicit market for

HTPs in Ukraine today, and it is important not to create preconditions for its emergence in the future.

3.2. Risks of implementing the proposed innovations

The Draft Law of Ukraine "On Amending the Tax Code of Ukraine to Revise Excise Tax Rates on Tobacco Products" provides for the introduction of excise tax rates on tobacco products in euros. As of the beginning of 2024, such tax rates are in effect in the vast majority of EU countries: twenty member states have set rates in euros. This proposal is primarily aimed at ensuring that the MET for cigarettes reaches the level of EUR 90 euros per 1000 units, as required by Council Directive 2011/64/EU. The move to set interest rates in euros is a means of protecting the state against a possible devaluation of the national currency.

An analysis of the updated schedule for increasing the excise tax, as presented in the Draft Law, suggests that the increase in cigarette excise rates by 22.9% in euros from January 1, 2025 poses a certain risk to the market. Without improving the system of government control over the production and circulation of tobacco products, the share of illicit cigarette trade may increase. The average shadow market for these products in Ukraine over the past three years has been 19.5%.

At the same time, the Draft Law envisages that temporarily, for the period of martial law, during the three consecutive reporting months preceding the month in which the excise tax rates on tobacco products are increased, the average monthly sales of excise tax stamps to the manufacturer and/or importer of tobacco products may not exceed 120% (vs. 115% before) of the average monthly sales of tobacco products by such manufacturer and/or importer during the previous nine calendar months. *This legislative change is aimed at ensuring a smoother increase in the price of tobacco products following another increase in excise tax rates.*

The excise tax will still be paid in the national currency and calculated at the official exchange rate of the National Bank of Ukraine (the "NBU"). However, the Draft Law provides for a different approach to calculating the excise tax rate for tobacco products produced in Ukraine and their imported analogs. The excise tax on tobacco products produced in the customs territory of Ukraine will be calculated at the official UAH to EUR exchange rate set by the NBU *on the first day of the quarter preceding the quarter in which the excise tax is paid.*

For tobacco products imported to Ukraine, the excise rate calculation will be based on the official NBU exchange rate of UAH to EUR *effective at 00:00 on the day of submitting the declaration on the maximum retail prices for excisable goods (products), which is effective for such excisable goods on the day of submitting the customs declaration.* Moreover, upon importing such excisable goods, the tax shall be paid upon purchasing excise tax stamps with a surcharge (if required) on the date of submitting the customs declaration.

Different dates of the official UAH to EUR exchange rates set by the NBU will lead to a rather significant gap in tax rates. For example, on January 1, 2024, the official exchange rate of EUR 1 was equal to UAH 42.0059, and on January 22, 2024, UAH 40.8404. Accordingly, in Q1 2024, the MET for one thousand cigarettes produced in Ukraine would be UAH 2,665.27. However, for cigarettes imported to Ukraine with the date of excise stamp purchase on January 22, 2024, the minimum excise tax liability would be UAH 2,591.32. As we can see, even a few weeks' difference can have a significant impact on the MET: an imported standard pack of cigarettes (20 units) will be subject to an excise tax of UAH 51.82 compared to UAH 53.31 for the one produced in Ukraine. ***This approach creates conditions for unfair competition and budget losses.***

Currently, the MET for cigarettes is UAH 2,516.54 per 1,000 units. Thus, a devaluation of the national currency in early 2024 will further increase the tax burden. Given this, we can predict that prices for tobacco products will also grow at a higher rate than expected, increasing benefits for the shadow market. Rapidly rising cigarette prices are driving an increase in the volume and share of the illicit market.

Conflicts of law also arise. According to Subclause 4.1.2, Clause 4.1. of the Tax Code of Ukraine, Ukraine must ensure the equality of all taxpayers before the law and the prevention of any manifestations of tax discrimination. This rule is based, in particular, on the provisions of the Agreement Establishing the World Trade Organization and the General Agreement on Tariffs and Trade of 1994, which entered into force in Ukraine in 2008. The latter indicate the need for countries to ensure compliance with the general principles of non-discrimination, eliminate discriminatory treatment in international trade relations and prevent unjustified discrimination between countries.

Moreover, these provisions of the draft law are in conflict with EU law, which does not allow for different excise tax rates for excisable goods, on those produced domestically or imported. According to Art. 8(2) of Council Directive (EU) 2020/262 of December 19, 2019 "Regarding the general provisions for the excise duty (revised), "excise duty shall be levied and collected and, where appropriate, reimbursed or remitted, according to the procedure laid down by each Member State. Member States shall apply the same procedures to national goods and to those from other Member States."

In view of the above, *it is advisable to ensure a uniform approach to the calculation of the excise tax rate on both tobacco products produced in Ukraine and imported ones.*

3.3. Improving the fight against illicit cigarette trade as a fiscal reserve

We need to remember that, according to the *Kantar* study, the share of illicit cigarette trade in Ukraine in 2023 accounted for **21.8%** of the total market. The

shadow market has exceeded the 20% mark, which is known in the world as an "*illicit tobacco disaster*,"⁴⁸ i.e. a disaster of the illegal trade in tobacco products. The consequences of this phenomenon are well known: irrecoverable losses of budget revenues, increased unfair competition, generation of financial flows by criminal groups, increased damage to the healthcare sector and loss of trust in the government's financial policy.

During the period of armed aggression in 2014-2023, the loss of tax revenues to budgets of various levels caused by the illicit tobacco market in Ukraine amounted to UAH 79.2 billion, including about UAH 49 billion in the two years since the beginning of the full-scale invasion. The amount of these losses over the past two years is higher than the amount allocated in the 2024 State Budget for drones (UAH 43.3 billion), and almost equal to the amount of expenditures on the production of weapons and ammunition (UAH 51.0 billion)⁴⁹. Accordingly, it is extremely important to strengthen the effectiveness of government policy in the field of combating the illicit cigarette market.

Based on the analysis of the KPMG 2023 report data, we see that the situation with the illicit market in Central Europe is quite optimistic. In Bulgaria, the share of illicit cigarettes in the total consumption structure is 2.1%, in Slovakia - 2.8%, in Czech Republic - 3.7%, in Poland - 4.2%, in Moldova - 6.0%, in Romania - 6.4%, and in Hungary - 7.2%. Latvia is demonstrating progress in reducing the shadow cigarette market, where it has decreased to 15.2%⁵⁰. Domestic policy makers should take into account the positive experience of EU member states included in the Central European sample.

As demonstrated in Section 1.1, the excise tax policy has an impact on the level of illicit trade in tobacco products. ***Increases in excise tax rates should be balanced and consistent.*** The practice of EU countries shows that the deshadowing of the cigarette market can increase budget revenues even with unchanged excise rates. However, for deshadowing to take place and to maintain this effect in the future, comprehensive efforts must also be made to combat related criminal activity.

We have identified and systematized priority measures to counteract the illicit trade in cigarettes in the current environment:

1. ***Increasing the functional efficiency of supervisory bodies (Economic Security Bureau of Ukraine, tax and customs services, police, border guards).*** Fighting the illicit tobacco market is the focus of the Economic Security Bureau of Ukraine (ESBU). In the first three weeks of 2024 alone, ESBU detectives uncovered

⁴⁸ Illicit tobacco disaster: Tougher laws aired as high prices hit smoker habits. URL: <https://www.smh.com.au/politics/federal/illicit-tobacco-disaster-tougher-laws-aired-as-high-prices-hit-smoker-habits-20201112-p56e46.html>

⁴⁹ Official data of the Cabinet of Ministers of Ukraine. URL: <https://www.kmu.gov.ua/news/derzhbiudzhzet-ukrainy-na-2024-osnovni-tsyfry>. (Request date: January 12, 2024)

⁵⁰ KPMG LLP. Illicit cigarette consumption in the EU, UK, Norway, Switzerland, Moldova and Ukraine. 2023. URL: www.pmi.com/resources/docs/default-source/itp/kpmg-report---illicit-cigarette-consumption-in-the-eu-uk-norway-switzerland-moldova-and-ukraine---2022-results.pdf

illicit cigarette trade networks in Volyn, Kyiv, Lviv, Odesa, Cherkasy, Kharkiv Oblasts and the city of Kyiv; they also stopped the sale of illicit products through Telegram channels. This indicates that this phenomenon is widespread throughout the country. At the same time, the detected cases of illicit cigarette trade have identical features: counterfeits of well-known brands, tobacco products without excise stamps or with stamps that have signs of counterfeiting.

The peculiarity of the current illicit cigarette trade is the simultaneous sale of legal products of major tobacco brands and their counterfeits (at prices half as high as the legal analog). The problem of the counterfeiting of well-known brands is only growing, as evidenced by the results of a study by *Kantar*: in 2023, more than 3.1 billion counterfeit cigarettes were sold, which accounts for 40% of the total illicit trade in these products. Thus, issues in improving the system of government control over the production and circulation of tobacco products require increased attention.

Government agencies (primarily the ESBU) should focus on identifying the largest channels of production and supply of illicit tobacco products and raw materials. The supply chain from retailers to distributors and manufacturers should be tracked. Fighting the latter will reduce the volume of illicit products supplied to tobacco retailers. Identification of suppliers of smuggled raw materials and manufacturers of billions of counterfeit cigarettes will help reduce the loss of budget revenues and protect the population from consuming low-quality products.

An important measure to reduce the illicit trade in tobacco products is ***to enhance the coordination of fiscal and law enforcement agencies***. First of all, we are talking about the ESBU, *State Tax Service and State Customs Service, State Border Guard Service, National Police*, etc. The experience of EU countries shows that an adequate level of coordination of these agencies enhances the effectiveness of their authority in combating the shadow economy. Positive cases were identified in the Baltic states, Poland and Romania. Economic expert Oleh Hetman believes that it is important to intensify and coordinate the efforts of the State Tax Service, police, and the ESBU to minimize the level of the illicit tobacco market. He notes that the coordinated activities of these institutions and the active work of the Temporary Investigation Commission of the Verkhovna Rada of Ukraine on Economic Security provided for additional budget revenues in the first half of 2023 as a result of the reduction in the size of the illicit tobacco market⁵¹.

2. The intensification of cooperation with European institutions and customs services of neighboring countries that are EU members in the area of combating the illegal circulation of tobacco products; increasing the effectiveness of the fight against smuggling.

⁵¹ Oleh Hetman's official Facebook page. URL: <https://www.facebook.com/oleg.getman.54> (request date January 17, 2022)

The smuggling of tobacco products, which decreased slightly in 2023 in Ukraine, still accounts for 1.5% of the total market (about 0.5 billion cigarettes). In addition, the smuggling of tobacco products also goes in the opposite direction, with illicit products entering the EU market, damaging the country's image. Since Ukraine received candidate status to join the EU, the issue of detecting and prosecuting smuggling has reached a new level.

Among the measures of the National Revenue Strategy until 2030, important attention is paid to strengthening measures to combat smuggling and violations of customs rules (Clause 5.2.3) and measures required to establish criminal liability for the smuggling of goods and excisable goods, as well as for the false declaration of goods (Clause 5.3.3). In the EU countries neighboring Ukraine, namely Poland, Romania, Hungary and Slovakia, smuggling is criminalized⁵².

At the same time, it is important to increase the institutional capacity of the ESBU, as this agency will be given jurisdiction over cases of excisable goods smuggling. Yaroslav Zhelezniak, Deputy Chairman of the Parliamentary Committee on Finance, Taxation and Customs Policy, emphasizes the importance of increasing the effectiveness of the ESBU in combating the illicit tobacco market, which cannot be accomplished without its complete reboot through the adoption of a relevant law⁵³.

It is necessary to ensure effective cooperation with the European Anti-Fraud Office (OLAF), the European Judicial Network for Criminal Matters (EUROJUST), and Europol. The experience of EU member states shows that such cooperation facilitates the investigation of offenses in the field of illicit trafficking of excisable goods and prevents shadow market participants from continuing to organize smuggling flows. The continued technical equipping of checkpoints to optimize their operation with modern means (scanning systems, intelligent video surveillance systems, etc.) remains relevant. Continuous professional development of customs and border guard officials, along with the use of modern equipment, is also an important priority of the government policy.

3. Implementation of a system to monitor and control the tobacco supply chain, since it is important and essential to identify "oases" of the counterfeit production of billions of cigarettes under martial law, when borders are closed.

Given the current realities of the tobacco market development, it is urgent for the state to eliminate the factors of mass counterfeiting and illicit trade in excisable goods. It is important to focus on identifying the sources of origin and supply of illicit products and documenting the constituent parts of the organized crime chain, which is a fairly effective practice of combating illicit tobacco trafficking in EU member states. As a result of the identification and seizure of illicit products,

⁵² The National Revenue Strategy until 2030. 2023. URL: https://mof.gov.ua/storage/files/National%20Revenue%20Strategy_2030_.pdf

⁵³ Yaroslav Zhelezniak's official Telegram channel. URL: <https://t.me/yzheleznyak/6848> (Request date: January 25, 2024)

numerous facts of rather large volumes of trade through postal shipments were revealed. The ESBU's findings indicate that the wholesale supply of counterfeit cigarettes and raw materials for their manufacture was sent by mail from different regions of Ukraine⁵⁴.

Counterfeit cigarette production requires raw tobacco materials, so it is logical to create an effective system of monitoring and control of the tobacco supply chain, which aims to create restrictions in the tobacco market and prevent its circulation among illegal market participants. Identification of tobacco supply channels will help identify the main producers of counterfeit cigarettes and prevent their billion dollar supplies to retailers (stores, kiosks, displays, websites and Telegram channels).

The study *conducted by the Ukrainian Institute for the Future* contains relevant proposals on the need to strengthen control over the circulation of raw materials and to stop the illicit circulation of tobacco products using postal and courier transportation⁵⁵.

Implementation of the above steps will not eliminate the shadow cigarette market completely, but will significantly reduce it, thus providing additional budget revenues worth billions of hryvnias. Danylo Hetmantsev, Chairman of the Parliamentary Committee on Finance, Taxation and Customs Policy, sees significant fiscal potential for the budget as a result of the deshadowing of the tobacco market. In 2023, he estimated possible additional revenues at UAH 15-17 billion⁵⁶. The financial resources received should be allocated to the production of modern weapons and the creation of prerequisites for improving the defense capability of our state.

⁵⁴ Official website of the BES. URL: <https://esbu.gov.ua/news/beb-na-volyni-vyluchylo-tiutiunovi-vyroby-na-piv-miliona-hryven>; <https://esbu.gov.ua/news/beb-u-kyievi-likvidovalo-masshtabnu-merezhu-prodazhu-falsyfikovanykh-syharet-vartist-vyluchenoho-ponad-12-mln-hrn> (request date January 19, 2024)

⁵⁵ Ukrainian Institute for the Future. The illicit tobacco market in the context of a full-scale war: challenges and threats. 2023. 40 pages. URL: https://drive.google.com/file/d/1Ftoq2rIALzVPrZ84LteJbJu58_mbXQ2t/view

⁵⁶ Deshadowing the tobacco market could add UAH 15-17 billion to the state budget. URL: <https://interfax.com.ua/news/economic/902676.html> (Request date: January 19, 2024)

CONCLUSIONS

1. An analysis of the KPMG report on the illicit trade in cigarettes in Europe in 2022 confirms the conclusions about the *link between the excise policy and the consumption of illicit tobacco products*. In particular, the following can be stated: 1) a sharp increase in excise taxes on tobacco products poses a high risk of an increase in the level of illicit trade in tobacco products, and it is important to take into account the relevant rates in the region when formulating the excise policy; 2) the counterfeit component of the cigarette market is difficult to combat even for developed EU countries with an effective law enforcement system; 3) to achieve a sustainable result in reducing the level of illicit trade in tobacco products, it is important to combine a balanced excise policy with effective measures to counteract such criminal activity.

2. Ensuring the proper functioning of the domestic market for excisable goods in the EU requires coordination of excise policies of the countries, which is the focus of the European Commission's efforts. The latter recommended that HTPs be taxed in accordance with the approaches used for the harmonized excisable category of "other smoking tobacco", which provides for the setting of relatively low excise rates.

In all EU countries, the United Kingdom, Norway and Switzerland, the excise tax on HTPs is lower than on cigarettes. Among the 18 EU countries analyzed, the ratio of the excise burden on HTPs to cigarettes in 2023 ranged from 82.5% in the Netherlands to 14.9% in Hungary, with an average value of 66.3%. In seven member states, the excise tax on HTPs was at least four times lower than on cigarettes, and in only one country was the ratio less than two times.

3. Today, the discussion on the revision of Council Directive 2011/64/EU is continuing in behind the scenes, and its urgency becomes clear from leaks in the media about certain novel aspects. In particular, unofficial information was circulated that amendments to the legislation proposed to *increase the minimum excise tax liability on cigarettes in the EU from EUR 1.80 to EUR 3.60 per pack of 20 cigarettes*. Such an increase in the level is associated with the risk of an increase in the level of illicit trade in countries with relatively low incomes. There was also information that the European Commission proposed *to set the minimal excise tax on HTPs at half of the excise tax on cigarettes*.

The discussion about raising the excise tax on tobacco products without violating the "fine line between achieving public health goals and preventing the illicit market growth" is gaining a new focus. With regard to HTPs, this question cannot be posed unequivocally in an "either/or" format. On the one hand, research continues to prove the reduced health risks of their consumption. On the other hand, there are currently no prerequisites for the development of the illicit HTP market, and this

will remain unchanged as long as the countries choose a coordinated and balanced approach to raising excise rates.

4. Taking into account, among other things, the impact of the full-scale invasion, Ukraine has recorded a sharp decline in the consumption and production of the main categories of tobacco products. In 2023, compared to 2021, 36.50% fewer excise stamps for cigarettes were purchased, 4.3% fewer stamps for HTPs, and 79.81% fewer stamps for e-liquids. The latter trend most likely indicates a significant increase in the illegal component of the market for these liquids. At the same time, the structure of tobacco consumption has changed in favor of the use of tobacco used to make roll-your-own tobacco (in 2022) and cigarillos (due to the ban on flavoring additives). *Smokers' switching from one type of tobacco product to another hinders the achievement of the regulatory goals of excise taxation to reduce smoking prevalence.*

The excise tax accounted for 11% of tax revenues of the State Budget of Ukraine in 2022 and 13.9% in 2023. The share of the excise tax on tobacco products in the total structure of excise revenues in 2022 was 56%, and in 2023, – 48%. excise tax revenues from tobacco products amounted to UAH 80.29 billion. *At the same time, budget revenues could have been even higher if not for the high share of the illicit cigarette market.*

5. In 2023, Ukraine saw another *increase in the level of illicit trade in tobacco products* from 19.9% in 2022 to 21.8%, accompanied by *an increase in tax revenue losses* (excise tax + VAT + retail excise) from UAH 19.1 billion to UAH 23.5 billion. The main reason for this negative trend was the increase in sales of counterfeit products, the share of which part of the total volume of all cigarettes consumed in Ukraine increased from 6.6 to 8.7%. A new anti-trend is the distribution of *counterfeits of well-known brands.*

The level of illicit trade in products labeled "Duty Free" or intended for export remained high.

In 2023, *69% of illicit cigarettes were sold in kiosks and stores*, where they were placed next to legal products. A year earlier, this figure was 63%. A regional analysis confirms the systemic nature of the problem and shows that *the proximity to the front line increases the risks of illicit trade in tobacco products.*

The following circumstances should be taken into account when developing measures to counteract the relevant illegal activities: 1) the counterfeit tobacco market is the most difficult to combat; 2) countries with low incomes have high risks of illicit cigarette trade; 3) aggravation of social problems encourages higher tobacco consumption.

6. *The transition of consumers to HTPs, the market for which, unlike the markets for traditional and electronic cigarettes in Ukraine, is developing only in the legal segment, ensures the stability of tax revenues.* This is important to take into

account when taxing them along with a potentially reduced risk of their consumption to human health and the corresponding approaches to the formation of the excise policy in the EU countries.

7. The Ministry of Finance published the Draft Law of Ukraine "On Amending the Tax Code of Ukraine to Revise Excise Tax Rates on Tobacco Products", which provides an updated schedule of an increase in excise tax rates and the transition to rates in euros. According to the proposed amendments, *Ukraine in 2028 is guaranteeing its compliance with the European standard of a minimum excise tax liability on cigarettes of EUR 90 per thousand units. In addition, the level of differentiation of the excise tax burden on cigarettes and HTPs will gradually increase to 20% (the excise tax on HTPs will be 20% lower than on cigarettes).* Both innovations are in line with current European practice; in EU countries, the ratio of the excise tax burden on HTPs to cigarettes is even higher.

The adoption of the draft law will favor higher revenues for state and local budgets. On the one hand, there will be no currency risks for the state. On the other hand, switching to HTPs that are sold only legally does not result in the loss of tax revenues (which are associated with illicit trade; they equal the sum of unpaid excise tax, VAT, and retail excise). There is no illicit market for HTPs in Ukraine, and it is important not to create preconditions for its emergence in the future.

At the same time, the draft law provides for a different approach to calculating the excise tax rate for tobacco products produced in Ukraine and their imported analogs. This, in addition to legal inconsistencies, *creates conditions for unfair competition and budget losses. It is advisable to ensure a unified approach to the calculation of the excise tax rate on both tobacco products produced in Ukraine and imported ones.*

8. Priority measures to combat the illicit trade in cigarettes in the current situation are: 1) *to increase the functional efficiency of supervisory bodies (Bureau of Economic Security, tax and customs authorities, police, border guards); 2) to strengthen cooperation with European institutions and the customs authorities of neighboring EU member states in the field of combating illicit circulation of tobacco products; 3) to increase the effectiveness of the fight against smuggling; 4) to avoid tax shocks when increasing excise rates; 5) to introduce a system for monitoring and controlling the tobacco supply chain, because under martial law, when all borders are closed, it is crucial to identify "oases" of the counterfeit production of billions of cigarettes.*

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